The Hangover Part III:
Proxy Access, Say-on-Pay and
What Else to Expect in 2012 Corporate Governance

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Contents
(available on www.dorsey.com)

1. PowerPoint

2. SEC Issues Interpretive Guidance on Cybersecurity Disclosures
   Christopher L. Doerksen, Dorsey & Whitney LLP
   October 20, 2011

3. D.C. Circuit Court Vacates SEC’s Proxy Access Rule
   Kimberley R. Anderson and Timothy S. Hearn, Dorsey & Whitney LLP
   July 22, 2011

4. SEC Adopts Final Whistleblower Rules
   Timothy S. Hearn and Robert A. Kuhns, Dorsey & Whitney LLP
   June 10, 2011
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AGENDA

• Dodd-Frank Act Governance and Executive Compensation Rulemaking Update
• Company Responses to DFA Rulemaking
• Shareholder Proposals in 2012 Season
• Expansion of SEC Disclosure Requirements
• Board and Annual Meeting “Tidbits”
DFA UPDATE

• Proxy access (again??)
  – Where we are today
  – What to expect in 2012
  – MN vs. DE law

• Say-on-pay
  – 2011 proxy season recap
  – What we have learned
  – What to expect in 2012
DFA UPDATE

• Executive compensation regulations:
  – “Pay equity”
  – “Pay for performance” linkage
  – Hedging and clawback policies
  – Voting disclosure by investment managers on executive compensation matters

• Section 956 “detour:” Executive compensation at “covered financial institutions”
  – How it works
  – Bellwether for non-financial institutions?
DFA UPDATE

- Whistleblower regulations
  - Finalized May 25, 2011
  - How they operate
  - Company responses

- “Conflict minerals” proposed regulations
  - What has been proposed
  - Company-side reaction
  - What companies are doing to prepare
COMPANY RESPONSES

• Increasing shareholder engagement
  – Review of 2011 vote and targeting key shareholders
  – More continuous outreach
  – Engagement with shareholder representative groups (e.g., CII)

• Routine review of charter documents, governance policies (“best practices” model)

• Compensation committee review of programs for NEOs and directors

• Some good news out of DE: In re The Goldman Sachs Group, Inc. Shareholder Litigation (Del. Ch. 10.12.11)
COMPANY RESPONSES

• Proxy statement review
  – Overall review for clarity, ease of understanding and persuasiveness
  – Consider use of up-front summary for entire proxy statement
  – Consider letter from board of directors
2012 PROXY SEASON:
SHAREHOLDER PROPOSALS

- Proxy access: laser focus or scattershot approach?
- Majority voting: beyond the S&P 500
- Political contributions: multi-pronged approach
- Separation of Chair and CEO
2012 PROXY SEASON: SHAREHOLDER PROPOSALS

- Board diversity
- Board declassification: beyond the S&P 500
- Executive compensation clawbacks
- Supply chain sustainability reports
EXPANSION OF SEC DISCLOSURE REQUIREMENTS

• Loss contingency in liquidity and capital resources section of MD&A
  – SEC Guidance issued September 17, 2010

• Cybersecurity disclosure
  – Suggests five different possible areas of disclosure

• “Conflict minerals” per DFA Section 1502
BOARD AND ANNUAL MEETING
“TIDBITS”

- Considerations regarding use of iPads in the boardroom
- Virtual annual meetings: wave of the future?
October 20, 2011

SEC Issues Interpretive Guidance on Cybersecurity Disclosures

In response to the increasing frequency and severity of cybersecurity incidents, the staff of the Securities and Exchange Commission ("SEC") has issued interpretive guidance for registrants to assist them in assessing what, if any, disclosures should be provided in periodic reports and registration statements about cybersecurity matters in light of each registrant’s specific facts and circumstances.

Background
As registrants have migrated toward increasing dependence on digital technologies to conduct their operations, the risks to registrants associated with the security of such technologies, known as cybersecurity, have also increased. Registrants have been subject to both intentional and inadvertent cyber incidents, such as unauthorized release of proprietary or sensitive information, misappropriation of assets, corruption of data and loss of service, resulting in costs and liability, lost revenues, litigation and reputational damage.

Required Disclosures
The staff’s new guidance does not change existing disclosure standards, but provides a useful reminder to registrants that cybersecurity matters may require disclosures of the following nature:

- Risk factors – if the risk of cybersecurity incidents or the consequences of preventative or remedial actions are among the most significant factors that make an investment in the company speculative or risky.
- Results of operations (MD&A) – if the costs or other consequences associated with known incidents or the risk of potential incidents represent a material event, trend or uncertainty that is reasonably likely to have a material effect on the company’s results of operations, liquidity or financial condition or would cause reported financial information not to be necessarily indicative of future operating results or financial condition.
- Description of business – if cyber incidents have had a material effect on the company’s (or any reportable segment’s) products, services, relationships with customers or suppliers, or competitive conditions.
- Legal proceedings – if a material pending legal proceeding involves a cyber incident.
- Disclosure controls and procedures – if cyber incidents pose a risk to a company’s ability to record, process, summarize and report information that is required to be disclosed in SEC reports that is sufficient to render the company’s controls ineffective.
Form 8-K or 6-K reports – if a cyber incident results in a reportable event, or if additional disclosures are required in order to maintain the accuracy and completeness of information in effective shelf registration statements.

The staff also provides guidance regarding the effect that cybersecurity matters may have on financial statements.

**Action Items**
Registrants should:

- Assess whether the company’s current disclosures regarding cybersecurity issues are adequate, in light of the company’s exposure to cybersecurity risks, the existence and effect of any known cyber incidents, the status of its cybersecurity measures, its industry and the disclosures made by similarly-situated companies;
- Be prepared for the disclosures that may be necessary following a cyber incident; and
- Consider cybersecurity issues in connection with management’s periodic evaluation of the effectiveness of the company’s disclosures controls and procedures.

A complete copy of the staff’s guidance can be found [here](#).

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D.C. Circuit Court Vacates SEC's Proxy Access Rule

In a stinging rebuke of the Securities and Exchange Commission, a three-judge panel of the U.S. Court of Appeals for the District of Columbia Circuit has vacated SEC Rule 14a-11, finding that the SEC had acted arbitrarily and capriciously in adopting the proxy access rule without realistically assessing and weighing the rule’s effect upon efficiency, competition and capital formation. Business Roundtable and Chamber of Commerce of the United States of America v. Securities and Exchange Commission (D.C. Cir. July 22, 2011). Read the full decision here.

Unlike certain other aspects of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), the SEC was authorized, but not required, to establish rules governing access to proxy statements. Rule 14a-11 was adopted on August 25, 2010 in a 3-2 vote split along party lines and challenged by the Business Roundtable and U.S. Chamber of Commerce in a lawsuit filed on September 29, 2010. As a result of the suit, the SEC voluntarily stayed effectiveness of both Rule 14a-11 and certain revisions to Rule 14a-8 (although the revisions to Rule 14a-8 were not challenged in the lawsuit).

Rule 14a-11 would have required public companies to permit any shareholder or group of shareholders owning at least 3% of a public company’s voting stock for at least three years to include director nominees in company proxy materials. The rule applied to all public companies and registered investment companies subject to the proxy rules, unless applicable state or foreign law or a company’s governing documents prohibited shareholders from nominating board candidates. At the same time it adopted Rule 14a-11, the SEC also adopted amendments to Rule 14a-8 that would permit shareholders to include proposals in the company's proxy materials to establish procedures for shareholders to nominate directors (such as proxy access bylaws).

In its ruling, the Circuit Court stated that "the Commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.” The opinion reserved special criticism for the SEC’s cost-benefit analysis relating to application of the rule to investment companies registered under the Investment Company Act of 1940.

Kevin J. Callahan, an SEC spokesman, said the agency was “reviewing the decision and considering our options.” The SEC could pursue the case before the Circuit Court or appeal the case directly to the Supreme Court. The SEC could also decide to begin the proxy access rulemaking process again and address the cost-benefit issues.
raised by the Circuit Court. If the SEC does this it is highly unlikely that a new rule will be in place in time for the 2012 proxy season. The SEC could also simply decide to abandon the Rule 14a-11 initiative.

Whether the SEC decides to continue or abandon its Rule 14a-11 initiative, it may decide to lift its voluntary stay on the revisions to Rule 14a-8, paving the way for companies and their shareholders to adopt proxy access rules by private ordering.

We will continue to update you as there are further developments related to the proxy access rule.

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June 10, 2011

**SEC Adopts Final Whistleblower Rules**

On May 25, 2011, by a 3-2 vote, the Securities and Exchange Commission approved new Rules 21F-1 through 21F-17 under the Securities Exchange Act of 1934 which implement the whistleblower program mandated by Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. These rules provide a powerful new monetary incentive for employees and others to report misconduct with no requirement to do so internally before contacting the Commission. The whistleblower program will be administered by the Commission’s Office of the Whistleblower, and the new rules become effective on August 12, 2011.

**Overview**

Section 21F of the Exchange Act, which was added to the Exchange Act by Section 922 of the Dodd-Frank Act, directs the Commission to pay cash awards to whistleblowers who voluntarily provide the Commission with original information about a violation of the securities laws that leads to a successful enforcement action in which the Commission obtains monetary sanctions in excess of $1 million. Despite concerns raised by a number of the persons commenting on the proposed rules, the final rules do not require whistleblowers to report violations through their companies’ internal compliance and reporting systems. Instead, the Commission made certain changes from the proposed rules designed to incentivize whistleblowers to use internal reporting systems when appropriate, such as:

- clarifying that the Commission will give weight to a whistleblower’s participation in (or interference with) an internal compliance process when determining the amount of an award,
- giving credit to a whistleblower who provides information to a company which then passes the information along to the Commission, and
- extending to 120 days the period of time during which a whistleblower can wait before reporting to the Commission, after reporting internally, and still receive credit back to the original date of the internal report.

Amounts awarded to one or more whistleblowers in connection with any prosecution can range from 10% to 30%, in the aggregate, of monetary sanctions collected.

The final rules also expand upon the anti-retaliation protections set forth in Section 21F(h)(1) of the Exchange Act. In particular, the protections from employment retaliation apply to a whistleblower if he or she has a reasonable belief that the information provided relates to a possible securities law violation that has occurred, is ongoing or is about to occur. The rules clarify the authority of the Commission to enforce such protections and that the protections apply regardless of whether the
whistleblower ultimately satisfies all of the requirements for payment of an award. Employers will not be allowed to require employees to waive or limit such rights.

Who is a “whistleblower?”
Rule 21F-2 defines a “whistleblower” as a natural person who, alone or jointly with others, provides the Commission with original information relating to a possible violation of the federal securities laws, rules or regulations that has occurred, is ongoing, or is about to occur. Reporting a “possible violation” means that the information submitted has a facially plausible relationship to a federal securities law violation; frivolous claims or information relating only to state or foreign law violations will not be sufficient.

The whistleblower must submit the information in accordance with the procedures set forth in the rules. The Commission has attempted to simplify the procedures through the adoption of new Form TCR (Tip, Complaint or Referral), which requires a declaration by the whistleblower under penalty of perjury that the information submitted is true and correct to the best of his or her knowledge and belief. The Commission may, in its sole discretion, waive any failure to follow these procedures upon a showing of extraordinary circumstances.

Certain categories of persons are not eligible to receive an award. For example, members, officers or employees of the Commission, the Department of Justice, the Public Company Accounting Oversight Board (“PCAOB”), certain other regulatory agencies and self-regulatory organizations (“SRO”), or any law enforcement organization are ineligible. Similarly, foreign government officials are ineligible, as are family and household members of Commission employees, and persons who receive the information with the intent to evade the eligibility rules. Anyone convicted of a criminal violation that is related to the action for which he or she otherwise could receive an award, and anyone who, in the whistleblower submission or other dealings with the Commission or another authority in a related action, knowingly and willfully makes any false, fictitious or fraudulent statement or knowingly uses any false document with intent to mislead or otherwise hinder the Commission, will lose their eligibility.

A whistleblower is also not eligible for an award if the information given to the Commission was obtained through an audit of a company’s financial statements, and making the submission would be contrary to the requirements of Section 10A of the Exchange Act. Thus, members of an audit engagement team who discover or detect an illegal act during the course of their audit procedures or audit work (including quarterly reviews) would be ineligible, as the auditor is required to comply with the reporting requirements of Section 10A. A member of the audit team could, however, make a submission alleging that his or her firm violated Section 10A if, for example, the audit firm failed to assess or investigate illegal acts of an audit client or failed to report to the Commission.

Qualifying for an Award
Meeting the eligibility requirements does not automatically lead to the payment of an award. To qualify for an award, an eligible whistleblower must also satisfy four requirements. The whistleblower must:

- voluntarily provide the Commission,
Information is "voluntarily" submitted if it is provided before a request, inquiry or demand relating to the information is directed to the whistleblower (a) by the Commission, (b) in connection with an investigation, inspection or examination by the PCAOB or an SRO, or (c) in connection with an investigation by Congress, any other federal authority, or a state attorney general or securities regulatory authority. Information submitted after a request, inquiry or demand will not be considered voluntary even if the response is not compelled by subpoena or other law. A submission also will not be considered voluntary if it is required to be reported because of a pre-existing legal duty, a contractual duty owed to the Commission or one of the other listed authorities, or a duty arising out of a judicial or administrative order.

"Original information" is information derived from the independent knowledge or independent analysis of the whistleblower, and not already known to the Commission from another source. "Independent knowledge" means factual information not derived from publicly available sources, while "independent analysis" includes the examination and evaluation of information that may be publicly available, but which reveals information not generally known or publicly available. In other words, some additional evaluation or insight by the whistleblower is required.

The rules also enumerate certain circumstances under which the Commission would not consider a whistleblower’s submission to be derived from independent knowledge or analysis. These exclusions apply to persons whose knowledge is acquired because of their role in the compliance activities of a company, or by illegal means. These excluded persons include:

- persons who obtain information through an attorney-client privileged communication or in connection with the legal representation of a client (including by in-house counsel), unless disclosure would otherwise be permitted by applicable federal or state rules;
- officers and directors who are informed by another person of allegations or who learn the information in connection with an internal compliance process;
- an entity’s compliance and internal audit personnel;
- personnel of a firm retained to conduct an inquiry or investigation; and
- employees of a public accounting firm working on an audit or other engagement required under the federal securities laws, if the information relates to violations by the client.

But exceptions to these exclusions also exist. If the potential whistleblower has a reasonable basis to believe that disclosure of the information to the Commission is necessary to prevent conduct likely to cause substantial injury to the entity or
investors, or that the entity is engaging in conduct that will impede an investigation, or at least 120 days have elapsed since the whistleblower provided the information to the audit committee, chief legal officer, or chief compliance officer of the company, then such person will no longer be ineligible to make a submission based on the information in his or her possession.

As noted above, the information must also lead to a "successful enforcement" of a judicial or administrative action, and the final rules provide for the following three circumstances under which that requirement can be met:

1. by giving original information that causes the Commission to commence an examination, open or reopen an investigation, or inquire concerning different conduct as part of a current examination or investigation, and the Commission’s action is successful based in whole or part on such original information;
2. by giving original information about conduct already under examination or investigation, and such information significantly contributes to the success of the action; or
3. by reporting original information through an entity's internal compliance procedures before or concurrently with a report to the Commission, and the entity later provides to the Commission the information or the results of an internal investigation initiated in response to the information.

With respect to the third circumstance, the whistleblower must submit the same information to the Commission in accordance with its procedures within 120 days of providing it to the entity.

The final requirement involves "monetary sanctions in excess of $1 million," which can be satisfied by any money (including penalties, disgorgement and interest) ordered to be paid and any money deposited into a fund as a result of a Commission action or related action. Two or more smaller actions arising from the same operative facts may be aggregated by the Commission when calculating the threshold. In determining whether the $1 million threshold has been met, or for purposes of determining the amount collected for purposes of making payments, the Commission will not take into account any monetary sanctions that the whistleblower himself is ordered to pay or that an entity is ordered to pay because of conduct that the whistleblower directed, planned or initiated.

Calculating the Payment Amount
Assuming the eligibility and procedural requirements are met, the Commission then decides, in its discretion, the amount of the award or awards to be paid. The aggregate amount of the awards will be at least 10% and no more than 30% of the monetary sanctions collected by the Commission and the other authorities. For purposes of determining the appropriate award percentage, the Commission considers the unique facts and circumstances of each case, including the factors listed below which the rules say may influence the decision.

Factors that may increase the amount of an award include:

1. the significance of the information provided,
2. any assistance provided by the whistleblower,
3. the law enforcement interest of the Commission in the subject matter of the
particular action, and
whether the whistleblower participated in, and the extent to which he assisted, an
entity’s internal compliance or reporting system or investigation.

Factors that may decrease the amount of an award include:

- the culpability or involvement of the whistleblower in the matter,
- whether the whistleblower unreasonably delayed reporting the violations, and
- whether, in cases where the whistleblower interacted with an internal compliance
  or reporting system, the whistleblower interfered with or undermined the integrity
  of the system.

If more than one whistleblower is entitled to an award in connection with the same
or related action, the Commission will allocate the awards among the whistleblowers,
up to the 30% maximum aggregate amount.

**Next Steps for Public Companies**
The Commission’s whistleblower program sets in motion new and significant
monetary incentives for people to report misconduct, whether to their employer or
directly to the Commission. Prior to adoption of this program, there were reports
that the Commission had already seen an increase in the quantity and quality of the
tips it is receiving. With the adoption of these new rules, it seems certain that the
level of whistleblower activity will only increase.

While certain features of the rules are intended to incentivize whistleblowers to
report violations through internal channels first, employees will do so only in a work
environment where they feel comfortable that their claims will be taken seriously.
Companies that wish to have an effective internal compliance and reporting system,
and thereby maintain some control over the investigative process and the potential
benefits of self-reporting violations if an issue arises, should take a fresh look at
their internal systems and procedures.

The internal reporting process should be easy to use and protect the confidentiality
of those who access it. Employees should be routinely trained on how to report
potential violations, whether through hotlines or other means of accessing the
company’s chief legal officer or audit committee. Most importantly, a company policy
and culture that protects employees from retaliation should be strongly emphasized.

Companies should also review the investigative procedures they have in place to
ensure swift action will be taken should an issue arise. This would include a review of
who will be on the investigative team and what procedures will be followed in any
particular scenario. As public awareness of the Commission’s whistleblower program
and its potential awards increases, companies likewise should increase their
readiness to respond.

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