AUDIT COMMITTEE UPDATES

Presented by Scott Gootee and Allison Hardy of Stinson Leonard Street LLP and David Seay and Shaun Stoker of KPMG LLP

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OVERVIEW

- Top lessons for COSO 2013 implementation
- SEC comment letter and accounting and auditing enforcement action updates
- Regulatory developments

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COSO 2013 IMPLEMENTATION: BACKGROUND

- 2013 framework builds on the 1992 framework while retaining the core definition of internal control and the five components of internal control (i.e., control environment, risk assessment, control activities, information and communications and monitoring activities)
- Retains the requirement to assess each of the five components when evaluating internal control
- Expands the reporting category of objectives to include both internal and external financial and nonfinancial reporting
- Considers the globalization of markets and operations, as well as the increased relevance of technology in today's business environment

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COSO 2013 IMPLEMENTATION: BACKGROUND *(CONTINUED)*

- Recognizes the roles of regulations and standards in achieving the objectives of the entity
- Enhances the concept of governance and the role of those charged with governance
- Contains a considerably enhanced discussion on fraud and includes the potential for fraud in its principles relating to the risk assessment component of internal control

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COSO 2013 IMPLEMENTATION: TRANSITION PLAN

- COSO published "The 2013 COSO Framework & SOX Compliance – One Approach to An Effective Transition"
- The article discusses a five-step transition process:
  1. Develop awareness, expertise and alignment
  2. Conduct a preliminary impact assessment
  3. Facilitate broad awareness, training and comprehensive assessment
  4. Develop and execute a COSO transition plan for ICOFR assessment
  5. Drive continuous improvement
     - Have a remediation plan
     - Prioritize the gaps
     - Design and implement whatever controls you need in place
     - Test operating effectiveness of those controls

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TOP LESSONS FROM COSO 2013 IMPLEMENTATION

- Implementation points:
  - Principles highlight the role of the Board of Directors throughout the Control Environment component of the Framework
  - Ascertain whether Principle 8 (fraud risk assessment) is aligned with external auditor's assessment
  - SEC is expected to begin questioning issuers that have not adopted by December 31, 2015

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SEC COMMENT LETTER UPDATE

- Number of comment letters issued in a given year has continued to decline
- Large accelerated filers have been the focus of the SEC in recent years
- MD&A and significant judgments and estimates have continued to be areas of focus
- Internal control over financial reporting is an emerging area of comment
- New accounting standards are likely to be a focus going forward (i.e., revenue standard, consolidation standard, leasing standard, etc.)

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ACCOUNTING AND AUDITING ENFORCEMENT RELEASE UPDATE

- Number of AAERs issued has remained steady in last 3 years, with what appears will be a slight increase in 2015
- 93 AAERs issued in 2015 to date vs. 93 total AAERs issued in 2014
- Hot areas:
  - Financial reporting frauds
  - Internal control deficiencies
  - FCPA violations
- SEC continues to bring charges against individuals (CEOs, CFOs, other senior employees)

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AAERS REPRESENTATIVE ACTIONS

- Action for financial reporting fraud
  - *In re: Airtouch Comm'ns Inc., Hideyuki Kanakubo and Jerome Kaiser, CPA, January 30, 2015 & April 9, 2015*
- Action for improper revenue recognition
  - *In re: JDA Software Group, September 2014*
- Action for FCPA violation
  - *In re: Goodyear Tire & Rubber Company, February 24, 2015*

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SEC CONCEPT RELEASE

- Trend towards enhanced audit committee disclosure
- SEC concept release issued July 1, 2015
- Comments were due September 8, 2015
- Release focuses primarily on enhanced disclosure about the audit committee's selection and oversight of the independent auditor

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SEC CONCEPT RELEASE CONT'D

- Three main areas of focus:
  - Audit committee's oversight of the independent auditor
  - Audit committee's process for selecting the independent auditor
  - Qualifications of the independent auditor

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SEC CONCEPT RELEASE CONT'D

- Related PCAOB Developments
  - PCAOB is considering an alternative to disclosure of the audit partner and other participants in the auditor's report, whereby the information would be required to be disclosed on a new PCAOB form

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IFRS UPDATES

- In May 2015, the SEC's chief accountant said he won't recommend the SEC to mandate the use of International Financial Reporting Standards for U.S. companies, ending the SEC's decade long effort to converge IFRS and GAAP

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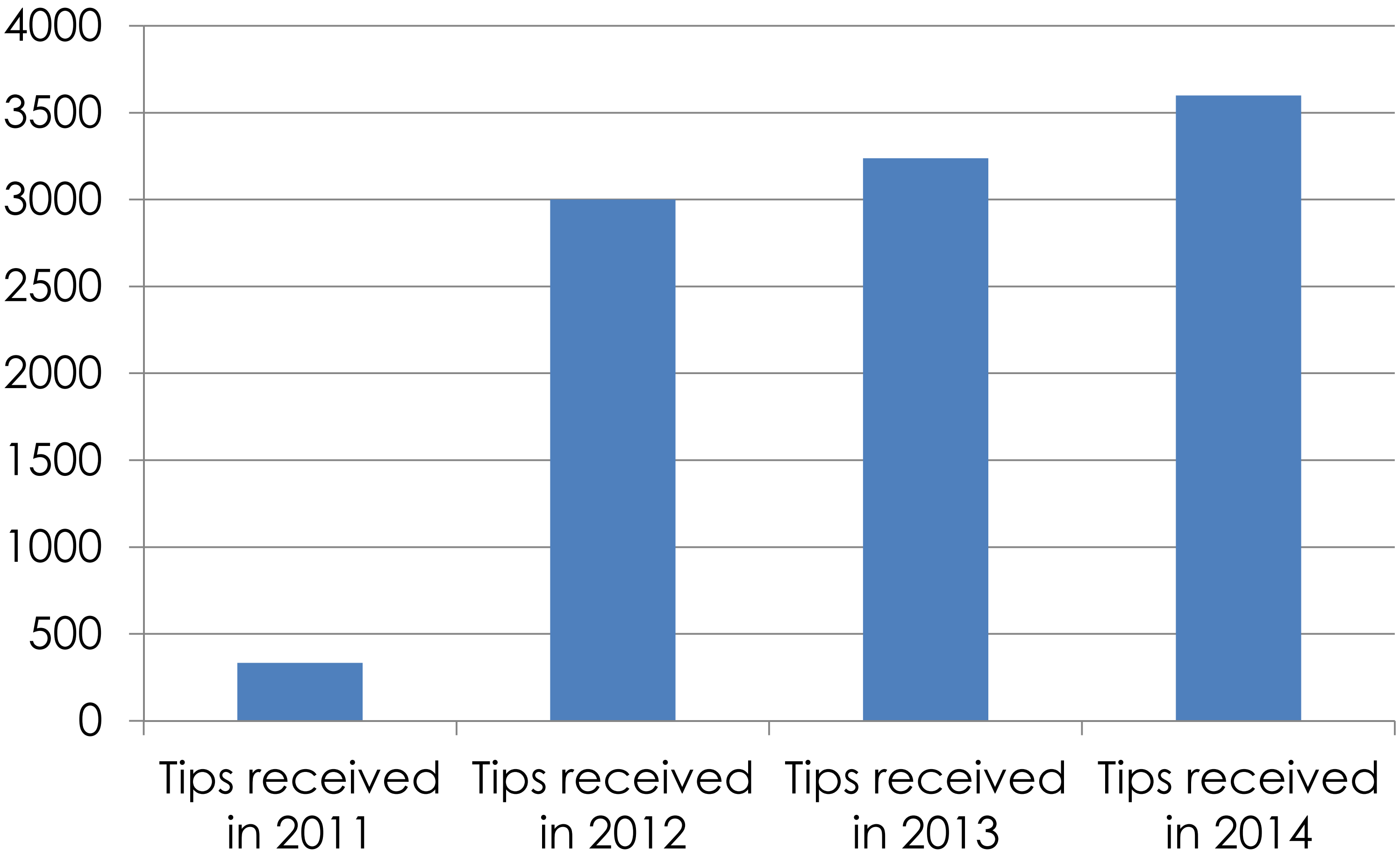
REVENUE RECOGNITION

- Core Principle: An entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services
- ASU 2015-14, *Deferral of the Effective Date*, defers the original effective date by one year – now fiscal years beginning after December 15, 2017 for public business entities
- Multiple transition approaches are available
- SEC staff provided relief on the 5-year data table
- The deferral should not be viewed as a reason for Companies to delay their preparation for adoption

WHISTLEBLOWER TIPS RECEIVED BY YEAR SINCE PROGRAM EFFECTIVE DATE



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WHISTLEBLOWER PAYOUTS

- 17 whistleblowers had received awards as of April 2015
- Payouts have totaled nearly $50 M
- Highest award to date is $30 M
- 10 of 17 awards were issued in the last fiscal year
- Tips are up 20% this year
- Trend is expected to accelerate

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WHISTLEBLOWER UPDATES

- Consider reviewing confidentiality agreements to ensure that it is clear that reporting possible securities violations is permitted
- In August 2015, the SEC issued guidance to clarify who qualifies for whistleblower protections: a person is not required to report misconduct to the SEC's Office of the Whistleblower to qualify for the expanded anti-retaliation protections under the law

QUESTIONS?

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DOJ'S INITIATIVE TO TARGET DIRECTORS AND OFFICERS

Presented by John Granda, Scott Hecht and Steve Quinlivan

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YATES MEMO

1. To be eligible for any cooperation credit, corporations must identify, and provide all relevant facts about, all individuals involved in corporate misconduct.
2. Prosecutors are required to focus on individuals from the inception of their investigations.
3. Other than in antitrust cases, no corporate resolution will protect individuals from criminal or civil liability absent extraordinary circumstances.
4. Prosecutors may not resolve corporate cases without a clear plan to resolve related individual cases, and declinations as to individuals must be approved by a high-level official.
5. Prosecutors and civil attorneys handling corporate investigations should be in routine communication with one another.
6. Civil attorneys should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond the individual's ability to pay.

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COOPERATION CREDIT

1. To be eligible for any cooperation credit, corporations must identify, and provide all relevant facts about, all individuals involved in corporate misconduct.

- Yates Speech: Previously partial cooperation credit was earned even if individuals not identified
- Caldwell Speech:
  - If individuals cannot be identified after thorough investigation, the corporation is eligible for cooperation credit by otherwise assisting DOJ
  - No need to "boil the ocean"
  - Call DOJ for guidance on scope of investigation

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FOCUS ON INDIVIDUALS FROM INCEPTION

2. Prosecutors are required to focus on individuals from the inception of their investigations.

- Yates Speech: If investigation focuses on entity from the start it is too difficult to go back later and build a case against individuals

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CORPORATE RESOLUTIONS WILL NOT PROTECT INDIVIDUALS

3. Other than in antitrust cases, no corporate resolution will protect individuals from criminal or civil liability absent extraordinary circumstances.
4. Prosecutors may not resolve corporate cases without a clear plan to resolve related individual cases, and declinations as to individuals must be approved by a high-level official.

- Yates Speech:
  - Where corporate matters are resolved first, care will be taken to ability to pursue individuals
  - Declining to prosecute individuals takes approval of US Attorney or Assistant Attorney General

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CIVIL AND CRIMINAL DIVISIONS TO COOPERATE

5. Prosecutors and civil attorneys handling corporate investigations should be in routine communication with one another.

- Yates Speech:
  - Regardless of whether the case begins as a civil or criminal matter, the DOJ attorney initiating the matter must notify the "other side of the house"
  - Make sure nothing slips through the cracks
  - Avoid having to build a new case after the other side finishes their inquiry

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CIVIL LITIGATION WILL NOT DEPEND ON ABILITY TO PAY

6. Civil attorneys should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond the individual's ability to pay.

- Yates Speech:
  - Hold wrongdoers accountable
  - Take what they have and ensure they do not benefit
  - It's on their resume to follow throughout their careers

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IMPLEMENTATION OF YATES MEMO

- Effect is uncertain
- Perhaps less plea deals where corporation is unable to provide information on individuals
- Perhaps more corporations will fight charges where culpability is unclear rather than turn over individuals
- All-or-nothing approach to disclosure may mean less self-reporting by corporations
  - Submission may be deemed inadequate and not credited
  - The submission can still be used against the corporation

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WHAT IT MEANS FOR A COMPANY

- Relevant employees may be reluctant to participate in interviews for internal investigations
- Employees may request separate counsel at an earlier stage
- Company should advise individuals to retain separate counsel at an earlier stage
- Disruption in operations when individuals are under investigation
- Breeds distrust amongst employees to "rat" another out

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WHAT IT MEANS FOR A COMPANY

- More thorough investigations – longer and more expensive
- Individuals less likely to cooperate in civil investigations as Yates memo says the same principles apply

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COMPLIANCE AND GOVERNANCE IMPLICATIONS OF YATES MEMO

Presented by John Granda, Scott Hecht and Steve Quinlivan

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COMPLIANCE AND GOVERNANCE IMPLICATIONS OF YATES MEMO

A clear implication of the Yates Memo is that the best defense remains a proactive response by organizations and their boards and management, including:

- Encouraging and insisting upon a culture of compliance and corresponding tone-at-the-top;

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COMPLIANCE AND GOVERNANCE IMPLICATIONS OF YATES MEMO

(CONTINUED)

- Implementation of robust ethics and compliance programs designed to deter, identify and remediate violations of laws and regulations, coupled with equally robust employee training and issue reporting mechanisms;
- Extensive management support of those compliance efforts, including dedication of resources and active oversight by management, up to the board level;

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COMPLIANCE AND GOVERNANCE IMPLICATIONS OF YATES MEMO

(CONTINUED)

- Prompt management response to issues escalated to their attention; and
- Documentation that will allow the company and its executives to demonstrate that they are working in good faith to operate the company in an ethical and compliant fashion.

These goals are consistent with the duty of oversight under Delaware corporate law.

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DUTY OF OVERSIGHT

- Under Delaware law, Caremark and Stone establish that a director's failure to exercise oversight constitutes bad faith and a breach of the duty of loyalty
- Information and reporting systems must exist that provide management and directors with adequate information to effectively monitor the company's compliance with law
- The oversight responsibility of the board is the obligation to implement and proactively engage with an effective compliance program

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PRACTICAL JUSTIFICATIONS OF ACTIVE OVERSIGHT

- Deter violations of the law
- The costs of potential fines, penalties and civil damages can easily exceed the costs of an effective compliance program
  - Even without wrongdoing, the direct and indirect costs of document production, outside advisors and possible reputational harm along with the distraction of management that can come with a government investigation are alone significant
- Effective compliance programs:
  - Increase production and profitability
  - Enhance customer and vendor relationships
  - Prevent damage to reputation/brand
  - Improve director retention and recruitment

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PRACTICAL JUSTIFICATIONS OF ACTIVE OVERSIGHT *(CONTINUED)*

  - Can mitigate the potential fine range up to 95% under the U.S. Sentencing Guidelines
  - Are a significant factor in the exercise of prosecutorial discretion on whether to indict
- A Compliance Week Survey in 2015 of Compliance Trends showed that organizations are increasingly taking the needed compliance actions, such as:
  - 57% of respondents said their CCOs report directly either to the CEO or the Board
  - 51% said the CCO has a seat on the executive management committee

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PRACTICAL JUSTIFICATIONS OF ACTIVE OVERSIGHT *(CONTINUED)*

- 82% said they now undertake some sort of enterprise-wide compliance risk assessment (of which 2/3 said such assessment is conducted annually or more often)
- These risk assessments are done in a variety of ways (1/3 do it as a stand-alone exercise; 1/3 do it in conjunction with internal audit's risk assessment; and 1/3 do it as part of a larger assessment of all organization risks)

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PRACTICAL JUSTIFICATIONS OF ACTIVE OVERSIGHT *(CONTINUED)*

- 70% of organizations measure effectiveness of their compliance programs and they look at a range of metrics in doing so, including hot line calls, internal audit findings and analysis of self-assessments
- However, only 43% said their organizations have designated compliance officers in subsidiary business units or geographic divisions

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INCREASED SEC FOCUS ON FRAUD

- After the financial crisis, the SEC placed less of an emphasis on financial fraud issues, instead focusing on cases involving the financial instruments and transactions involved in the downturn
- In recent years, the SEC has refocused on financial fraud cases
  - Allocating increased resources towards uncovering and prosecuting fraud
  - Operating an accounting fraud task force
  - Utilizing new, more sophisticated enforcement tools

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FRAUD "RED FLAGS"

- With regard to oversight, a director's fiduciary duties include having adequate reporting and monitoring systems in place to spot red flags and, if red flags emerge, actively responding to potential concerns
- Mechanisms that ensure the board is receiving accurate and timely information both deter fraud before it happens and mitigate the effects of fraud once it has occurred and is discovered

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DETECTING RED FLAGS

- Hotlines and whistleblower reporting mechanisms and/or policies
  - Importance of anonymity and protection
  - Since its inception the SEC's whistleblower program has paid more than $54 million to 22 whistleblowers
- Substantive testing and risk assessment
- Retrospective review of financial statements and forensic data
- Director engagement with management
  - Ask probing and effective questions
- Board ownership of agendas and information flow
- Board access to multiple layers of management

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EXAMPLES OF RED FLAGS

- Financial
  - Metrics out of line with past reporting or peer group
  - Internal inconsistency in financial reports
  - Diminishing cash, ballooning debt, recurring deficits
- Structural
  - Complex organizational structure without apparent business purpose
  - Decentralized management with poor internal reporting

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FRAUD PREVENTION

- An effective compliance program prevents fraud through:
  - Communicating a commitment to compliance with laws and regulations and to ethical business conduct with employees, customers and the government
  - Providing an outlet to report violations and ask questions about conduct
  - Training employees to understand procedures in place and how to conform behavior with laws and regulations
  - Identifying problems early and correcting
  - Instituting processes for documentation of operational and compliance-related activities
  - Assessing periodically compliance and enforcement risks and procedures to address them

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PROACTIVE BOARD

"Tone at the top"

- Be knowledgeable about the compliance program
- Exercise effective and ongoing oversight
- Ensure appropriate commitment of human and financial resources to compliance and proper skill level and commitment by those heading and staffing the compliance program
- Focus on the activities and ask the hard questions suggested on pages 25-30 of the Legal Compliance White Paper included in the Materials for this Institute

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RESPONDING TO THE POSSIBILITY OF FRAUD

- Internal investigation- the complete array of information-gathering actions that a company uses when it learns of possible wrongdoing
- Complexity and scale of the investigation vary depending on the potential fraudulent activity:
  - Investigation can be conducted by internal HR, security, in-house counsel, outside counsel or accountants, or other non-attorney outside investigators

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RESPONDING TO THE POSSIBILITY OF FRAUD *(CONTINUED)*

- Considerations of privilege, independence, and whether senior management or directors are potentially culpable, should factor into determinations of who should conduct the investigation
- If financial or accounting fraud is involved, forensic accountants should be engaged by counsel to provide protection of investigation by attorney-client privilege

WHY DO INVESTIGATIONS?

- Detect and deter violations of law, the Code of Conduct and company policies
- Cease and mitigate harm to the company and its employees (fines, debarment, reputational harm)
  - Stop the conduct
  - Aid in settling enforcement actions
- Gather information to assist management in making decisions about personnel (discipline or termination) and whether compliance programs need revision
- Provide the audit committee and senior management with visibility into the ethical culture of the company
- Verify compliance with laws and regulations

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INVESTIGATION GOVERNANCE AND PROCESSES: PLAN IN ADVANCE

- Establish clear protocols, lines of authority, roles and responsibilities and communication paths in the event the need for an investigation arises
  - Who is in charge?
  - How is it staffed?
  - When is counsel involved?
  - Timelines for decision-making
  - How to address conflicts

> "[C]ompanies should have in place an efficient, reliable, and properly funded process for investigating [an] allegation and documenting the company's response, including any disciplinary or remediation measures taken." DOJ FCPA Guidance

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CONSIDER SELF REPORTING TO GOVERNMENT

- Decision can be made after results are in, but…
- Helpful to consider issue early on, and revisit as investigation progresses
  - If you will be self reporting, consider discussing investigation plan and progress with government
  - Decision to self report may also affect how witness interviews and other investigative matters are memorialized

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POST-INVESTIGATION REMEDIATION

- Disciplinary action against wrongdoers
  - Deterrent effect
  - Message about company culture of compliance
  - Potential impact on government action
- Strengthen company policies and controls
  - Consider improving employee training on policies
  - Consider more frequent review and update of controls and policies
  - Identify and correct any weaknesses in current policies, controls or compliance programs that allowed misconduct to occur
    - Consult with outside counsel and accountants

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THE YATES MEMO: D&O Indemnification and Insurance Problems and Solutions

Presented by: Scott C. Hecht

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U.S. Department of Justice

Office of the Deputy Attorney General

The Deputy Attorney General

Washington, D.C. 20530

September 9, 2015

MEMORANDUM FOR THE ASSISTANT ATTORNEY GENERAL, ANTITRUST DIVISION
THE ASSISTANT ATTORNEY GENERAL, CIVIL DIVISION
THE ASSISTANT ATTORNEY GENERAL, CRIMINAL DIVISION
THE ASSISTANT ATTORNEY GENERAL, ENVIRONMENT AND NATURAL RESOURCES DIVISION
THE ASSISTANT ATTORNEY GENERAL, NATIONAL SECURITY DIVISION
THE ASSISTANT ATTORNEY GENERAL, TAX DIVISION
THE DIRECTOR, FEDERAL BUREAU OF INVESTIGATION
THE DIRECTOR, EXECUTIVE OFFICE FOR UNITED STATES TRUSTEES
ALL UNITED STATES ATTORNEYS

FROM: Sally Quillian Yates
Deputy Attorney General

SUBJECT: Individual Accountability for Corporate Wrongdoing

Fighting corporate fraud and other misconduct is a top priority of the Department of Justice. Our nation's economy depends on effective enforcement of the civil and criminal laws that protect our financial system and, by extension, all our citizens. These are principles that the Department lives and breathes—as evidenced by the many attorneys, agents, and support staff who have worked tirelessly on corporate investigations, particularly in the aftermath of the financial crisis.

One of the most effective ways to combat corporate misconduct is by seeking accountability from the individuals who perpetrated the wrongdoing. Such accountability is important for several reasons: it deters future illegal activity, it incentivizes changes in corporate behavior, it ensures that the proper parties are held responsible for their actions, and it promotes the public's confidence in our justice system.

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DOJ'S OBJECTIVE

- To combat corporate misconduct by seeking accountability from individual perpetrators
- According to DOJ, pursuing individuals:
    - Ensures that Perpetrators are held Responsible
    - Deters Illegal Conduct
    - Promotes Public Confidence in Justice System
- These are all worthy "public" interests

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DUTIES OF DIRECTORS & OFFICERS

- Ds & Os owe duties to the corporation:
  - of Care
  - of Loyalty
  - of Good Faith
  - (and corollary duties)

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TENSION BETWEEN PUBLIC INTEREST AND D&O DUTIES?

- Before the misconduct, the public interest and D&O duties might be satisfied through compliance
- After the (alleged) misconduct, there is tension
  - Maybe the government is overzealous (it's been known to happen)
  - Move forward and solve the problem? Or dwell on the past and exact punishment?
- This tension manifests in problems involving D&O Indemnification and Insurance

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REFRESHER ON D&O INDEMNIFICATION

- Delaware and other states' laws permit corporations to indemnify Ds & Os for matters suffered "by reason of the fact that the person is or was" a D/O
- In civil matter, the D/O conduct must be "in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation"
- In criminal matter, the D/O must have "had no reason to believe . . . the conduct was unlawful"

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C

West's Delaware Code Annotated Currentness
Title 8. Corporations
Chapter 1. General Corporation Law
Subchapter IV. Directors and Officers

§ 145. Indemnification of officers, directors, employees and agents; insurance

(a) A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in the right of the corporation) by reason of the fact that the person is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by the person in connection with such action, suit or proceeding if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful. The termination of any action, suit or proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner which the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had reasonable cause to believe that the person's conduct was unlawful.

REFRESHER ON D&O INDEMNIFICATION

- D/O compliance with standard for indemnification can only be determined in retrospect

- In meantime, Delaware and other states' laws permit corporations to advance defense expenses

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REFRESHER ON D&O INDEMNIFICATION

- Corporation's bylaws usually make indemnification and advancement ***permissive***
- Sometimes separate indemnification agreements make indemnification and advancement largely ***mandatory***
- Corporation is often liable to pay D/O's attorneys' fees in compelling indemnification and advancement

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549-1004

FORM 8-K

CURRENT REPORT

PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Date of Report (Date of earliest event reported) August 3, 2010

ARTICLE V
INDEMNIFICATION

5.1 *Right to Indemnification of Directors and Officers.*

Subject to the other provisions of this article, the Corporation shall indemnify and advance expenses to every director and officer of the Corporation in the manner and to the fullest extent permitted by applicable law as it presently exists or may hereafter be amended, against any and all amounts (including judgments, fines, payments in settlement, attorneys' fees and other expenses) reasonably incurred by or on behalf of such person in connection with any threatened, pending, or completed investigation, action, suit or proceeding, whether civil, criminal, administrative or investigative ("a proceeding"), in which such director or officer was or is made or is threatened to be made a party or called as a witness or is otherwise involved by reason of the fact that such person is or was a director or officer of the Corporation, or is or was serving at the request of the Corporation as a director, officer, employee, fiduciary or member of any other corporation, partnership, joint venture, trust, organization or other enterprise, whether the basis of such proceeding is an alleged action in an official capacity as a director, officer, employee, fiduciary or member or in any other capacity while serving as a director, officer, employee, fiduciary or member. The Corporation shall not be required to indemnify a person in connection with a proceeding initiated by such person if the proceeding was not authorized by the board of directors of the Corporation.

REFRESHER ON D&O INDEMNIFICATION

- Lenient indemnification/advancement is a great idea. . . before the misconduct:
  - Who would choose to be a D/O without robust indemnification?
  - Who would choose to continue if colleagues are not honest and doing a good job?
  - How many weak claims are asserted by plaintiffs/government in comparison to strong claims?

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YATES MEMO REQUIREMENTS

- Corporations must identify all individuals and facts concerning misconduct, effectively arming the government
- Corporate settlement cannot release individuals, absent high level approval based on extraordinary circumstances
- Governmental pursuit necessitates defense of individuals with personal liberty and livelihood at risk but who have no financial or other ability to settle or satisfy government

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UPSHOT OF YATES MEMO AND INDEMNIFICATION

- Indemnification, which is ordinarily a good idea, ensures that the ***corporation ultimately will pay*** for the government's pursuit of the individual
- What purpose does this serve?
  - Does this serve the "public interest"?
  - Or compound the injury to the corporation/shareholders?
  - Or both?

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SHOULDN'T THE CORPORATION LIMIT/ELIMINATE LENIENT D/O INDEMNIFICATION?

- Indemnification/advancement might be limited, in the abstract, but . . .
  - Recruitment/retention of Ds/Os demands lenient indemnification/advancement
  - D&O Insurance essentially requires indemnification/advancement to the extent permitted by law

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HOW DO D&O INSURANCE POLICIES REQUIRE LENIENT INDEMNIFICATION?

- Side A Coverage (Insured Persons) typically carries ***no*** retention
- Side B Coverage (Entity coverage for indemnification of Insured Persons) typically has a ***substantial*** retention
- Side C Coverage (Entity coverage for Securities Claims) typically also has a ***substantial*** retention
- What is "substantial?" $250,000, $500,000 and $1,000,000 retentions are common. (Higher retentions = lower premiums)

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Berkley Insurance Company

Directors, Officers and Corporate Liability Insurance Policy

This is a Claims Made Policy. Please read it carefully.

I. Insuring Agreements

Coverage A. Directors and Officers Liability Insurance

This Policy shall pay the **Loss** of the **Insured Persons** arising from any **Claim** first made against the **Insured Persons** during the **Policy Period** or the Extended Reporting Period (if applicable) for any actual or alleged **Wrongful Act**, except and to the extent that the **Company** has indemnified the **Insured Persons**.

Coverage B. Corporate Indemnification Insurance

This Policy shall pay the **Loss** of the **Company** arising from any **Claim** first made against the **Insured Persons** during the **Policy Period** or the Extended Reporting Period (if applicable) for any actual or alleged **Wrongful Act**, but only to the extent that the **Company** has indemnified the **Insured Persons** for such **Loss**.

Coverage C. Corporate Securities Claim Insurance

This Policy shall pay the **Loss** of the **Company** arising from any **Securities Claim** first made against the **Company** during the **Policy Period** or the Extended Reporting Period (if applicable) for any actual or alleged **Wrongful Act**.

election together with the additional premium due is received by the **Insurer** within 30 days of the effective date of cancellation or non-renewal.

B. In the event of a Transaction, as defined in section VIII. D., the **Parent Organization** shall have the right, within 30 days before the end of the **Policy Period**, to request an offer from the **Insurer** of an Extended Reporting Period of no less than 3 years or for such longer or shorter period as the **Parent Organization** may request (but such extension shall only be with respect to any **Wrongful Act** occurring prior to the Transaction). The **Insurer** shall offer such Extended Reporting Period pursuant to such terms, conditions and premium as the **Insurer** may reasonably decide. In the event of a Transaction, the **Insureds** shall have no right to an Extended Reporting Period except as indicated in this section II. B.

C. The additional premium for the Extended Reporting Period shall be fully earned at the inception of the Extended Reporting Period. The Extended Reporting Period is not cancelable.

DO 31300 (12-08) Page 1 of 10

The descriptions in the headings of this Policy are solely for convenience, and form no part of the terms and conditions of coverage.

HOW DO D&O INSURANCE POLICIES REQUIRE LENIENT INDEMNIFICATION?

- If Side A Coverage (Insured Persons) typically carries no retention, why doesn't it apply?
  - D&O Policies typically presume corporate indemnification of Ds/Os ***unless prohibited*** by law or insolvency
  - If indemnification is possible, it is required, and Side B coverage (which has a substantial retention) applies

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HOW DO D&O INSURANCE POLICIES REQUIRE LENIENT INDEMNIFICATION?

- The corporation's failure to indemnify may eliminate the insurer's obligation to provide coverage
  - The failure to indemnify up to a retention (e.g., $250,000) may frustrate coverage up to the limit of the primary policy (e.g. $10,000,000) and up to the limit of the tower (e.g., $100,000,000)
  - This really does happen.

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WHAT'S THE INDEMNIFICATION SOLUTION?

- Recognize the potential problem of mandatory lenient indemnification
  - It's always a concern in the event of actual serious misconduct
  - Consider whether to extend lenient indemnification categorically or on an as needed basis
- Recognize the potential problem of the interaction of D&O Indemnification and high D&O Insurance retentions
  - Fortunately, the retention may be exhausted by any defense dollars concerning a particular claim or related claims (e.g., both the "innocent" and the culpable D/Os' defense dollars apply to exhaust the single retention)

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WHAT'S THE INSURANCE SOLUTION?

- After the retention is exhausted . . . D&O insurance with the broadest coverage/narrowest exclusions/most beneficial other conditions can fund lenient D&O indemnification
  - This is the subject of entirely different and lengthy presentation
  - Notably, defense costs and settlements/judgments are typically higher for culpable Ds & Os, who eat more than their fair share of limits
  - Innocent Ds & Os sometimes regret favorable D&O insurance provisions

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WHAT'S THE INSURANCE SOLUTION?

- Sufficient D&O insurance limits, considering primary policy and all excess policies (the "Tower")
  - Always necessary
  - Particularly necessary if coverage is broad and allegations are severe

- Consider "Side A Excess/DIC Policy"
  - Ordinarily provides excess coverage to Insured Persons at top of D&O Insurance Tower
  - In event of specified "difference in conditions" (DIC), can provide first dollar coverage – no exhaustion of retention or other limits is required
  - Example of DIC is corporation's failure to indemnify when not prohibited by law or insolvency
    - Policy funds retention
    - Insurer has subrogation claim for indemnity and underlying coverage
    - Subrogation may not occur against corporation because retention may be exhausted by other insureds' defense costs or settlements/judgments before subrogation claim is asserted
    - Other features make "Side A Excess and DIC Policy" attractive

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COMPENSATION COMMITTEE

Mick Thompson, Mercer
Patrick Respelier, Stinson Leonard Street LLP
TJ Lynn, Stinson Leonard Street LLP

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PAY FOR PERFORMANCE AND GOAL SETTING

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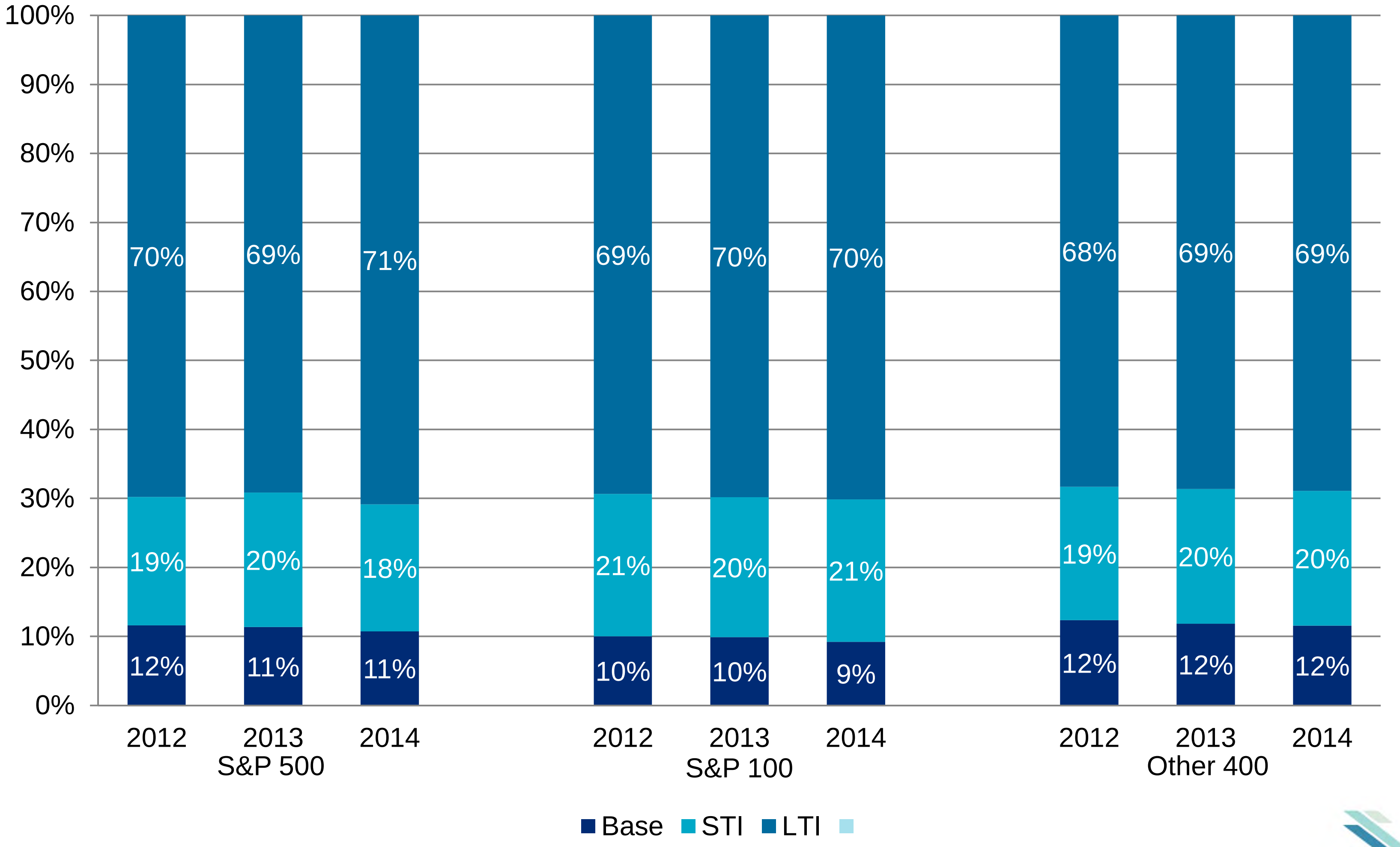
FOCUS ON PAY FOR PERFORMANCE CONTINUES TO INTENSIFY

- Additional Measures of Pay Competitiveness
  - Realizable compensation
  - Realized compensation
  - Value of outstanding equity
- Institutional Shareholder Services
  - CEO pay for performance relationship
  - At least 50% of long-term incentive performance vested
  - Disclosure of performance goal details
- New Pay-for-Performance Disclosures (covered in detail later)
- Activist Investors

PAY MIX HAS BEEN AND CONTINUES TO BE FOCUSED ON INCENTIVES (CEO DATA BELOW)



Source: 2015 Mercer Analysis of Proxy Statements

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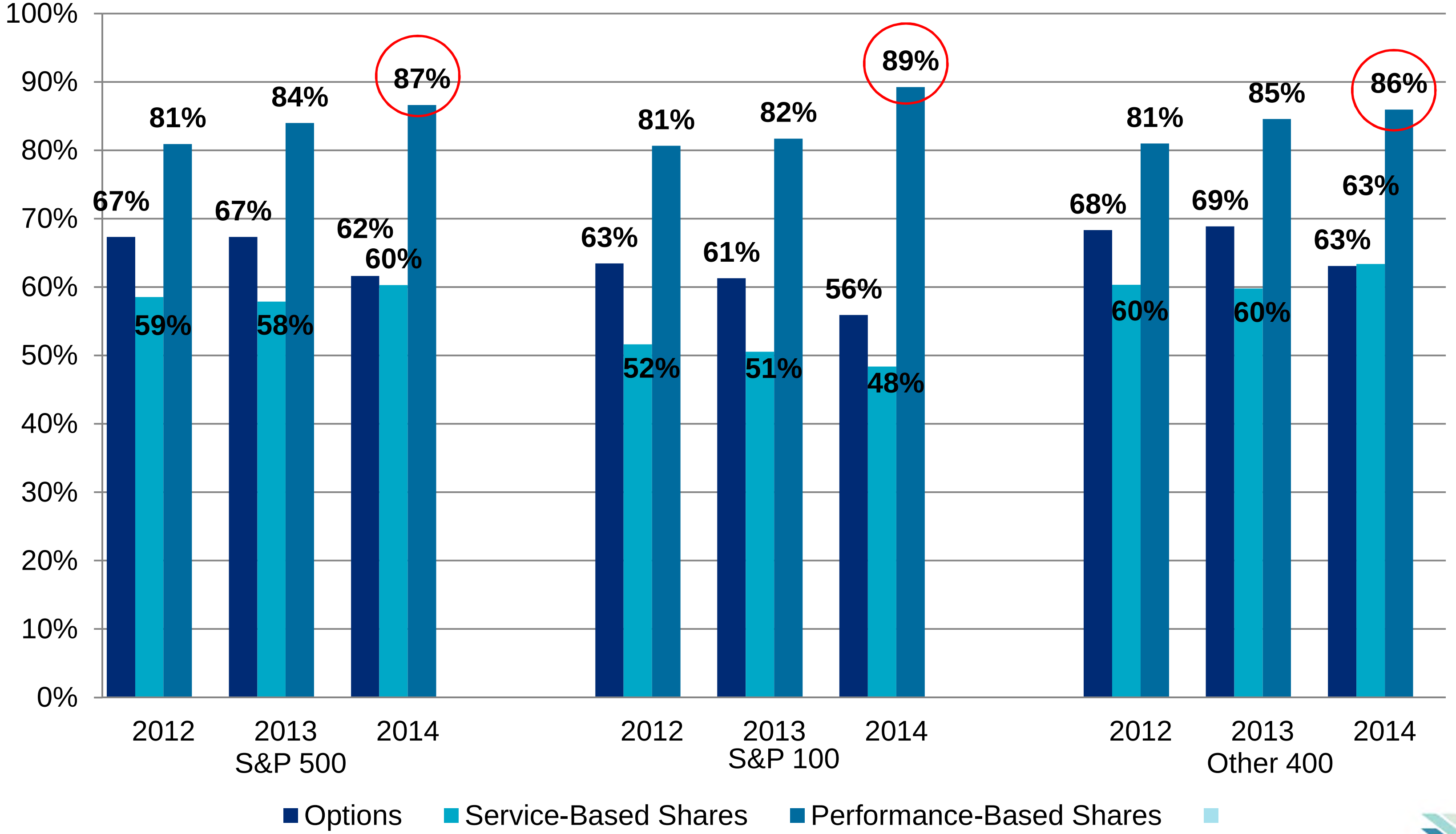
PERFORMANCE VESTED INCENTIVES HAVE BECOME THE MOST COMMON TYPE OF AWARD (LONG-TERM)



Source: 2015 Mercer Analysis of Proxy Statements

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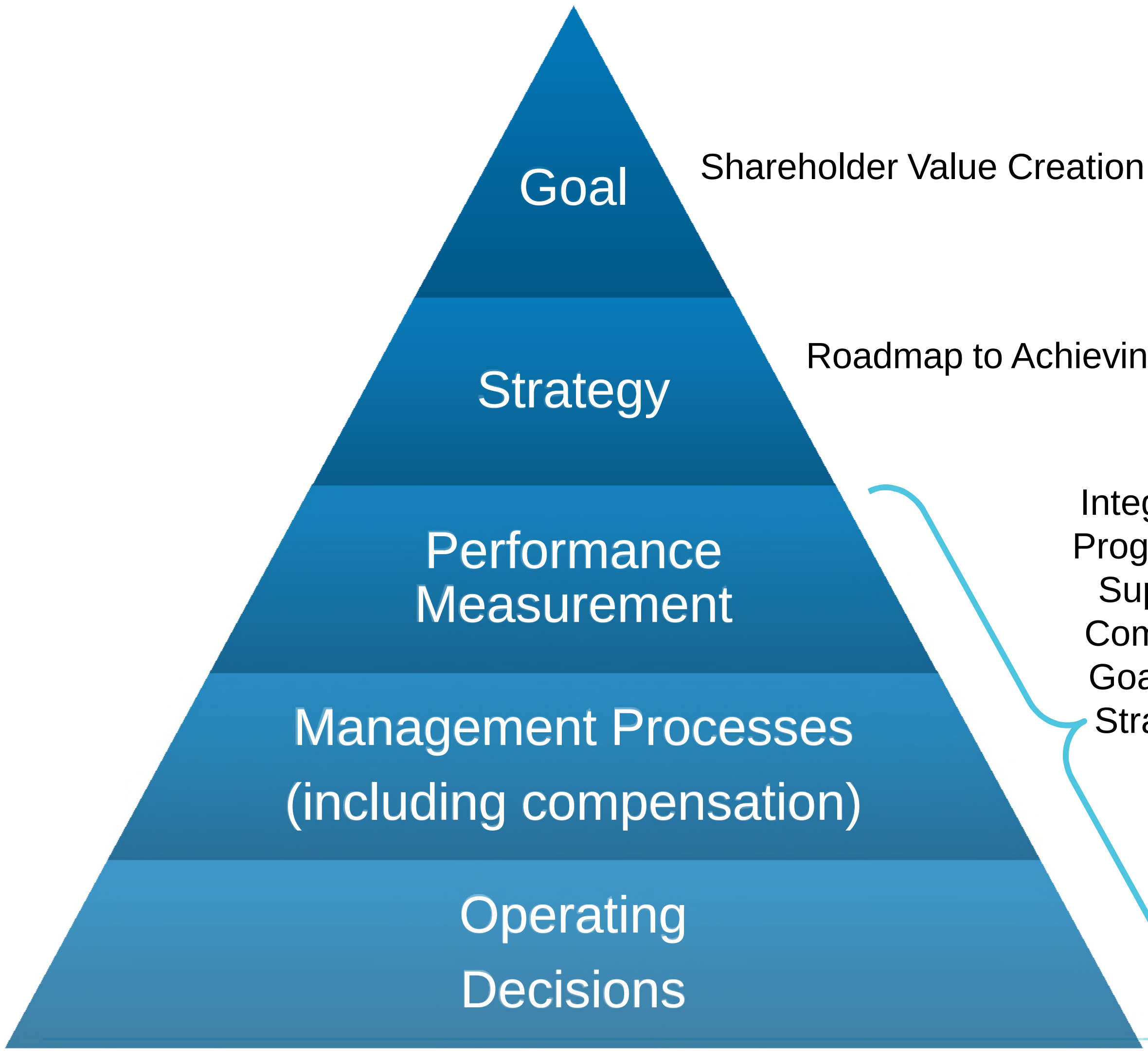
PERFORMANCE MEASURES SELECTED FOR INCENTIVES ARE AN INTEGRAL PART OF THE FRAMEWORK FOR CREATING SHAREHOLDER VALUE



Shareholder Value Creation

Roadmap to Achieving Goal

Integrated Program to Support Company Goal and Strategy

Examples

- Exceed median peer TSR
- Double value in 5 years

- Penetrate markets
- Develop new products

- Revenue Growth
- Return on Total Capital
- Economic Value

- Incentive determination process
- Consistency with planning, budgeting and financial reporting processes

- Inventory Turns
- Customer Retention
- New Product Revenue

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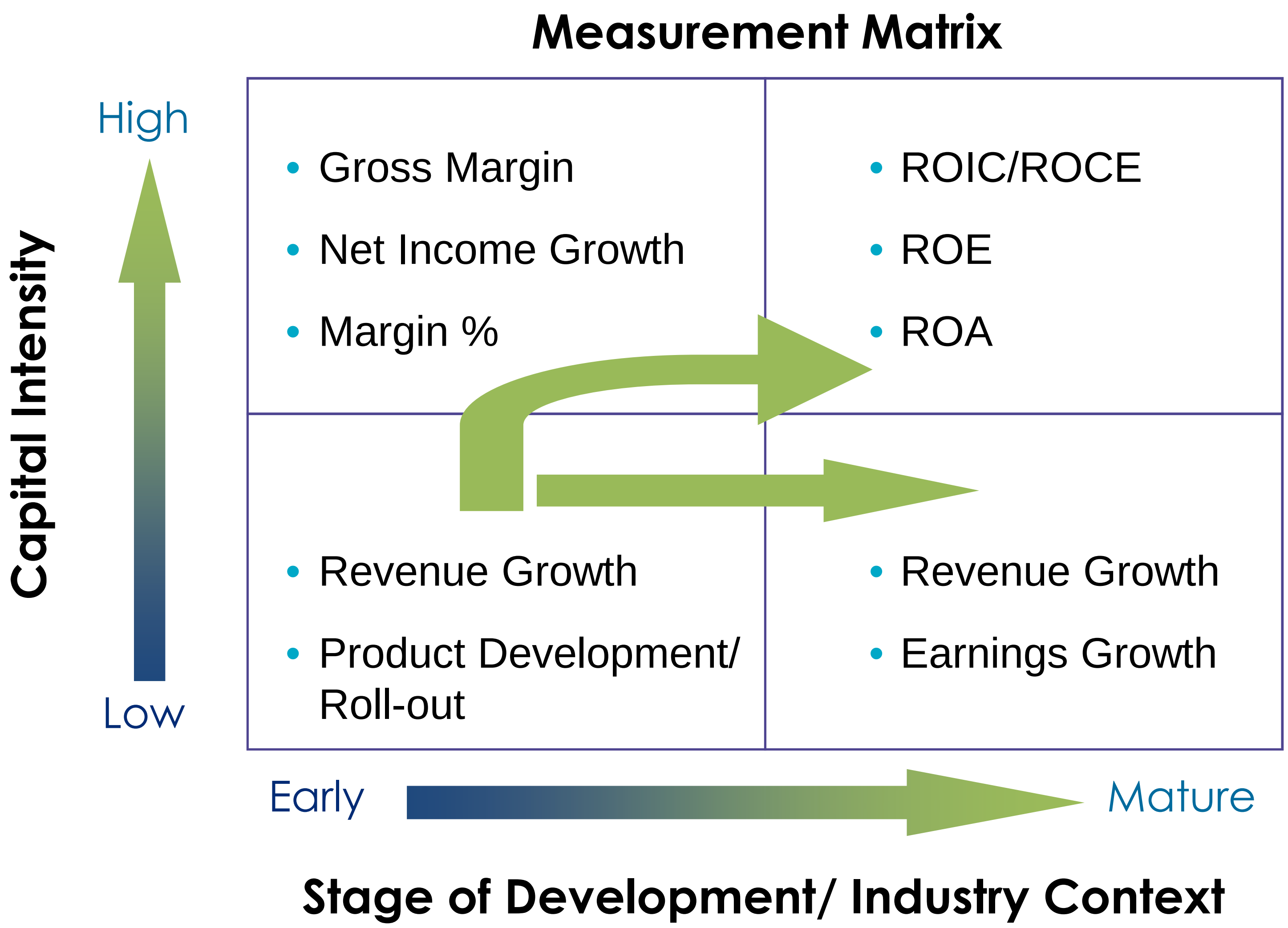
THE CHARACTER OF EACH BUSINESS DRIVES THE SELECTION OF PERFORMANCE MEASURES



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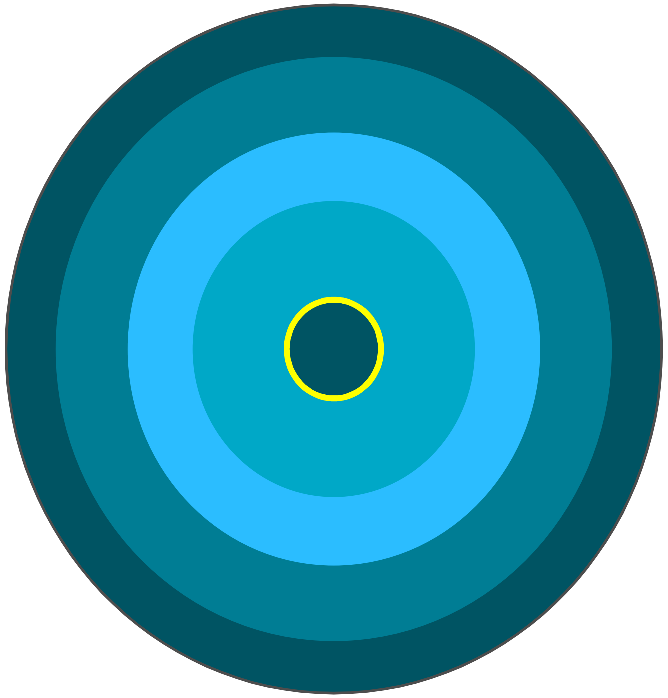
INDUSTRY ALSO SHOULD BE CONSIDERED

Industry / Growth Stage	Sample Metrics	Considerations
Start-Ups	• Revenue growth • Profit margins (usually less emphasis) • Strategic metrics	• Building scale or taking market share with rapid growth is usually most critical • Profits are important, but may come later
Manufacturing	• ROIC • Operating cash flow • Profit margins • Inventory or asset turns	• Efficient management of capital is often most critical • Competitive advantage derived from doing more with less
Services	• Revenue growth • Profit margins or growth	• Very little capital investment • Revenue and profit growth indicate market success and ability to expand offerings or take share
Retail	• Same store revenue growth • Total revenue growth • Profit margins	• Different revenue metrics indicates organic or expansionary success • Margins ensure profitable growth
Hotels	• ROIC • Efficiency metrics (e.g., revenue per available room) • Customer satisfaction	• Capital efficiency is critical due to large investments • Efficiency is daily measure of success • Customer satisfaction is leading indicator of future revenue

EFFECTIVE PERFORMANCE GOALS FOR EACH MEASURE MUST BE ACHIEVABLE, YET MEANINGFUL

ACHIEVABLE

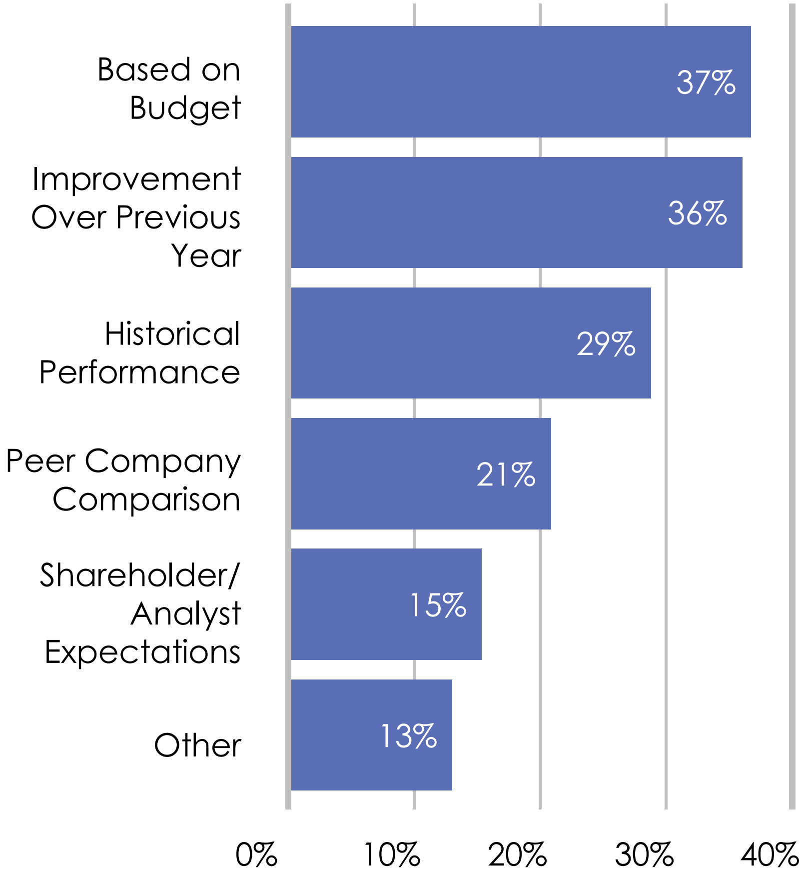
- Reasonable given current market environment
- Perceived by participants as attainable, especially at threshold



MEANINGFUL

- Aligned with shareholder value creation expectations
- Sufficient stretch (especially for upside rewards)
- Sustainable over time

GOAL SETTING IS MOVING BEYOND ONLY FOCUSED ON BUDGETS



Source: 2015 Mercer Executive Compensation Trends Survey

Other Considerations

- Cost of capital
- Volatility of measures and confidence intervals
- Implied growth in current profit levels based on market capitalization

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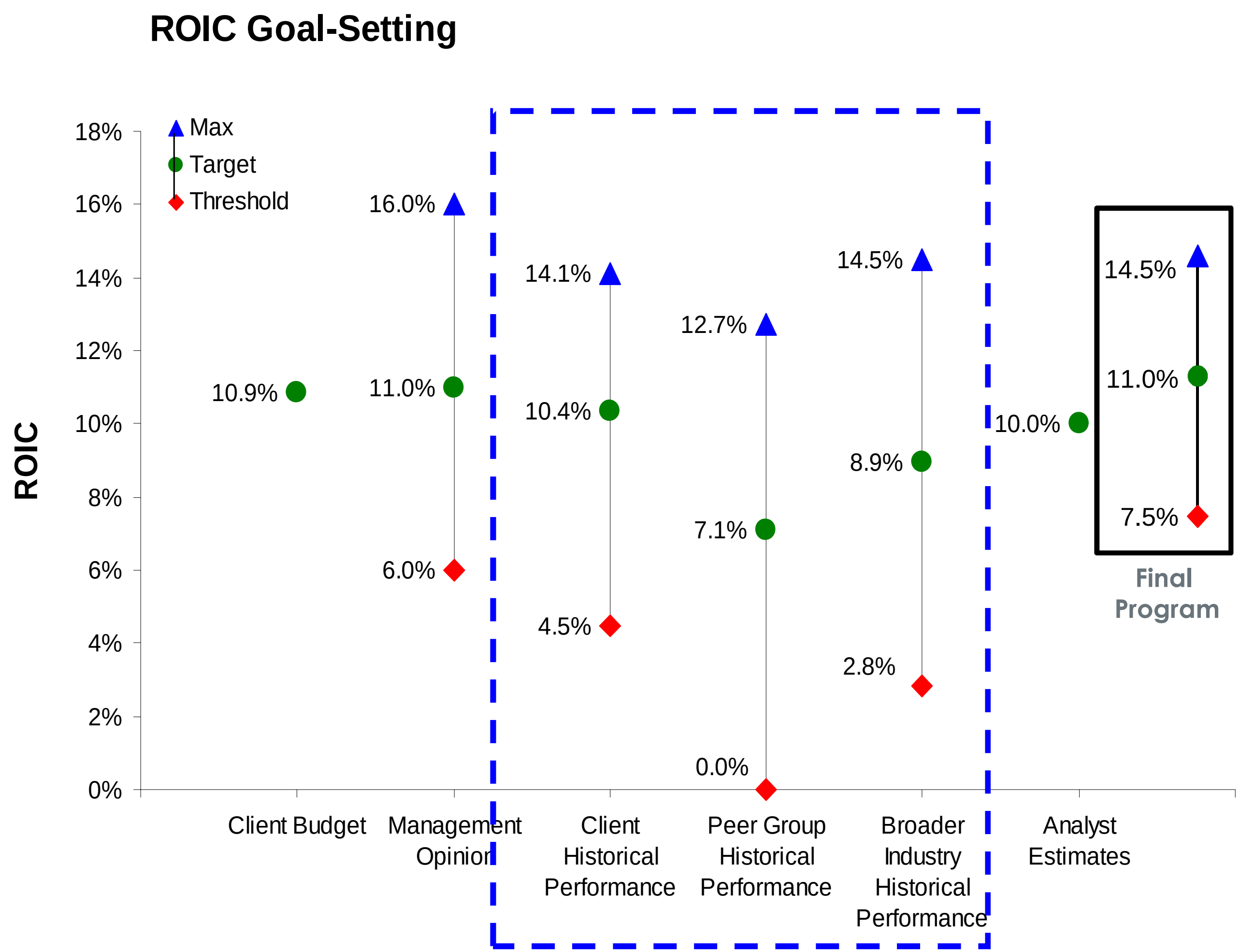
EXAMPLE OF CONSIDERING MULTIPLE VIEWPOINTS IN GOAL SETTING

Example



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ULTIMATELY, MULTIPLE INTERNAL AND EXTERNAL BENCHMARKS NEED TO BE COMBINED TO PROVIDE AN INFORMED DISCUSSION OF REASONABLENESS

Company ABC
ROIC Goal-Setting

Internal Perspectives

Company Historical
15%

Company Budget
12%

Management/BoD Opinion
13%

Corporate Performance Objective
15%

External Perspectives

S&P 500

50th %ile	75th %ile
10%	17%

Peer Companies

50th %ile	75th %ile
8%	12%

Industry Index

50th %ile	75th %ile
15%	17%

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MANY ORGANIZATIONS USE RELATIVE GOAL-SETTING BUT THERE ARE SEVERAL KEY REQUIREMENTS

- A viable number of “peers”, now and later
  - Fewer industries qualify today
  - The number continues to shrink
- Timely availability of data
  - Better for long-term plans
  - More difficult for short-term plans
- Comparable data for your metric
  - Similar definitions, and/or
  - Few if any required adjustments

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CONSIDERATIONS FOR COMPENSATION COMMITTEE MEMBERS

- Are performance measures supportive of strategy?
- Do performance measures either drive or measure valuation creation?
- Do we consider growth, profitability, returns, and valuation creation?
- Is there a reasonable balance between short-term and long-term performance focus?
- Are the measures being used redundant?
- What other than budget should we consider in setting performance goals to align pay and performance?
- Should goals be mostly set based on expected company performance or industry/peer expected performance?
- How should we calibrate the range of performance goals?

PROPOSED PAY FOR PERFORMANCE DISCLOSURE RULES

This table would be included in any proxy statement relating to the election of directors or approval of executive compensation arrangements (for each of the last five years):

PAY VERSUS PERFORMANCE					
(a) Year	(b) Summary Compensation Table Total for PEO	(c) Compensation Actually Paid to PEO	(e) Average Compensation Actually Paid to non-PEO Named Executive Officers	(f) Total Shareholder Return	(g) Peer Group Total Shareholder Return

- In addition, issuers would be required to describe the relationship between:
  - Executive compensation actually paid and the company's Total Shareholder Return (TSR); and
  - the company's TSR and the peer group's TSR.

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PROPOSED PAY FOR PERFORMANCE DISCLOSURE RULES *(CONTINUED)*

Interpretative Issues

- Is the five year data static or does it change as the officers change?
- What happens if a stock award vests before performance criteria is known?
- Is TSR an annual or cumulative number?
- What happens if a peer group changes?
- Requiring disclosure of relationship between TSR and compensation may require explanation of a relationship that doesn't exist
- Explaining relationship for each of the five years may be too short a time frame.

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PROPOSED PAY FOR PERFORMANCE DISCLOSURE RULES *(CONTINUED)*

Comment Letters from Issuers and relate trade groups and consultants

- Prefer a more principles based approach
- Eliminate TSR as sole measure (not correlative to performance)
  - disconnect between performance measurement period and TSR period
  - mismatch between vesting periods and performance periods
  - not all companies use TSR to set compensation
- Peer group disclosure:
  - Eliminate peer group disclosure
  - furnished not filed
  - provide flexibility in selecting the peer group
  - TSR shouldn't be weighted average
- Stock options valued at intrinsic value (not fair value) on vesting date
- Exclude signing bonuses and severance payments.
- Limit items covered to salary, bonus and incentive compensation
- Only three years
- Limit to the CEO

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PROPOSED PAY FOR PERFORMANCE DISCLOSURE RULES *(CONTINUED)*

Comment Letters from Institutional Investors

- Want more than just CEO
- Generally like peer group and TSR for comparability
- Some preferred more principles based disclosure requirements
- Would prefer better alignment between equity vesting and performance periods—although they acknowledge that can be difficult

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TALENT MANAGEMENT AND COMPENSATION COMMITTEE

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WHY TALENT MANAGEMENT IS AN IMPORTANT GOVERNANCE TOPIC

- Compensation and benefits are a significant cost to the organization
- Talent is critical for delivering on strategy to achieve goals and objectives
- Need to have right talent in key positions goes beyond the senior leadership team
- Companies looking to develop management talent internally
- Challenge for some companies to find talent with global business and technology experience/skills need for future leadership
- Talent is at the core of organizational risk

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THE FOCUS ON TALENT MANAGEMENT CHANGING

Current	Future
• Executive officer individual performance reviews • Executive succession planning • Leadership development • Broad-based incentives and benefits	• HR risks (probability and impact) • Workforce planning • Global mobility • Labor relations • Critical roles and top talent • Talent scorecard • Organization structure • Culture

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HOW INCORPORATING TALENT MANAGEMENT INTO THE COMMITTEE AGENDA..

- New name for Committee
  - HR Committee
  - Compensation and Talent Management Committee
- Change charter to include oversight of talent management strategy (examples)
  - Review the Company's talent management and diversity strategies
  - Review organization engagement and effectiveness, talent sourcing strategies, and employment development programs. Monitor policies, objectives, and programs related to diversity and inclusion and review performance in light of appropriate measures

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..CONTINUED

- Require a certain percentage of the meeting time be dedicated to talent management topics (common 25%-50%)
  - Some routine compensation items which do not require approval become pre-read materials with discussion as needed
- Ensure HR executive attends the Committee meeting
- Start by asking questions about current practices
- Develop a talent management scorecard

EXAMPLE MEASURES IN TALENT SCORECARDS

- Voluntary Separation Rates
- Top/Key Talent Voluntary Separation Rates
- Top/Key Talent in Critical Roles
- Top/Key Talent in Global Development Roles
- Internal Promotions vs. External Hires
- % Female Salaried Workforce
- % Female Leaders
- % Diversity in Workforce
- % Diversity in Leaders
- Employee engagement score

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EXAMPLE QUESTIONS FOR MANAGEMENT

- What are our voluntary and involuntary turnover rates? How does it vary by job level, employee demographics, and employee performances?
- Do we have a strategy to build management talent internally or externally? If internally, what are our development programs?
- How does our talent move in (external hires), through (promotions), and out (turnover) the organization?
- Do we have an assessment process to identify key talent?
- Have we identified our critical roles in the company?
- How do we measure employee engagement? How do we support employee engagement?
- How far down do we take succession planning? What percent of management do we have at least one named potential successor?

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PAY RATIO DISCLOSURE RULES

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PAY RATIO RULES

- September 2013, SEC proposed rule on divided 3-2 vote
- August 2015, SEC issued final rule reflecting significant changes
- New rule Item 402(u) of Regulation S-K

PAY RATIO RULES

- Disclosure required of:
  - Median annual total compensation of all employees other than CEO
  - Annual total compensation of CEO
  - The ratio of the two amounts

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PAY RATIO RULES

- New Item 402(u) does not apply to:
  - Smaller reporting companies
  - Emerging growth companies
  - Foreign private issuers
- Disclosure must be provided for full fiscal year beginning on or after January 1, 2017
  - First disclosures in 2018

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PAY RATIO RULES

- Transition Rules:
  - Companies transitioning from smaller reporting or emerging growth company status must provide for first year after losing this status (after January 1, 2017)
  - New registrants not required to include in initial registration statement, but required for first full fiscal year after it has been reporting company for 12 calendar months and has filed annual report without disclosure (after January 1, 2017)

PAY RATIO RULES

Disclosure is required in any filing described in Item 10(a) that calls for executive compensation disclosure under Item 402 (i.e., Form 10-K, registration statements, and proxy/information statements)

PAY RATIO RULES—CALCULATION OF RATIO

- "All Employees"
  - Includes all full time, part time, seasonal and temporary employees of the company or its consolidated subsidiaries (including non-wholly-owned subsidiaries), regardless of location
  - Excludes independent contractors or "leased" workers, so long as they are employed, and their compensation is determined, by unaffiliated third party

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PAY RATIO RULES—CALCULATION OF RATIO

- Foreign employees are generally included, but limited exemptions for:
  - Foreign data privacy laws
  - De minimis cases

PAY RATIO—DATA PRIVACY EXEMPTION

- Can exclude employees in jurisdictions with data private limits on transfer of payroll data
  - Must exercise reasonable efforts to obtain information, including seeking relief
  - Must exclude all employees if any excluded
  - Must provide certain limited information (list jurisdictions, laws at issue, efforts to seek relief)
  - Must obtain legal opinion regarding inability to obtain or process information

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PAY RATIO RULES—DE MINIMIS EXEMPTION

- Registrants with five percent or less non-US-employees may exclude all foreign employees when calculating median
  - If any foreign employees excluded under this exemption, all must be

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PAY RATIO RULES—DE MINIMIS EXEMPTION

- Registrations with five percent or more non-US employees may exclude foreign employees up to five percent threshold, but if company excludes any in a particular jurisdiction, must exclude all in that jurisdiction
- Must count foreign employees exempted under data privacy against availability of exemption

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PAY RATIO RULES--CALCULATIONS

- Annualization is permitted for permanent full-time and part-time employees who did not work the full fiscal year
- Annualization is not permitted for seasonal or temporary employees
- Full-time equivalent adjustments are not permitted
- Supplemental disclosures to explain the effect of prohibited adjustments is permitted

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PAY RATIO RULES--CALCULATIONS

- To identify median employee, can use annual total compensation calculation in Rule 402(c)(2)(x) of Regulation S-K, or any other compensation measure consistently applied to all employees (such as tax information or payroll records) so long as disclosed
- Can use entire employee population or can use statistical sampling or "other reasonable methods"

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PAY RATIO RULES--CALCULATIONS

- Can use reasonable estimates in identifying median employee and can use reasonable estimates in calculating total compensation or any element of compensation
- Must identify actual employee, but not disclose personally identifiable information

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PAY RATIO RULES--CALCULATIONS

- Companies permitted to makes COLA adjustments to compensation of employees located in jurisdictions other than jurisdiction where CEO resides
- If applying COLA, just apply to all foreign employees, adjustment compensation to cost of living in CEO's jurisdiction, describe the COLA, and disclose median employee's annual compensation and pay ratio without COLAs

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PAY RATIO RULES--CALCULATIONS

- Date used to identify median employee must be within the last three months of the completed fiscal year, and must be disclosed
  - Any change in the date from prior year must be explained
- If CEO is replaced during fiscal year, may calculate total compensation for each CEO and combine the amounts, or may annualize the compensation of the CEO serving on date chosen to determine median employee

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PAY RATIO RULES--PERQS

Rule permits, but not does not require, companies to include value of personal benefits valued at less than $10,000, if company takes same approach when calculating CEO's total compensation for purposes of pay ratio disclosure; if included, must explain any material differences between SCT compensation amounts and total compensation used for pay ratio disclosure

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PAY RATIO PRESENTATION

- Ratio can be shown either:
  - Numerically, showing median employee's total compensation equal to one and the CEO's as the number compared to one(e.g., 30 to 1 or 30:1)
  - Narratively, describing the pay ratio by stating how many times higher the CEO's annual total income is to that of the median employee

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PAY RATIO—SUPPLEMENTAL DISCLOSURES

- Permitted to supplement required disclosure with additional information provided any additional information is:
  - Clearly identified
  - Not misleading
  - Not presented with greater prominence than the required ratio

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PAY RATIO RULES—ACTION ITEMS

- Compensation Committees should be aware of the rule, and management’s plan for complying with the rule
- Those advising Compensation Committees should be prepared to offer estimates on the company’s pay ratio (or to explain why estimates are not available) and to offer view on how pay ratio is likely to compare to peers

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COMPENSATION CLAWBACK RULES

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PROPOSED COMPENSATION CLAW-BACK RULES

- Requires each public company to adopt a policy on recovery of incentive-based compensation (a "claw-back") that is received by an issuer's current and former executive officers in excess of what would have been received under an accounting restatement.
- Written claw-back policies would be filed as an exhibit to Form 10-K
- Any actions taken pursuant to the claw-back policy would be disclosed in the Form 10-K.
- Issuers are required to comply whether the incentive-based compensation is received pursuant to a pre-existing contract or arrangement, or one that is entered into after the effective date of the rules.

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PROPOSED COMPENSATION CLAW-BACK RULES
(CONTINUED)

- An issuer would be required to perform a "claw-back" of executive incentive-based compensation if the issuer is required to restate a financial statement to correct material non-compliance with a financial reporting requirement.
- Incentive-based compensation includes "any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure."
- "financial reporting measures" are measures that are determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, any measures derived wholly or in part from such financial information, and stock price and total shareholder return.
- The incentive-based compensation to be recovered by an issuer would be the difference between
    - the amount received by an executive officer as a result of materially incorrect financial statements and
    - the amount the executive officer would have received had the compensation been based on the restated financial statements.

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PROPOSED COMPENSATION CLAW-BACK RULES *(CONTINUED)*

Comments to the Proposed Rules

- Limit to CEO, CFO and other officers that contributed to the events leading to the restatement
- Exclude existing employment agreements
- Companies should not be required to seek recoupment if it would violate state law
- Provide guidance as to what constitutes reasonable efforts to recover excess compensation
- Issuers should be able to consider items other than cost/benefit analysis and illegality in determining not to seek recovery

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HEDGING DISCLOSURES RULES

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PROPOSED HEDGING DISCLOSURE RULES

The proposed rules require annual meeting proxy statement disclosure of whether

- directors, officers and other employees
- are permitted to purchase financial instruments, including prepaid variable forward contracts, equity swaps, collars, and exchange funds
- that are designed to hedge or offset any decrease in the market value of equity securities granted by the company as compensation or held, directly or indirectly, by employees or directors.

Applies to all companies subject to the federal proxy rules.

Applies to equity securities of the company, its parent, subsidiary, or any subsidiary of any parent of the company that is registered under Section 12 of the Exchange Act.

PROPOSED HEDGING DISCLOSURE RULES *(CONTINUED)*

Comments by Issuers and related service providers

- Hedging should be defined
  - Distinguish between hedging and portfolio diversification
  - Suggest tying to derivative securities under section 16a-(c)
  - Exclude broad based indices
- Limit to directors and officers (and maybe key employees)
- Exclude stock of parents and affiliates
- Limit disclosure to a description of the hedging policy

Comments by Institutional Investors

- Cover all employees
- Generally supported the policy as drafted

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SAY ON PAY

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SAY ON PAY

- 2015 is the 5th year of say on pay votes
- Failed votes remain rare
  - For Russell 3000 companies, average approval vote was 91% in favor in 2015
  - Only 2.5% of these companies had a failed vote in 2015
  - 91% of the Russell 3000 have never had a failed vote
  - Most companies with a failed vote have only one
- Larger companies (S&P 500) have lower failure rate than smaller companies
  - Only 3 S&P 500 companies with failed votes in 2015
  - 37 companies outside S&P 500 with failed votes in 2015
- Proxy advisor vote recommendations remains important
  - ISS recommendation against typically reduces support by 20-30%
  - Glass Lewis recommendation against typically reduces support by 5-15%
- "Say When On Pay" votes will generally be required in 2017 proxy statement.

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COMPENSATION DISCLOSURE CHALLENGES

Presented by Russ Keller and Sean Colligan

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COMPENSATION DISCLOSURE CHALLENGES

- Background
  - July 2010: Dodd-Frank Act becomes effective
    - Companies must conduct non-binding shareholder votes on executive compensation ("say-on-pay" votes) at least once every three years
  - 2011-12: "First wave" suits challenge approval of executive pay despite negative say-on-pay vote
    - Notable lack of success
    - Half dismissed on pleadings
    - Dodd-Frank expressly stated that say-on-pay does not alter director fiduciary duties

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COMPENSATION DISCLOSURE CHALLENGES

- 2012: Plaintiffs' firms try "second wave":
  - Class action suits (most often in state courts) challenging sufficiency of disclosures relating to say-on-pay votes and other comp proposals
  - Typical case commenced shortly after company filed its proxy statement and sought to enjoin upcoming shareholder meeting
  - Plaintiffs' strategy similar to that used in litigation over proxies in the M&A context, except:
    - Where no major transaction pending, companies more willing to fight
    - Companies had success fighting

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COMPENSATION DISCLOSURE CHALLENGES

- Third Wave: Alleged failure to comply with IRS rules for deductibility (IRC 162(m))
  - Equity grants in excess of per-person limit set forth in plan.
  - Failure to structure the plan in compliance with Sec. 162(m) such that deduction was lost
    - Failure to seek shareholder re-approval of plan every five years
  - Failure to comply with Sec. 162(m) where proxy said Company would do so.

TYPICAL PROXY CHALLENGE AREAS OF FOCUS

- Alleged Omissions - Approval of Additional Shares
  - Historical grant practices.
  - Dilutive impact.
  - Data used to determine number of shares to authorize.
  - Projections for future awards, including hiring projections.
  - Criteria used to determine awards.

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TYPICAL PROXY CHALLENGE AREAS OF FOCUS

- Alleged Deficiencies - Approval of Additional Shares
  - Fair summary of consultant's projections of future awards and analysis of dilutive impact omitted.
    - Knee v. Brocade Communications Systems, Inc., Case No. 1-12-CV-220249 (Santa Clara County, Cal. Super. Ct. April 10, 2012) (example of second wave suits).
  - Failure to obtain consultant input on number of shares to authorize.
  - Peer group comparisons
  - IRC 162(m) compliance and deductibility

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TYPICAL PROXY CHALLENGE AREAS OF FOCUS

- Garnitsching v. Horovitz, Case No. 8:12-cv-00774-PWG (D. Md. Sept. 5, 2014) (third wave)
  - 2011 Plan approved by shareholders erroneously contained restricted stock award limit 10x lower than the plan recommended by Compensation Committee (25,000 shares vs. 250,000 shares)
  - 2011 Proxy stated that Plan awards were designed to meet deductibility requirements of IRC 162(m)
  - Board approves awards exceeding 25,000 in 2012 and 2013
  - 2013 Proxy sought approval of corrected 250,000 limit.
  - Proxy failed to disclose that board already had made awards that exceeded limits of existing plan.

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TYPICAL PROXY CHALLENGE AREAS OF FOCUS

- Garnitsching v. Horovitz, Case No. 8:12-cv-00774-PWG (D. Md. Sept. 5, 2014)
  - Motion for preliminary injunction denied – annual meeting to approve increased limits allowed to proceed.
    - Several large shareholders submitted affidavits urging that annual meeting proceed.
    - Not clear that reasonable shareholder would view past excessive awards as material to vote on increasing awards
  - Motion to dismiss denied; demand excused.
    - Awards exceeding 25,000 shares not made pursuant to plan ratified by shareholders

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DIRECT OR DERIVATIVE

- A direct action belongs to an individual shareholder and can be brought on behalf of a class of shareholders.
- A derivative action belongs to the corporation and can be brought only after demand requirements are fulfilled.
- An action for breach of fiduciary duty to Company is derivative.
- An action to vindicate individual shareholder rights (e.g., voting rights) is direct.

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DIRECT OR DERIVATIVE

- Corporate Benefit Doctrine (Derivative claims)
  - If the corporation takes action demanded by a shareholder, the shareholder's lawyer is entitled to a fee if the action benefitted the corporation.
  - Commencement of an action not required.
  - Raul v. Astoria Financial Corp., Case No. 9169-VCG (Del. Ch. June 20, 2014) – No fee for supplemental disclosure because potential claim based on omission of supplemented information would not have been meritorious. Challenged omissions were:
    - How Board considered results of shareholder vote on frequency of say on pay vote (shareholders voted to hold say on pay vote each year and Company implemented annual vote)
    - Whether and how the Board considered results of 2011 say-on-pay vote (which approved Board's pay recommendations)

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THE NEXT WAVE?

- More litigation on non-employee director compensation may be coming
- Compensation decisions by the board are traditionally subject to business judgment rule
- Decisions regarding non-employee directors may be subject to an “entire fairness” review
- Shareholder authorization was believed to preserve protections of business judgment rule

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THE NEXT WAVE?

- Earlier decisions
  - In re 3COM Corp. S'holders Litig., 1999 WL 1009210 (Del. Ch. Oct. 25, 1999)
  - Seinfeld v. Slager, 2012 WL 2501105 (Del. Ch. June 29, 2012)
- Recent case
  - Calma v. Templeton, 114 A.3d 563 (Del. Ch. Apr. 30, 2015)
  - Reviews prior precedent and rules in favor of derivative plaintiffs

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THE NEXT WAVE?

- The 3Com decision in 1999
  - Granted motion to dismiss claim against directors, applying the business judgment rule
  - Stock option plan with "sufficiently defined terms" was approved by shareholders
- The Slager decision in 2012
  - Denied motion to dismiss claim against directors, applying the "entire fairness" standard
  - Plan approved by stockholders lacked specific guidance and a "meaningful" limit on director compensation

THE NEXT WAVE?

- The Calma decision in 2015
  - Shareholders didn't approve specific "magnitude" of non-employee director compensation
  - Approved plan allowed issuance of restricted stock units worth up to $55 million
  - Court invoked "entire fairness" standard and denied motion to dismiss

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THE NEXT WAVE?

- Other suits may follow in Calma's footsteps
- Binning v. Ogunlesi, No. 11118-CB (Del. Ch. 2015)
  - Filed in June, and includes the following allegations
  - Non-employee board members of Goldman Sachs "abused" their power to set compensation
  - Directors receive more than peers and have "carte blanche" under an equity incentive plan

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RISK REDUCTION STEPS

- Recognize that one size does not fit all
- Review existing director compensation
  - Examine substance of shareholder approvals
  - Compare cash and equity to peer group
  - Balance litigation defense against flexibility

RISK REDUCTION STEPS

- Amend omnibus plan and seek approval
  - Add "meaningful" compensation limits
  - Avoid generic limits on equity grants
  - Obtain shareholder approval

RISK REDUCTION STEPS

- Consider other factors
  - Stand-alone director compensation plan
  - Approval of past compensation
  - Reaction of shareholders or ISS to proposals

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RISK REDUCTION STEPS

- Keep core principles in mind
  - Contours of an “interested transaction”
  - Required level of shareholder approval
  - Record to establish “entire fairness”

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NOMINATING & CORPORATE GOVERNANCE

Scott Claassen, Chuck Hatfield and Vicki Westerhaus

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POLITICAL ACTIVITY

- Government demands compliance
- Shareholders demand fidelity
- Fiduciary duties demand oversight
- Best practices demand transparency

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LOBBYIST ACTIVITY

- Who is a lobbyist/principal?
- Registration requirements
- Reporting requirements
- Restrictions on arrangements
- Restrictions on methods (expenditures)

POLITICAL CONTRIBUTIONS - OVERVIEW

- Federal law
  - No corporate contributions to candidates
  - Federally qualified PAC
  - 501(c)(4) organizations
  - Citizens United – direct corporate expenditures
- State laws
- Local laws
- Industry specific laws

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CONTRIBUTION POLICIES

Aetna shareholders reject proposal to shine light on political contributions

By Bob Herman | May 20, 2015

Shareholders of Aetna voted against a measure last week that would've required the Hartford, Conn.-based health insurance giant to disclose political donations that are directed toward not-for-profit groups.

That the proposal even made it to a vote indicates many with a stake in Aetna aren't thrilled with the company's clandestine political spending—a rising theme for numerous other corporations since a controversial U.S. Supreme Court ruling in 2010.

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BEST PRACTICES

- **Adopt a political activities policy**
  - Contributions by Citi's PACs—or when permitted, from corporate funds—support candidates or political party committees whose views on specific issues are consistent with Citi's priorities. Consideration is given to candidates who represent the communities that Citi serves, are in leadership roles, or serve on committees relevant to our industry.
  - Citi does not use corporate funds for independent political expenditures in support of, or opposition to, any candidate for office. That prohibition also applies to payments made to trade associations. Each payment to trade associations is individually reviewed, and subject to attestation, to ensure compliance with this prohibition.
  - Citi publicly discloses all our political contributions—from corporate funds and from Citi's PACs. The list is updated and posted on our website annually in the first quarter.

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BEST PRACTICES

- Adopt a code of conduct
- Monitor compliance through reporting
- Take action on non-compliant activity
- Consider transparency

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DIRECTOR 360 EVALUATIONS

Mick Thompson
Partner
MERCER
312-917-9313
mick.thompson@mercer.com

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BOARD EVALUATIONS ARE STANDARD PRACTICE

- Contributions by Citi's PACs—or when permitted, from corporate
- NYSE-listed companies have been required to conduct a performance evaluation at least once a year
- Although NASDAQ does not have the same requirement, many companies have adopted a routine committee evaluation process
- Evaluations typically include:
  - Board evaluation
  - Committee evaluation
- NACD governance survey data shows a majority of companies conducting evaluations (at least at the Board level)

Evaluation Level	Public Companies	Private Companies
Board	85%	62%
Committee	75%	30%

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MANY COMPANIES HAVE TAKEN THE NEXT STEP BY CONDUCTING INDIVIDUAL DIRECTOR EVALUATIONS

- 41% of public companies and 30% of private compensation conduct an evaluation of individual board members based on NACD governance survey data
- Individual director evaluations involve each board member evaluating the performance of other board members
- The thinking is feedback may enhance a director's future performance

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ASSESSMENT FORMS TYPICALLY ASSESS FACTORS DOWN THE PAGE AND DIRECTOR NAME ACROSS THE PAGE

- Sample layout of form

Use a 1- 4 scale as follows: 4 Strongly Agree, 3 Agree, 2 Disagree, and 1 Strongly Disagree.	Director 1	Director 2	Director 3	Director 4	Director 5
1) Attends board meetings					
2) Attends committee meetings					
3) Comes to meetings prepared having read material in advance					
4) Contributes to board meetings					

- Factors typically evaluated include attendance, preparedness, value of skills and experience, and contribution
- A complete sample is available for NACD members (https://www.nacdonline.org/)

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THERE ARE SOME KEY DECISIONS IN THE EVALUATION PROCESS

- **Objectives** – improve performance, identify board development topics, and/or identify potential future board leaders
- **Participants** – non-employee directors, employee directors, or other members of management
- **Administration** – lead director, chairman, outside legal counsel, or compensation consultant
- **Evaluation Approach** – written survey or individual interviews
- **Communication of Results** – written summary or individual discussion with evaluator. Consider if written documentation be destroyed with exception of minutes which describe the process followed

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2015 AMENDMENTS TO THE DGCL

- **Fee Shifting Bylaws**
- **Forum Selection Bylaws**

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FEE SHIFTING BYLAWS

- **ATP Tour Inc. v. Deutscher Tennis Bund** (2014)
  - Federal district court held that Section 109(b) authorizes allocation of litigation expenses in "intracorporate litigation"
  - Holding not limited to nonstock corporations
- **Strougo v. Hollander** (2015)
  - Delaware Chancery Court held that fee shifting bylaw does not regulate the rights or powers of former stockholders

FEE SHIFTING BYLAWS

- New subsection 102(f) and language in section 109(b) provide that bylaws may not impose liability on a stockholder for attorneys' fees or expenses in connection with an internal corporate claim
- Amendments do not apply to Delaware LLCs or LPs
- Statutory amendments do not prevent fee shifting provisions in stockholders agreements or other agreements

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FORUM SELECTION

- **Boilermakers Local 154 Retirement Fund v. Chevron Corp.** (2013)
  - Upheld forum selection bylaws but noted may be unenforceable where "its application would be unreasonable" or "used for improper purposes inconsistent with directors' fiduciary duties"
- **City of Providence v. First Citizens Bancshares Inc.** (2014)
  - Bylaw providing for exclusive jurisdiction in North Carolina is facially valid

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FORUM SELECTION

- New section 115 provides that bylaws may require that internal corporate claims be brought exclusively in the Delaware courts, and no provision may prohibit bringing such claims in the courts of Delaware
- Bylaws may:
  - select Delaware as the exclusive forum
  - select Delaware and another forum
  - not exclude Delaware as a forum
- Statutory provisions do not prohibit companies and stockholders from agreements to limit the forum in which litigation may be brought.

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ISS PRELIMINARY 2016 UPDATES

- ISS announced on Oct. 26, 2015, that it is considering changes in U.S. voting policies in three areas for 2016 proxy season:
  - **Overboarding:**
    - For CEOs with outside directorships, limit of one outside public company directorship besides own
    - For non-CEO directors, reduced from current 6 to either 5 or 4
  - **Unilateral board actions**
    - Without vote for directors of post-IPO companies who unilaterally amend governing documents to classify board or add supermajority requirements
  - **Compensation at externally managed issuers**
    - Recommend "against" say-on-pay" due to insufficient disclosure

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PROXY ACCESS

- **What is proxy access?**
  - The ability to include shareholder nominees in the company's own proxy materials
- **Background**
  - Without proxy access, a shareholder can solicit proxies, but process is complicated and expensive
  - SEC has attempted to impose proxy access
    - Issue dates back to the 1940s
    - Rule adopted in 2010, but vacated by federal court decision in 2011
      - Key variables of vacated 2010 SEC rule:
        - 3% ownership
        - 3-year minimum ownership period
        - Up to 25% of board members can be elected pursuant to proxy access

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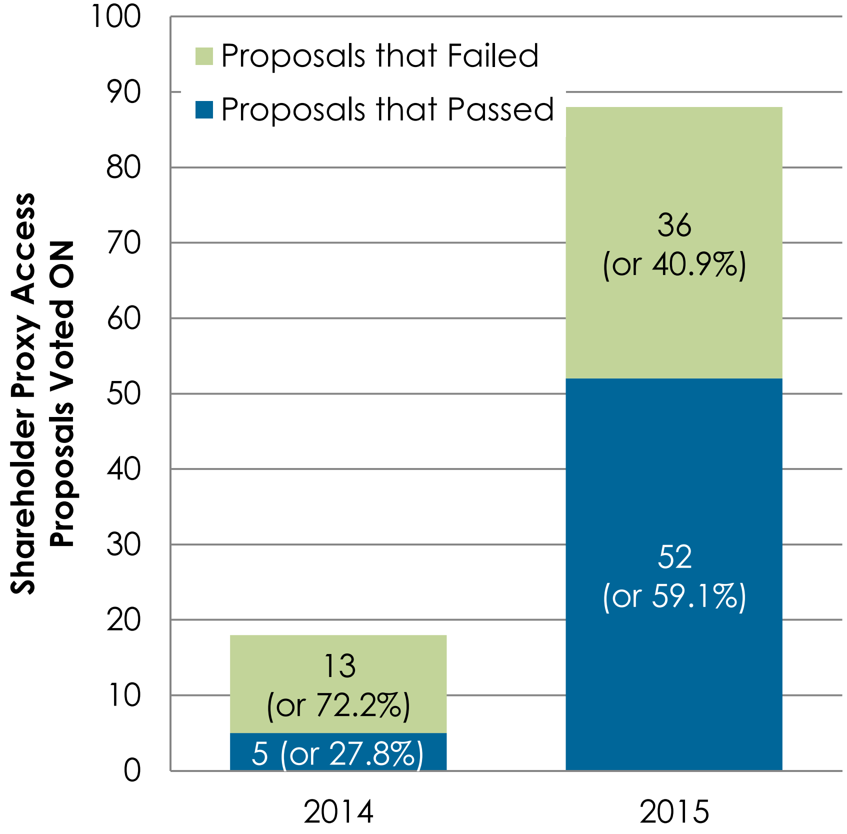
KEY 2015 PROXY ACCESS HIGHLIGHTS*



- 88 proposals were voted on, up from 18 in 2014
- 52 passed (59.1%), up from 5 (27.8%) in 2014
- 36 did not pass (40.9%), compared to 13 (72.2%) in 2014
- Average percentage of votes cast in favor was 54.3%, up from 34.0% in 2014

*Data points from SharkRepellent.net.

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SHAREHOLDER PROPOSAL CAMPAIGNS

- After SEC rule was vacated, proponents used Rule 14a-8 process to propose that companies adopt proxy access bylaws
  - Inspired by success of previous declassified boards and majority voting campaigns
- Over 100 companies received precatory proxy access shareholder proposals
  - 75 companies targeted by New York City Pension Funds
  - All proposals for 3% / 3 years / 25% of board

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SEC INVOLVEMENT AND REVERSAL

- **Whole Foods strategy and SEC reversal**
  - Whole Foods received 3% / 3 year / 25% of board proposal
  - Management said it would propose 9% / 5 years
  - In December 2014, SEC staff granted no-action relief to exclude proposal based on conflicting management proposal
  - 24 companies quickly sought similar no-action relief
  - SEC **revoked** Whole Foods no-action relief and stated that **no further guidance** would be available

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NEW SEC GUIDANCE

- **Staff Legal Bulletin No. 14H (Oct. 22, 2015)**
  - SEC staff will interpret rule more narrowly
  - Company can exclude shareholder proposal as directly conflicting with management proposal only if:
    - "a reasonable shareholder could not logically vote in favor of both proposals, i.e., a vote for one proposal is tantamount to a vote against the other proposal."
      - Proposals seeking a similar objective (proxy access) but on different terms would not "directly conflict" because a reasonable shareholder would not logically vote in favor of both proposals

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2016 PROXY SEASON

- **Companies should assume they might receive a proxy access proposal**
    - Pension funds and activist investors have indicated they will continue to focus on proxy access
- **Consider shareholder outreach**
    - Institutional investors may ask about company's thinking/intention on proxy access
    - Possible arguments against proxy access
        - Shareholder composition
        - Specific board demands (industry experience, etc.)
        - Solid track record on significant governance issues
        - Track record for responsiveness to shareholders

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BASIC ALTERNATIVES TO CONSIDER BEFORE COMPANY RECEIVES PROPOSAL

- Option 1: Preemptively adopt a 3% /3 year /25% of board bylaw
  - Takes issue off table; favorable terms for future nominators
- Option 2: Preemptively adopt an aggressive bylaw
  - Terms favorable to management now, but may be challenged in future
- Option 3: Wait and see, but plan to negotiate withdrawal and adopt bylaw
  - Defers/avoids proxy access, but negotiation may be difficult
- Option 4: Wait and see and develop plan to oppose it
  - Could avoid proxy access, but also result in unfavorable publicity

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MAIN ALTERNATIVES IF COMPANY RECEIVES PROXY ACCESS PROPOSAL

- Option 1: Oppose the proposal based on specific company circumstances
- Option 2: Negotiate withdrawal in exchange for commitment to adopt a bylaw (likely 3%/3 years/25%)
- Option 3: Support the proposal
- Option 4: Adopt a bylaw and exclude proposal based on substantial implementation (uncertain whether this would work, given new SEC guidance)
- Option 5: Include both shareholder proposal and competing management proposal

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