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SPECIAL FEATURE

For in-house counsel, complexities in SEC developments

By Stephen M. Honig

As we approach the proxy season, the SEC landscape has changed significantly. We have one year of "say-on-pay" under our belts; private ordering of shareholder proxy nominations (see my January column); and a flurry of SEC guidance, including compensation, risk, financial statements, derivatives and offshore financial exposure.

Some developments present complex issues for in-house counsel and members of public boards.

Risk disclosure

Issues of material risk wend their way through SEC pronouncements concerning '34 Act disclosure. In two areas, disclosure pressure is intense: MD&A and financial statements.

In MD&A, no disclosure is required if a risk is not reasonably likely to eventuate. If that exclusionary threshold is not met, disclosure must be made unless the impact is not reasonably likely to be material.

Counsel know that this standard is difficult to apply when an event, not disclosed in MD&A, actually arises. In such instances, the reasonableness of having excluded MD&A disclosure is measured with hindsight.

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Hence, MD&A disclosure becomes broad and generic, touching as a failsafe on risks that are remote.

At the November PLI Annual Institute on Securities Regulation, the SEC made it clear it also expects companies continually to reevaluate risk factors, and update disclosure, and that altered disclosure should be specific and not generic. That admonition leaves a lot to the judgment of the draftsman.

The correlate disclosure of risk in financials involves disclosure of "material loss contingency." While general business risks, risks of the economy and risks driven by corporate strategy require disclosure only in the MD&A, risks inherent in disputes, litigation or holding-impaired assets may give rise to disclosure requirements both in MD&A *and* in financials. If something is accrued or footnoted in the financials, it must be discussed in the MD&A.

The financial disclosure two-step is similar to the MD&A standard. A financial statement loss must be accrued if the liability is probable and the amount reasonably can be determined. If there is no quantification possible, footnote treatment is required under a vague standard: Is likelihood of loss more than "remote?"

The SEC is suspicious of companies that claim they cannot quantify litigation loss; a range of loss likely has been identified and informs strategic decisions about how the litigation is pursued.

There may be two reasons for a failure to quantify losses that are only footnoted in the financial statements: First, no one likes to acknowledge the beating they are about to take; second, a granular disclosure of a company's perception of risk becomes a valuable tool for opposing litigants.

Outside directors

In SEC Press Release 2011-238, Nov. 10, 2011, the SEC announced that three independent public company directors settled SEC charges that they were complicit in accounting fraud. The outside directors agreed to monetary sanctions and a bar from serving as officers or directors of public companies.

The directors did nothing overtly wrong. They did not conspire. They did not lie or steal. They seemingly did not, in fact, know that management was committing material fraud against the company.

Nonetheless, the SEC took the unusual step of charging the independent directors for failure to pursue the clues that a fraud might be occurring.

Entering the realm of corporate governance, the SEC noted that while it would not "second guess" the good-faith judgments of directors (which would run afoul of the corporate business judgment rule protecting such directors), it *would* sue directors who "completely abdicate" their obligation to monitor the operations of their corporation.

In this case, the outside directors ignored warnings from a whistleblower and the resignation of two outside auditors, which had sent "material weakness" letters to the audit committee.

The SEC thus has joined the Delaware judiciary, which, in effect, asserts that directors failing diligently to perform their responsibilities may breach their fiduciary duty of good faith (therefore negating the protection of the business judgment rule).

Although the line of Delaware cases starting with *Caremark* seldom finds actual liability on the part of inattentive directors, suggesting that the courts are fearful to second-guess just how much diligence is required, the principle

in corporate law is well established that wholly negligent directors are as culpable as venal directors.

The rationale driving SEC enforcement in this case may be that these directors were selling stock during the entire period; the legal analysis is by no means dependent upon this contemporaneous profit making, but the SEC is "only human" and it could not have helped the directors' cause that they were pocketing money while "the fraud swirled around them."

Comp and the ISS

On Dec. 20, 2011, ISS (the rating agency that provides the report card on board performance) issued a white paper touching on comp.

ISS utilizes the ever-increasing data that SEC regulations generate to develop sophisticated mathematical models to rate boards on the propriety of executive compensation.

One issue is the selection of the peer group against which to measure comp. ISS tries to mark compensation to market within a peer group of comparable companies.

Discussions at the National Association of Corporate Directors/New England reveal that directors are divided as to the usefulness of having dialogue with ISS before ISS judges the performance of a board on comp issues.

Some directors believe that ISS has become intransigent, refusing to move from its rigid statistical report card. Some directors — believing that it is much harder to manage certain companies than other companies, even in the same industry of the same size — think that ISS is denying directors the exercise of their judgment in particular cases.

Under the ISS Dec. 20 pronouncement, each company will be judged against a peer group of 14 to 24 companies, based on industry classification, revenue and market value.

In that fashion, ISS purports to cover both operational aspects and the ability of management to translate operational performance into stock market price, a measure that some might think inconsistent with ISS's stated goal of rewarding management that keeps an eye on long-term value as opposed to short-term stock prices.

Boards and counsel must read the ISS pronouncement in detail. It runs many pages and includes charts and graphs, and the bottom line is that it is a statistically objective exercise. It is designed to identify companies with high pay and "low performance."

If a misalignment between performance and pay arises, there is a methodology for reexamining comp to see if the elements composing executive compensation nonetheless align management with long-term shareholder interests.

That often comes down to deferred compensation, which is tied to performance and not the mere passage of time. There is also evaluation of the clarity with which performance standards are articulated and an effort at averaging equity grants over a three-year period.

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With the business press identifying 2012 as a year during which executive comp will be "hot," particularly given the increase in executive compensation in 2011, increased experience in say-on-pay, and anticipated SEC regulations on pay ratios and claw-back of executive comp, directors will feel assailed, and corporate counsel will be called on to unravel the regulatory and practical strands.

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It is no wonder that the industry of advising directors has become so profitable.

Private placements

At the end of December, the SEC took a significant step requiring counsel to revisit documentation of private placement of securities.

Placements generally are effected under SEC Regulation D, providing an exemption from registration and disclosure, when issuing to "accredited investors." An accredited investor historically was defined as having $1 million of net worth, or earnings of $200,000 per year ($300,000 with spouse).

The Dodd-Frank Act requires SEC rulemaking to exclude the value of a primary residence from the calculation of net worth (see Release No. 33-9287). (In a way, this requirement is anomalous in that so many people now find themselves under water with their mortgages.)

Pursuant to the new rule, both the value of a primary residence and the indebtedness on that residence now must be excluded from calculating net worth. If a mortgage is under water (owing more than the market value of the house), that excess liability also must be deducted from net worth.

In order to avoid gaming the system, 100 percent of borrowings secured by a principal residence made within 60 days of an investment also must be counted as a liability.

(Anomalously, someone who mortgaged a house a year ago and retained the proceeds may be able to invest, while someone who took the same mortgage last month could not, although they are in identical financial positions.)

Conclusion

The flood of regulation, disclosure and liability flowing out of the 2008 economic meltdown compounds disclosure and governance complexity, fostering unintended consequences.

Boards, and counsel, have no choice but to deal with that complexity while hoping that the regulatory pendulum swings back toward fewer restrictions sometime soon. NEIH

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