KING & SPALDING

Public Company Advisor

Practical Insights for Public Company Counsel

January 29, 2013

King & Spalding's Public Company Practice Group periodically publishes the Public Company Advisor *to provide practical insights into current corporate governance, securities compliance and other topics of interest to public company counsel.*

Considerations in Drafting Your 2013 Proxy Statement

The 2013 proxy season is shaping up to be another challenging year, with the new Securities and Exchange Commission ("SEC") disclosure requirements for compensation consultant conflicts of interest, the continued focus on governance and compensation issues by proxy advisors and institutional investors and the first year of say on pay for smaller reporting companies. In this edition of the *Public Company Advisor,* we provide a brief overview of five issues for companies to consider in drafting their 2013 proxy statement.

Compensation Consultant Conflict of Interest Disclosure

The SEC adopted new rules in 2012 broadening the already required proxy statement disclosure about compensation consultants to include a discussion of "conflicts of interest". Proxy statements for 2013 annual meetings must provide disclosure about any conflict of interest with the compensation consultant, including the nature of the conflict and how it is being addressed. The SEC did not define conflict of interest, but indicated that the following six factors are relevant to the analysis:

1. Other services provided by the compensation consulting firm to the company;
2. Fees paid by the company as a percentage of the compensation consulting firm's total revenue;
3. Policies or procedures maintained by the compensation consulting firm to prevent a conflict of interest;
4. Any business or personal relationship between the compensation consultant and a compensation committee member;
5. Any company stock owned by the compensation consultant; and
6. Any business or personal relationships between the compensation consultant or the compensation consulting firm and the executive officers of the company.

Companies should consider adding to the D&O questionnaire to assist in internal data gathering for items 4 and 6 above. Companies also will need compensation consultant input to assess these factors. It has been our experience that, when requested, the compensation consulting firm will provide a letter addressing the six factors, which can be a starting point for the conflict of interest analysis.

Although the rule does not require any specific disclosure in the absence of an identified conflict of interest, we expect many companies will consider providing “negative assurances” that the compensation committee undertook the assessment and concluded that there was no conflict of interest. This is similar to the approach taken with respect to the disclosure of whether the company’s compensation policies and practices create risks. If a company decides to include the disclosure in the proxy statement, it is best located near the discussion about compensation consultants, likely in the corporate governance section or CD&A.

Disclosing “Realizable” or “Realized” Pay

There is a growing trend for companies to include “realizable” or “realized” pay disclosure in proxy statements, along with the SEC-mandated summary compensation table, to provide a more complete picture of their compensation practices.

There is no SEC definition of what constitutes realizable or realized pay, so each company should use its discretion to define or present the information. Generally, realizable pay focuses on the value of all compensation actually earned over the past year plus the value of unearned awards (such as unexercised stock options or unvested restricted stock) as of the last day of the year. Realized pay focuses on the actual take home pay for the last year and is closer to what would be reflected in a W-2.

Institutional Shareholder Services (“ISS”) has recently weighed in on the issue with respect to its impact on the say on pay analysis. While ISS will continue to rely primarily on the summary compensation table compensation values for its say on pay analysis, beginning this year for S&P 500 companies, ISS will also consider realizable pay in its analysis. For these companies, ISS will disclose in its proxy report the company’s "three-year realizable pay" compared with its "three-year granted pay" (ISS’s historical calculation method). ISS will calculate realizable pay to include the following:

- Salary, bonus and “all other compensation” for the period.
- Share-based awards (such as restricted stock), which will be valued based on the stock price at the end of the period, less any shares or units forfeited due to failure to meet performance criteria, with ongoing (unearned) awards valued at the target level for such awards.
- The net value realized from stock options exercised in the period and the Black-Scholes present value for unexercised options granted in the period based on the stock price as of the end of the period.
- The change in pension value and value of awarded deferred compensation.

Companies should analyze their own compensation programs to determine whether including a realizable or realized pay table will enhance their CD&A disclosures. If a company includes this

information in its proxy statement, the SEC requires that the company briefly explain how the realizable/realized pay presentation differs from the required summary compensation table.

Including Non-GAAP Information in the Proxy Statement

The SEC's rules provide a limited exception to the requirements of Regulation G and Item 10(e) of Regulation S-K when non-GAAP financial measures are included in the CD&A. Under this exception, when a company discloses performance targets in the CD&A that are non-GAAP financial measures, such as EBITDA or adjusted earnings per share, the company is not required to include a reconciliation to the equivalent GAAP measure or the related justification language. However, the company must provide narrative disclosure as to how the financial measure is calculated from the audited financial statements.

Because proxy statements often include discussion of the business environment in which compensation decisions are made, and because companies are using financial measures to establish the link between pay and performance, companies need to be aware that the limited exception described above is just that — limited. The SEC staff has made clear that if non-GAAP financial measures are presented in CD&A or in any other part of the proxy statement for any other purpose, such as to explain the relationship between pay and performance or to justify certain levels or amounts of pay, then those non-GAAP financial measures are subject to the usual requirements of Regulation G and Item 10(e).

If a company believes that a non-GAAP measure will be helpful to understand its executive compensation program, the company should not be reluctant to include it in the proxy statement, recognizing that the reconciliation and justification disclosure will be required. Failure to include the required Regulation G and Item 10(e) disclosures could result in a comment letter from the SEC. Companies should consider the following points in drafting:

- If the company already provides in its Form 10-K the reconciliation and justification disclosure for the non-GAAP measure, the SEC permits a company to include a cross reference in the proxy to the page in the Form 10-K where the disclosure is contained to satisfy the requirement.

- There is no requirement to include the reconciliation and justification language on the same page as the non-GAAP measure itself, so long as there is a clear cross reference to the location of the required disclosure. A company can include an appendix at the end of the proxy statement providing the reconciliation and justification disclosure, and include a cross reference to the appendix where the non-GAAP measure is used.

Hedging and Pledging of Company Securities

The SEC has not yet adopted the Dodd-Frank mandated rules requiring disclosure of a company's policy with respect to hedging company securities. Companies are currently required to disclose the number of shares of company stock pledged by directors and executive officers in a footnote to the beneficial ownership table that is part of the proxy statement.

Responding to its institutional investor clients, ISS is including an analysis of hedging and pledging as part of its annual proxy analysis. ISS argues that hedging and pledging of company stock by directors or executives may constitute a failure of risk oversight sufficient to warrant recommending against one or more directors.

With respect to hedging, the ISS policy states that any amount of hedging by directors or executive officers will be considered a problematic practice warranting a negative voting recommendation. With respect to pledging, the ISS policy takes a case-by-case approach in determining whether pledging rises to a level of serious concern for shareholders warranting a negative voting recommendation. The factors to be considered include the magnitude of aggregate pledged shares, whether a company's stock ownership guidelines are met after eliminating shares subject to pledge, progress made in reducing the number of shares pledged and disclosure of policies prohibiting future pledging.

Companies should consider a review of their insider trading policies to determine what is and is not currently permitted and undertake due diligence to determine whether there may be hedging or pledging concerns. Companies may wish to adopt prohibitions on hedging for director and executive officers, and prohibitions or limitations on pledging activity.

In drafting the 2013 proxy statement, companies should address their hedging and pledging policies. To the extent a company prohibits hedging for its directors and executive officers, it should be explicit in disclosing the policy in the proxy statement. If a company's policy does not expressly prohibit hedging, the company should consider making an affirmative statement (if it is able to do so) that none of its directors or executive officers have hedged their company stock. In addressing pledging policies and practices, a company should consider whether it can disclose that it has a policy that prohibits pledging of company stock by its directors or executive officers or that there are no outstanding pledges of company stock by its directors and executive officers (or no significant pledges).

Providing a Proxy Summary and Using Other Improved Communication Techniques

Proxy statements have significantly increased in scope and size since the SEC overhauled the reporting requirements in 2006. Much of the SEC required disclosure is dense and difficult to follow. Given the current focus on compensation and governance practices and the importance of the say on pay vote, in recent years companies have adopted a number of improved disclosure techniques to make their proxy statements more easily understood. Some popular drafting techniques include the following:

- Include a proxy summary at the beginning of the proxy statement to set out, in no more than three or four pages, key information about the board of directors, meeting agenda items and the board's voting recommendations on each agenda item and an overview of the executive compensation program and pay for performance connection.

- Include an executive summary or overview at the beginning of the CD&A that includes, at a minimum, the past year's business highlights, key compensation actions and key governance practices.

- Use more descriptive headings, bullet point lists (rather than dense paragraphs) and tables and graphs to disclose required information and to tell the company's story, especially as part of the CD&A.

Many practitioners believe that the design and formatting of the proxy statement can make a real difference in how it is perceived by shareholders.

About King & Spalding's Public Company Practice Group

King & Spalding's Public Company Practice Group is a leader in advising public companies and their boards of directors in all aspects of corporate governance, securities offerings, mergers and acquisitions and regulatory compliance and disclosure.

About King & Spalding

Celebrating more than 125 years of service, King & Spalding is an international law firm that represents a broad array of clients, including half of the Fortune Global 100, with 800 lawyers in 17 offices in the United States, Europe, the Middle East and Asia. The firm has handled matters in over 160 countries on six continents and is consistently recognized for the results it obtains, uncompromising commitment to quality and dedication to understanding the business and culture of its clients. More information is available at www.kslaw.com.

The Public Company Advisor *provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice. For more information on this issue of the* Public Company Advisor*, please contact:*

Jeffrey M. Stein	**Laura O. Hewett**	**Matthew D. Bozzelli**	**William S. Ledbetter**
(404) 572-4729	(404) 572-2729	(404) 572-3565	(404) 572-2767
jstein@kslaw.com	***lhewett@kslaw.com***	***mbozzelli@kslaw.com***	***wledbetter@kslaw***