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Don't Ask, Don't Waive After *Ancestry.com*

Companies routinely enter into non-disclosure agreements (NDAs) for a variety of reasons. Who could have predicted that 2012 would be the year that the commonplace NDA took center stage before the Delaware Chancery Court?

We have had a significant number of interesting Delaware Chancery Court and Delaware Supreme Court cases in 2012 focusing on NDA practice, including the bench ruling in *In Re Complete Genomics, Inc. Shareholder Litigation*, C.A. No. 7888-VCL (Del. Ch. Nov. 27, 2012), Vice Chancellor Parson's comments in *In re Celera Corporation Shareholder Litigation*, C.A. No. 6304-VCP (Del. Ch. March 23, 2012) (noting that "Don't Ask Don't Waive" provisions may "collectively operate to ensure an informational vacuum"), the Delaware Supreme Court decision in *RAA Management LLC v. Savage Sports Holdings Inc.*, (Del. May 18, 2012) (enforcing a non-reliance clause in NDA), and of course, the *Martin Marietta v. Vulcan* decision by Chancellor Strine, 56 A.3d 1072 (Del. Ch. May 4, 2012), affirmed on appeal, 45 A.3d 148 (Del. May 31, 2012), (addressing provisions in NDA that together operate as a standstill).

To end 2012, we had another bench ruling by Chancellor Strine in *In Re Ancestry.com Inc. Shareholder Litigation*, C.A. No. 7988-CS (Del. Ch. Dec. 17, 2012). We have written on interesting issues for NDA practice addressed by several of these cases (see our M&A and Corporate Governance Newsletter Spring 2012, May 25, 2012 client alert and May 8, 2012 client alert), but the issues addressed by *In Re Ancestry.com* establish additional practical considerations for counsel using NDAs for public companies.

Background

Ancestry.com raises issues about the board's fiduciary duties in a situation where the target company has entered into numerous NDAs with likely prospective bidders, which contain a standstill, or provision preventing the prospective bidder who is party to the standstill from seeking to obtain control, or even making a proposal to acquire the target company, without the express permission of the target company. A standard clause in the standstill provision also prohibits the bidder from seeking a waiver from the provision (a so-called "Don't Ask" provision). Such standstills are routinely used to encourage bidders in either a limited or broad auction to put in their best and final bid, since the effect of the standstill would be to prevent them from putting in a proposal after the bidding is over, unless expressly invited. As Chancellor Strine puts it in *Ancestry.com*, "how do we, in a public company context, get these most likely bidders to actually put their full bid on the table rather than holding something in reserve? We can use this tool to gain credibility so that those final-round bidders know the winner is the winner, at least as to them."

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The practice followed by both bankers and lawyers in an auction process is to negotiate for these standstills. Prior to the decisions in *Ancestry.com* and *Celera*, the "Don't Ask" provisions were considered standard provisions in standstills; there was not typically any discussion with the target board of directors about these provisions, other than perhaps a passing comment that these provisions were in place and were deemed to be value maximizing.

Note that a target company is always in a position to waive the standstill provisions either partially or completely, absent some other agreement, like the prohibition on such waivers sometimes found in a public company merger agreement. Thus, a target company is in the position to be able to waive all such provisions unilaterally prior to entering into a merger agreement. Blanket waivers are rare, however, because the board doesn't want to lose control of the process even after the successful bidder has entered into its merger agreement.

The plaintiffs bar has made it clear that the existence of "Don't Ask, Don't Waive" provisions will be a focus in the complaint and any discovery.

As part of the auction process, however, many bidders seek a so-called "lapse" or "fall-away" provision in these standstills. These provisions cause the contractual standstill to cease to be in effect upon some external event beyond the lapse of time. Examples of triggers for lapse provisions include the target entering into a merger agreement with a third party and publicly announcing the same, or in some cases, the mere public announcement of a third party's competing bid with respect to the target company. The latter type of lapse provision, where the standstill falls away on a third party's competing bid, creates significant risk for the target board to lose control of the process, without the assurance that a bidder has negotiated a board-approved merger agreement. Targets often resist this type of lapse provision, correctly noting that such bids may not be of value to the stockholders and that, in any case, third parties should not be in a position to void the contractual arrangements between these two parties to the NDA unilaterally.

In contrast, the lapse provision resulting in a lapse only upon the public announcement of a merger agreement allows the target board to retain control of the process. This type of lapse provision permits a competing bid only after the winner has negotiated an agreement with buyer-favorable provisions, such as matching rights, termination fees and a restriction on changes of recommendation or the ability to discuss a transaction other than one defined as a "superior proposal." Such a lapse provision can also be viewed as value maximizing because few motivated buyers would want the target company to sign a merger agreement with another party, given the significant leg up granted to the incumbent buyer in the form of matching rights, termination fees and other deal lockup provisions.

Absent a lapse provision, the "Don't Ask" provision in a standstill does contractually take a bidder out of the process completely at any time such bidder is excluded or voluntarily exits the process. That is its purpose, and it is that feature that provides the incentive for bidders to provide their "best and final" price. A public company merger agreement often also contains a prohibition on the target company, which prevents the target company from waiving any standstills (a so-called "Don't Waive" provision). Although target counsel may negotiate a fiduciary out to such prohibition, a target board would have no reason to grant a waiver to a former bidder who sits silently on the sidelines, as it is contractually obligated to do, and no contractual right to ask that bidder if it has any continuing interest in submitting a revised bid. Accordingly, the combination of the "Don't Ask" and "Don't Waive" provisions contractually assures the bidder that such former competing bidders are out of the process.

The Ruling

In *Ancestry.com*, Chancellor Strine considered these dual provisions after two other Vice Chancellors had concluded that the provisions considered together could be viewed as creating willful blindness.[1] In a bench ruling, Chancellor Strine refused to rule that these companion provisions are "per se" illegal, noting the potential value maximizing role that they might play in an auction. He noted that these are "pretty potent" provisions, and that "directors need to use these things consistently with their fiduciary

[1] *In Re Complete Genomics, Inc. Shareholder Litigation*, C.A. No. 7888-VCL (Del. Ch. Nov. 27, 2012); *In re Celera Corporation Shareholder Litigation*, C.A. No. 6304-VCP (Del. Ch. March 23, 2012).

duties, and they better be darn careful about them." He observes that such provisions are often used in cases governed by the *Revlon* standard where the board's obligation is to try to get the highest value. Chancellor Strine also makes it clear that one cannot proceed by assuming that an otherwise motivated bidder will breach its NDA provisions—contracts still mean something in Delaware!

Ancestry.com involved a going private Schedule 13e-3 transaction involving a rollover of shares. Twelve bidders, including 11 private equity firms, signed NDAs with the "Don't Ask" provision, and the merger also contained a "Don't Waive" provision. Chancellor Strine observed that, on the facts before him, it appears that a logical process was run by a competent banker. Three bidders were bidding at a level close to the final price and were not included in the final round of bidding; these bidders had not had access to the data room. The proxy statement did not disclose that the "Don't Ask" provision was not waived following the signing of the merger agreement until shortly before the stockholder meeting, and that until that waiver the competing bidders subject to that provision could not make any other competing proposal. Chancellor Strine ruled that this was material information "that should be part of the mix of information" and order disclosure. He also found that the target board was not informed of the potency of the "Don't Ask, Don't Waive" provisions working in tandem, and that their lack of awareness and failure to waive was possibly a violation of the duty of care.

What Does *Ancestry.com* Mean for Target Companies?

Some commentators are suggesting that companies never, or only sparingly use a "Don't Ask" provision. The plaintiffs bar has made it clear that the existence of "Don't Ask, Don't Waive" provisions will be a focus in the complaint and any discovery. This position seems like an unwarranted overreaction to the string of cases criticizing the preclusive effect of these agreements. Keep in mind that companies have these "Don't Ask" standstills out in the hands of former bidders, with a tail that may continue for a year or more; they weren't illegal on their face at the time they were entered into and there are ways to resolve the Ancestry.com issues without a blanket waiver. In any case it wouldn't make sense to waive these provisions until a process has resulted in a bid.

Here are some practical guidelines derived from the cases dealing with "Don't Ask, Don't Waive" provisions:

- A target company could avoid the preclusive effect of the "Don't Ask, Don't Waive" provisions by granting a lapse on a public announcement of a merger agreement. A lapse provision that allows only private proposals following a public announcement of a merger agreement may be preferable to a target, as such a provision would tend to avoid a situation where the target has to deal with a public jumping bid (at least until the target board makes its fiduciary determinations and determines its disclosure obligations with respect to a private proposal). Vice Chancellor Laster would have accepted such a lapse provision as consistent with *Revlon*, according to the transcript from an earlier bench ruling in *In Re Complete Genomics.*

- Alternatively, the target company could simply refuse to enter into a "Don't Waive" covenant. Not every merger agreement has a "Don't Waive" covenant in any case.

- A target company could waive the "Don't Ask" provisions prior to entering into the merger agreement with a "Don't Waive" provision, subject to any applicable restrictions under any exclusivity letter. Chancellor Strine notes that, in some cases, a failure to waive would be a breach of the duty of care.

- In any case, the lawyers and bankers advising a target board need to advise the board as to the use of the "Don't Ask" provision, the reasons for its use, the bidders foreclosed from bidding, and any mitigation. The target board should be informed of blanket waivers, and it would be reasonable to also inform the board of a decision to use a lapse provision.

- The use of the provisions and their continuing effect after the signing of the merger agreement needs to be disclosed in the proxy statement to the extent the provisions would be deemed to be preclusive. Stockholders need to understand the quality of the post-signing market check.

- The relevance of these provisions is heightened in a close, hard fought auction where the bids are very close and emotions could drive a grudge bid or an envy-based competing bid. Alternatively, in an auction where the bidders subject to this "Don't Ask" provision were not active participants in the process, and dropped from the bidding early on, particularly with an indication of limitations on their ability to make, or their interest in making, a competitive bid, it is not clear that the provisions would have any impact on the outcome of a post-signing market check. It would still be prudent to advise the board and disclose their existence. Although a waiver of such provisions on those types of facts seems unnecessary to assure a good *Revlon* process, it probably is not too likely to result in any new bid.

- In some auctions, at least some likely strategic bidders may refuse to sign a standstill, or may not have been invited into the process due to concerns regarding the impact on the target's competitive position, or customer or vendor relationships. Such facts may influence the analysis by the board of the impact of the "Don't Ask, Don't Waive" provisions, again depending on the auction process and the likely interest of such bidders.

- Target boards have to be especially careful to avoid any favoritism as to any particular bidder. The *Ancestry.com* deal was a transaction with inherent conflicts, and such transactions always raise the possibility of a duty of loyalty claim. Additional caution is warranted in such transactions to make sure no taint of favoritism exists.

The use of a lapse provision or a waiver upon the signing of a merger agreement removes the "willful blindness" issue otherwise posed by these provisions.

A Potent Tool

The "Don't Ask, Don't Waive" provisions are indeed a potent tool in the hands of a banker and lawyer assisting the target board in running a competitive auction process. The use of a lapse provision or a waiver upon the signing of a merger agreement removes the "willful blindness" issue otherwise posed by these provisions. Further, there may be facts in a particular situation that demonstrate that these provisions are irrelevant to the *Revlon* duties of the target board. Boards should be informed of the impact they will have on the post-signing market check and appropriate disclosures should be made to stockholders as to the existence of the provisions and their possible impact on the bidding process post-announcement.

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DOJ Sends Caution Signal to Companies Engaged in Mergers

The Antitrust Division of the Department of Justice (DOJ), which has just come under new leadership, began 2013 with two significant merger enforcement litigations in federal district court. The new cases may provide signals about what to expect from the Antitrust Division under its new Assistant Attorney General for Antitrust.

Sworn in on January 3, AAG William J. Baer is a highly-regarded antitrust practitioner with background in both the public and private sectors. Most recently, he was head of the antitrust practice of the Washington, DC-based law firm of Arnold & Porter, and prior to that, he served as Director of the Bureau of Competition of the Federal Trade Commission during the Clinton Administration.

In the first of its two recent merger challenges, the Antitrust Division filed suit in San Francisco federal court to unwind the acquisition of the software company PowerReviews, Inc. by its competitor, Bazaarvoice, Inc. (*United States v. Bazaarvoice, Inc.*, Case No. C-13-0133 JSC (N.D. Cal. filed Jan. 10, 2013)). The two companies had consummated their $168 million transaction in June 2012, six months before the government filed its case, and the government's complaint rests largely on quotations extracted from internal company documents.

Bazaarvoice faces the additional difficulty that the government is seeking to unwind the two businesses rather than requesting an injunction to block their pending transaction.

In the Antitrust Division's second action, the government seeks an injunction to block the $20.1 billion proposed deal between Anheuser-Busch InBev SA (AB InBev) and Grupo Modelo (Modelo) on the grounds that the transaction could make future industry coordination easier (*United States v. Anheuser-Busch InBev SA/NV and Grupo Modelo S.A.B. de C.V.*, Case No. 1:13-cv-00127 (D.C.D.C. filed Jan. 31, 2013)).

Both lawsuits are based on Section 7 of the Clayton Act, which makes illegal all transactions that substantially lessen competition in any US line of commerce. Together, the cases may provide insights into what can be expected from US government antitrust enforcers under AAG Baer's leadership in the upcoming years. The cases also serve as reminders that phrases taken out of context from internal company documents can be used in litigation and that consummated mergers may be challenged.

Bazaarvoice / PowerReviews

Bazaarvoice develops software for client businesses that require consumer-generated product ratings and review (PRR) platforms for their websites. Prior to being acquired by Bazaarvoice, the San Francisco-based PowerReviews engaged in the same type of business. The acquisition was reportedly valued at $168 million, but no Hart-Scott-Rodino Act premerger notifications were required. Like many start-up companies, PowerReviews' annual revenues were relatively low in the year before it was acquired, which meant that it did not meet the "size-of-person" test ($12 million) that would have triggered premerger filing requirements before the deal was consummated. Thus, the Antitrust Division today is faced with challenging a transaction that closed in mid-2012, and rather than seeking to block the transaction altogether, it is asking the court to impose a remedy designed to replace the competition lost through the transaction.

Product Market Alleged: PRR Platforms. The government will be required to demonstrate in court that the transaction either is likely to cause or has already caused anticompetitive harm in a market affecting US commerce. The Antitrust Division's complaint alleges that the acquisition adversely affects competition in what it terms the market for PRR platforms.

Clients for PRR platforms and attendant services include retailers and manufacturers, such as Costco, Best Buy and Crate & Barrel, that purchase PRR platforms for internet sales efforts. Many internet shoppers today expect that they will be able to check other consumers' product reviews before making their own purchase decisions, and PRR platforms help drive business to sellers who include these reviews on their websites. Also, PRR platforms may include analytics software that clients later use to identify customers for targeted marketing efforts or to pinpoint areas for product improvements.

According to the government's complaint, Bazaarvoice was the leader in providing PRR platforms prior to the transaction, and PowerReviews was its closest competitor. The government also alleges that no other significant PRR platform companies are able to provide meaningful competition.

Bazaarvoice counters the Antitrust Division's allegations by saying that it misunderstands the complexities of the market for PRR platforms. "We spent more than six months explaining that there is robust and ample competition in the market for Social Commerce Engagement Tools. We disagree with the DOJ's decision to ignore that evidence," Bazaarvoice stated in its SEC documents filed after the government brought suit. It has also made other public statements showing that it intends to provide evidence that the government's market definition is much too narrow:

> There is no single market for "product ratings and review platforms." Ratings and reviews are but one of many tools that brands and retailers can use to engage with their customers as part of an overall social commerce strategy to increase awareness of their products. Other prominent tools include Facebook, Twitter, question and answer, and community forums, and many others.

If Bazaarvoice can convince the court that PRR platforms face these or other alternative forms of competition, this will go a long way in helping it prevail against the Antitrust Division.

Anticompetitive Effects in the Market. The government also must prove that the merger either has caused or will cause competitive harm, and the complaint relies on the words of Bazaarvoice's executives for this element. The company's executives' writings include documents among themselves, to the Board of Directors and to their employees, which were taken out of their context and then used by the Antitrust Division to allege that the acquisition of PowerReviews "was a calculated move by Bazaarvoice that was intended to eliminate competition."

The complaint uses a number of quotes to illustrate its allegations:

- In April 2011, one of Bazaarvoice's co-founders wrote an email to senior company executives saying that:
  - Acquiring PowerReviews would "[e]liminat[e] [Bazaarvoice's] primary competitor" and provide "relief from [...] price erosion," and
  - Bazaarvoice would "retain an extremely high percentage of [PowerReviews] customers," because customers' alternatives were "scarce" and "low-quality."

- The next month, Bazaarvoice's CEO wrote to the board of directors explaining that the transaction provided an opportunity to "tak[e] out [Bazaarvoice's] only competitor, who ... suppress[ed] [Bazaarvoice] price points [...] by as much as 15%...."

- Statements from the CFO, who became the company's CEO in late 2012, provided a number of additional points for the government's complaint:

  - The combined company would be able to "avoid margin erosion" caused by "tactical 'knife-fighting' over competitive deals."

  - The acquisition would "[e]liminate [Bazaarvoice's] primary competitor" and "reduc[e] comparative pricing pressure."

  - Bazaarvoice had "literally, no other competitors" than PowerReviews.

  - The acquisition would (1) "eliminat[e] feature driven one-upmanship and tactical competition;" (2) "[c]reate [...] significant competitive barriers to entry;" (3) "eliminate the cost in time and money to take [PowerReviews'] accounts;" and (4) reduce [Bazaarvoice's] risk of account losses as [PowerReviews] compete[d] for survival."

These and other quotations in the complaint, standing on their own and without further business context, can be seen as suspect under the antitrust laws; but there is obviously more to this picture that will come out in the trial. The complaint does serve as a reminder that information for internal review and decision-making processes can readily be taken out of business documents and used in litigation.

Companies litigating against a complaint such as this will have opportunities to provide underlying explanations and contextual information about the industry and its competitive circumstances. Bazaarvoice will no doubt give a more complete explanation of its industry that describes the competition the company faces daily. In the meantime, however, the government has had the opportunity to make the first impression.

Executives need to be able to freely express their assessments and provide accurate and thorough valuations about a potential transaction. In doing so, though, they need to remember that their word choices are important. Most often, the same ideas can be explained in ways that will not raise concerns among antitrust enforcers.

Post-consummation Antitrust Merger Lawsuits. Because the Antitrust Division's complaint is post-consummation, Bazaarvoice faces the additional difficulty that the government is seeking to unwind the two businesses rather than requesting an injunction to block their pending transaction. The goal of the government's remedy request in the complaint is to reinstate the pre-closing market competition.

It is, of course, not a foregone conclusion that the government will prevail. It has a difficult burden of proof under Section 7 of the Clayton Act. If it is successful, however, it has asked that Bazaarvoice be required to divest assets sufficient to create a separate, distinct and viable competing business that can replace PowerReviews' competitive significance in the marketplace. This could be both difficult and expensive.

Trial or Settlement? The parties have requested a trial in July. Unless a settlement of the complaint is reached before that date, little more information will be available until the trial and the court's decision.

Although Modelo is a relatively small player in the US beer market, the government alleges that Modelo's pricing constrains its competitors.

AB InBev / Grupo Model

The second major merger action from the DOJ's Antitrust Division under its new leadership came on the last day of January. The government filed a lawsuit in federal district court in Washington, DC, seeking to enjoin the proposed transaction between AB InBev's and Grupo Modelo. Although Grupo Modelo's share of the US beer market is estimated to be only approximately 7 percent, the government's complaint alleges that the company's pricing plays a moderating force against AB InBev's 39 percent market share and MillerCoors' 26 percent market share. Although Modelo is a relatively small player in the US beer market, the government alleges that Modelo's pricing constrains its competitors.

According to the Antitrust Division, Modelo's pricing strategy has been to narrow the price gap between its beers and such lower-priced domestic brands as Bud and Bud Light (which are AB InBev brands). The government argues that the merger would likely lessen competition in the market by "increas[ing] the ability of AB InBev and the remaining beer firms to coordinate by eliminating an independent Modelo—which has increasingly inhibited [AB InBev's] price leadership—from the market." These allegations are based on the so-called "coordinated effects" antitrust theory that the merger facilitates the ability of the remaining industry members in a highly concentrated industry to coordinate their conduct post-merger, either implicitly or explicitly in outright collusion.

As with the case filed against Bazaarvoice earlier in the month, the government in the InBev case relies on internal company documents to support its allegations. The complaint has many fewer document quotations, however, so it may be inferred that the Antitrust Division discovered fewer quotable documents during its investigation. Nonetheless, those statements that are included in the complaint go directly to the heart of competition—pricing. The complaint alleges that "Modelo has put 'increasing pressure' on [AB InBev] by pursuing a competitive strategy *directly at odds* with [AB InBev's] well-established practice of leading prices upward." It also notes that AB InBev and MillerCoors "have been forced to offer lower prices and discounts for their brands to discourage consumers from 'trad[ing] up' to Modelo brands." The trial will bring out further evidence, and how the case is tried will likely provide important insights.

Conclusion

Although both the Bazaarvoice and AB InBev cases were only recently filed, the complaints can provide signals about what may attract the attention of antitrust enforcers under the new leadership of AAG Baer. Both matters were no doubt being investigated and developed long before Baer's arrival at the agency, but his willingness to send both litigation teams into court remains a telling factor.

Also, these suits reinforce antitrust advisors' consistent advice that companies need to be careful about what is written in their documents. Company documents are often quoted in government complaints, and executives' words are routinely quoted without full context to create early perceptions in litigation. This cannot be emphasized enough.

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How Should Compensation Committees Engage Compensation Committee Advisors? Very Carefully!

On January 11, 2013, the Securities and Exchange Commission (SEC) approved the proposed listing requirements of the New York Stock Exchange (NYSE) and The Nasdaq Stock Market (NASDAQ), providing compensation committees access to, and funding for, advisors, as well as rules requiring the compensation committee to consider the independence of advisors, heightened independence standards for compensation committee members and, for NASDAQ-listed companies, a new rule requiring the establishment of a compensation committee. The compensation advisor rules generally apply to covered companies on July 1, 2013, while the other compensation committee rules (including the heightened independence requirements) are effective on the earlier of the first annual meeting after January 15, 2014, or October 31, 2014.

These rules are in addition to the rules adopted last year by the SEC, and effective beginning with the 2013 proxy statement, that require companies to disclose conflicts of interest of compensation consultants who play a role in determining or recommending the amount or form of executive or director compensation. Obviously, issues of committee independence and access to and the independence of advisors are key issues for companies in 2013 and beyond.

In our M&A and Corporate Governance Fall 2012 Newsletter, we discussed the proposed listing requirements of both exchanges as originally proposed. Each of the NYSE and NASDAQ amended its original proposal, and such proposals, as so amended, have been approved by the SEC. Now that these new rules are final, there are many questions (discussed below) that companies will need to consider as they gear up to meet the new requirements for access to, and in considering the independence of, any compensation advisor, and the disclosure of conflicts of interests. The process and information gathering will include the committee, other board members and executive officers.

How does a company authorize the committee to retain and provide funding for the compensation advisors?

To the extent that the charter for the compensation committee does not already provide for authority, the board will need to amend the committee's charter to (1) provide the committee with the sole discretion to retain or obtain the advice of compensation advisors and with the direct responsibility for the appointment, compensation and oversight of any such advisors, (2) require that the company appropriately fund any such advisors and (3) clarify that the committee must evaluate the independence of any such advisor prior to selecting or receiving advice from the advisor. The requirement that the charter provide for the compensation committee's duty to evaluate the independence of advisors derives from the recently approved exchange rules, which expressly require that the charter address "the rights and responsibilities of the compensation committee" (NYSE) and the "specific compensation committee responsibilities and authority" (NASDAQ) under the compensation advisor rules.

When do we need to amend the compensation committee charter?

Generally, by July 1, 2013. NASDAQ-listed companies that do not have a compensation committee by that date should provide through board resolutions that the independent directors responsible for executive compensation have the appropriate authority over compensation advisors by July 1, 2013. A formal committee with a written charter is not required for such companies until the earlier of the first annual meeting after January 15, 2014 or October 31, 2014.

Does the committee have to use an outside compensation advisor?

No, the rules do not require committees to use an outside compensation advisor. Historically, however, many committees have used outside consultants for at least some compensation and equity award analysis, and that trend is increasing. Committees now also often retain experienced committee counsel beyond the company's outside counsel or in-house counsel to help the committee understand complex Dodd-Frank requirements as well as tax and securities rules. This may be an appropriate opportunity for the compensation committee to determine (i) whether it needs additional compensation counsel beyond the company's outside counsel or in-house counsel and (ii) whether the committee's current compensation advisors are still effective and suitable.

What new committee requirements are mandated?

The committee must conduct an independence assessment of any compensation consultant, legal counsel or other compensation advisor (with a few exceptions noted below) to consider whether they are independent.

What are the factors that must be considered in the independence assessment?

The rules require the committee to consider six factors: (i) whether the advisor's firm provides other services to the company, (ii) the amount of fees received by the advisor's firm from the company as a percentage of revenue of the advisor's firm, (iii) conflict of interest policies and procedures of the advisor's firm, (iv) any business or personal relationships between the advisor and members of the committee, (v) any stock ownership by the advisor in the company and (vi) any business or personal relationships between the advisor or the advisor's firm and an executive officer of the company. In addition, NYSE requires the committee to consider any other information that would be relevant to the determination of independence.

Companies can expect increased scrutiny from shareholders on the selection criteria for advisors and the process for the committee's assessment of independence.

Does the compensation advisor have to be independent?

No. Although the committee must conduct an independence assessment for all advisors (other than in-house counsel and advisors whose roles are limited as described below), once that determination of independence is made, nothing prevents the committee from using advisors who do not meet the independence test. Conflicts of interest must be disclosed, however, as explained in more detail below. The committee will want to carefully consider and document its independence determinations, as well as its selection of advisors, providing reasons in the minutes as to why the advisor was retained. Companies can expect increased scrutiny from shareholders on the selection criteria for advisors and the process for the committee's assessment of independence. Although only conflicts of interest are required to be disclosed affirmatively, any later challenge to a compensation committee decision will likely raise the issue of the quality and independence of the consultant or advisor.

When should the first independence assessment be conducted?

The exchange rules require an independence assessment commencing effective July 1, 2013. But under the new proxy rule, companies will need to determine any conflicts of interests of compensation consultants in time to have disclosure in proxy statements for annual or special meetings of shareholders at which directors are to be elected on or after January 1, 2013. The work to identify conflicts of interest is similar to the work to determine independence, and so, as a practical matter, the independence assessment will commence for this year's proxy statements.

How often should the independence assessment be conducted?

The SEC has indicated that it anticipates that committees will conduct an independence assessment at least annually.

We have worked with our outside compensation advisor for many years and we know that none of the factors are present—do we still have to go through this assessment process?

Yes, even if the committee thinks it knows the result, it will still need to conduct a full assessment and document the results of the assessment.

Our committee has not retained its own compensation advisor and is comfortable receiving advice from and meeting with the company's outside counsel—do they have to go through this analysis?

The revised rules clarify that the requirements apply to all advisors that provide advice to the committee, even the company's regular outside counsel. There is no independence assessment required for in-house legal counsel.

Are there exceptions for any advisors?

The committee is not required to conduct an independence assessment for a compensation advisor that either: (i) consults on any broad-based, non-discriminatory plan that is generally available to all salaried employees (for example, an advisor on health plans or tax-qualified retirement plans may meet these requirements), or (ii) provides information that is either not customized or is customized based on parameters that are not developed by the advisor or the advisor does not provide advice on those parameters. Also, as noted above, there is no independence assessment required for in-house legal counsel.

Companies will want to scrutinize the advisor's conflict of interest policies and procedures to confirm that these are adequate to flag issues. Further, companies will want to understand the advisor's diligence relating to stock ownership, and business and personal relationships.

The rules require the committee to consider the six factors in assessing independence—how will it obtain the information?

- Companies will want to send a questionnaire to each current compensation advisor to the committee, including current outside counsel to the company that may also provide advice to the committee. The questionnaire should request a response on each of the six factors and ask for any other information that would be relevant to the determination of independence. If you are interviewing potential advisors, or engaging in a Request for Proposal process, using a questionnaire can identify possible issues early in the process.

- Companies will want to scrutinize the advisor's conflict of interest policies and procedures to confirm that these are adequate to flag issues. Further, companies will want to understand the advisor's diligence relating to stock ownership, and business and personal relationships.

- The company or committee will also want to gather information from its board and committee members and executive officers to determine whether any possible conflict factors are present that the advisor has not disclosed. The D&O questionnaire may be the easiest place to gather this information to determine if there are any conflicts. For example, compensation committee members and officers will need to disclose any business or personal relationships they have with the advisor or the advisor's firm. While this requirement does not extend to directors not on the compensation committee, committees of NYSE-listed companies may consider that a relationship with any other director may call into question the advisor's independence. Even though NASDAQ does not require the consideration of information other than the six factors, the committee may want access to this information for all directors, in the event that a change in the composition of the committee is required.

- Designate the responsible party to accumulate and summarize all responses, and the process by which the committee considers the results of the completed questionnaires. The committee may prefer that the advisor whose independence is being considered not be the advisor working with the committee as they consider the retention of advisors. The committee should consider whether the work can be done by the company's outside counsel, in-house counsel, or another employee or advisor.

- Coordinate with all the relevant departments of the company. The human resources department may know if a compensation advisor has advised the company in addition to the committee, and the audit department will be able to verify fees paid to outside providers.

What should we disclose in our proxy statement?

- Under the proxy statement requirements effective for annual or special meetings at which directors are to be elected on or after January 1, 2013, if the work of a compensation consultant raises any conflict of interest, the company must disclose the nature of the conflict and how the conflict is being addressed. Obviously, this disclosure requirement is intended to discourage retaining consultants with conflicts of interest. Such disclosure will receive heightened scrutiny from investors and proxy advisory services.

- Some companies may decide voluntarily to disclose the negative conclusion that the committee has considered the independence factors and has determined that the compensation advisors are independent, and that there are no conflicts of interest identified. ISS and other proxy advisory firms and institutional shareholders may look for this voluntary disclosure. The disclosure confirms that the required due diligence process has been undertaken and completed. Accordingly, given that the diligence is reliant in part on the advisor's own processes, the disclosure carries some risk. Any such disclosure would be subject to the standards under Rule 14a-9 and so must not be false and misleading.

- Shareholders will likely scrutinize the upcoming proxy statement to see if there are relationships with the compensation consultant. This could impact the Say On Pay vote. This scrutiny is even more likely, and may be more exacting, if the shareholders are being asked to approve an equity or bonus plan.

Are any listed companies exempt from the rules?

Yes. Please see our October 9, 2012 client alert.

Finally, here are a few questions for companies establishing a compensation committee for the first time:

What do we do if the company was not previously required to have a compensation committee but now is?

The company will need to establish a committee with a charter consistent with the rules of the applicable exchange and appoint board members who are independent under the relevant rules (as described in our January 18, 2013 client alert) to the committee.

How should the committees be trained?

Boards and compensation committees will want to be sure that the members of the compensation committee receive training and ongoing updates. Such training can be provided by outside counsel, outside compensation advisors, special counsel and in-house counsel. The committee will want to assure monitoring for changes in law and the relevant market rules.

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Be Careful What You Wish For: When Drafting Indemnification Clauses, You May Get Exactly (and Only) What You Ask For

Viacom's purchase of video game developer Harmonix Music Systems serves as a testament to the adage "be careful what you wish for." As shown in *Winshall v. Viacom International, Inc. et al.* (Del. Ch. Dec. 12, 2012), the Chancery Court strictly interpreted indemnification provisions and concluded that Viacom, the potential indemnitee, was only entitled to the remedies expressly stated in the merger agreement. In *Winshall*, the court held that:

- Harmonix's shareholders (collectively, Sellers) made certain representations relating to video games under development as of the merger closing date and were only liable for breach if such representations were untrue as of such date. Consequently, Viacom was not entitled to indemnification for third party claims related to games that were completed post-merger, since Harmonix did not control the late stage development and publication.

- Because Viacom failed to show that Sellers had breached a representation, Viacom was not entitled to defense costs.

- Viacom could not unilaterally extend an escrow period by notifying Sellers of the possibility of a future indemnification claim prior to the expiration of the escrow period.

"It would ... be strange if the Sellers had indemnified Viacom [at the time of acquisition] against intellectual property claims arising out of a future version of Rock Band."

The *Winshall* case stems from the 2006 merger of Viacom and Harmonix. From the $175 million cash consideration, $12 million was placed in escrow to pay indemnification claims arising from losses suffered by Viacom as a result of any breach of Sellers' representations, among other things. In 2008, days before the 18-month escrow period was set to expire, Viacom requested indemnification for legal fees that it incurred in defending against three intellectual property infringement lawsuits related to "Rock Band," a video game under development by Harmonix at the time of the merger. After the escrow period expired, Viacom sought additional indemnification in connection with a fourth intellectual property infringement lawsuit. Sellers rejected Viacom's indemnification requests and, after Viacom refused to release funds from escrow, moved for summary judgment. In its opinion, the Chancery Court granted Sellers' motion on the basis that "Viacom cannot claim indemnification based on representations and warranties that Harmonix made as to the state of its business at the time Viacom bought it, because all of its claims relate to alleged infringements of intellectual property *after* the deal closed."

Date Certain Representations

Viacom alleged that Harmonix breached two representations made under the merger agreement. Harmonix represented that:

- it "ha[d] adequate rights ... as is necessary for the current use" of Harmonix-developed software (Title Representation); and

- "neither the operation of the Business, nor any activity of the Company, nor any manufacture, use, importation, offer for sale and/or sale of any Current Game" constituted a violation of any third party's intellectual property rights (IP Representation).

Title Representation

In response to Viacom's argument that Sellers had breached the Title Representation, the Chancery Court concluded that "it would ... be strange if the Sellers had indemnified Viacom, in 2006, against intellectual property claims arising out of a *future* version of Rock Band," since Sellers had no control over the final development and production of the game. The court emphasized that its conclusion was supported by the text of the representation, which (i) referred to "the current use" of Harmonix-developed software and (ii) used the present tense (i.e., "*has* adequate rights") to indicate that the representation was made as of the closing date.

Viacom's interpretation of the merger agreement ... violated a basic principle of contract interpretation: "where possible, effect is to be given to all terms of the contract."

The court also noted that Viacom sought indemnification based on third party claims made against the final, published version of Rock Band. Viacom did not allege that Harmonix failed to have the necessary rights required to develop the 2006 prototype of Rock Band. As such, the Chancery Court leaves open the possibility that, if Viacom had instead sought indemnification on the grounds that Harmonix did not have all rights as of the closing date, the court may have ruled against Sellers' motion for summary judgment because there was a dispute of fact for trial.

IP Representation

The court's analysis of the IP Representation was bifurcated. First, the court reviewed Viacom's claims that the Business and activities of Harmonix infringed on third-party intellectual property. In the merger agreement, "Business" was defined as "the business of the company *as currently conducted*." Accordingly, the court held that a representation as to the Business was tied to Harmonix's business as of the 2006 closing date. Likewise, the court dismissed Viacom's argument that Harmonix's 2006 activities breached the IP Representation because the infringement lawsuits related to Viacom's 2007 activities (i.e., publication of the Rock Band game).

Second, the court reviewed Viacom's claim that the sale of a Current Game infringed on third-party intellectual property. The court found that Viacom's interpretation of the merger agreement on this issue violated a basic principle of contract interpretation: "where possible, effect is to be given to all terms of the contract." It reasoned that the defined term "Current Game" and the disclosed list of Current Games would be superfluous if the IP Representation was interpreted to cover Harmonix-published software and *future* published games, such as Rock Band.

Legal Fees

Viacom represented that it incurred $28 million in defense costs in connection with the intellectual property infringement lawsuits. It argued that Harmonix was responsible for such costs based on the following provisions of the merger agreement: (i) Viacom had the right to conduct the defense of any indemnification claim "at the expense of the applicable indemnifying parties" and (ii) if Viacom chose not to permit Harmonix to assume the defense, Sellers were obligated to pay "the reasonable fees and expenses of counsel retained by [Viacom]."

However, the Chancery Court noted that such arguments were "out of their contractual and logical context" since such contractual rights were dependent on the existence of a breach of representation. Again, the court emphasized that its conclusion was supported by the text of the indemnification provision, which stated that the defense fees would be paid by the "indemnifying parties." If Viacom failed to show a breach of representation, then Sellers had no duty to indemnify and, therefore, no duty to pay defense costs.

In addition, the court found Viacom's argument "odd" because, if the court accepted the argument, it could result in Sellers being responsible for all defense costs related to the subject matter of Sellers' representations, irrespective of whether Sellers had breached any representation. Moreover, pursuant to Viacom's analysis, Sellers would be responsible for defense costs, which could not be foreseen as of the closing date, a risk that a sophisticated seller would never accept. Accordingly, the court held that "Viacom's argument that the Harmonix stockholders have a duty to pay its defense costs even when there has not been a breach of the representations and warranties in the merger agreement is based on a misreading of the agreement."

Time-Barred

In Viacom's April 2008 notice of the first three infringement lawsuits, it stated that it "reserve[d] the right to seek indemnification for any other claims by [the plaintiffs in the existing infringement lawsuits] or by other third parties that may result due to [Harmonix's] breach of its representations and warranties under the [merger agreement]." Almost three months after the indemnification escrow period expired, Viacom relied on this "placeholder" to seek indemnification for defense costs incurred in connection with a fourth intellectual property lawsuit.

The merger agreement required Viacom to notify Sellers "in writing of such claim" within 18 months of the closing date. In its April 2008 notice, Viacom did not notify Sellers of a *claim*, but rather of a *possibility* of a claim. Accordingly, the Chancery Court rejected Viacom's fourth indemnification request because it was "impermissible" under the terms of the merger agreement and time-barred.

Lessons Learned

The *Winshall* case reminds us of the following lessons in contract drafting and interpretation:

- Carefully review defined terms and provisions that introduce a timing qualifier to confirm that their use throughout the contract reflects the business deal.

- Courts strictly interpret contractual provisions. The mutual agreement among parties as expressed within "the four corners" of the document will prevail over one party's interpretation of the contract absent some ambiguity.

- To successfully claim a breach of representation, the claimant must show that the representation was breached as of the date made. Thus, with respect to representations regarding assets under development at the time of acquisition, a later claim must prove that the representation was breached as of the closing.

- A party cannot unilaterally amend contractual terms if such amendment will adversely affect the other party. In the context of indemnification claims, a party cannot simply extend a specified indemnification period by notifying the other party of the possibility of future claims.

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Offshore Fund Governance: What's on the Horizon?

Background

In January the Cayman Islands regulator outlined plans in the course of a consultation on corporate governance to create a public database of funds domiciled in the Islands for the first time. The database will also list funds' directors, pending an ongoing consultation process due to close in mid-March. As the *Financial Times* noted, this will break with "decades of secrecy by opening thousands of companies and hedge funds domiciled on the offshore Caribbean territory to greater scrutiny."

This is the latest regulatory response to a growing move towards greater accountability and transparency in the governance of offshore funds, and hedge funds in particular. Investors, and among them principally fund of funds investors, have led this drive towards better fund governance.

The turning point came following the Madoff scandal and the case of *Weavering*, where the directors of a Cayman Islands–based hedge fund were found guilty of willful default in the discharge of their duties. Those directors were related to the principal of the fund manager, and completely failed to supervise the activities of the investment manager, who on behalf of the fund had entered into a swap arrangement with a connected party that was significantly overvalued.

It is certainly the case that, on this side of the financial crisis, offshore fund boards are becoming increasingly professional, with individual directors being appointed with risk management, portfolio management, legal and auditing experience, and the majority of whom are independent both of the investment manager and of any other service providers.

From a legal and regulatory perspective, governance of offshore funds is left to local law and legislation. For example, in the Cayman Islands, where most hedge funds are based, there is no requirement to have directors with a particular qualification or expertise (but see the discussion below of the new Cayman Islands proposals). Under the EU's Alternative Investment Fund Managers Directive, the emphasis is on regulation of the manager and indirect regulation of the fund. Except in the case of a self-managed fund, the Directive looks very much to a fund's manager for protection of investors rather than to, in the case of a corporate fund, its board.

It is therefore still up to investors to scrutinize carefully a fund's constitutional documentation and its service provider agreements to assess the appropriate protection that they will receive indirectly as an investor in the fund. Indeed, in the private equity world, detailed negotiation of fund documentation is common and is the route to investor protection.

It is clear also within the industry that managers have different views about fund governance than do investors. Yet they agree that corporate governance centered around independent boards provides for better managed funds, with the role of the board principally being to oversee the implementation of the fund's strategy and the investment manager and the other service providers, and to deal with conflicts of interest.

Recent Changes in Corporate Governance

It is certainly the case that, on this side of the financial crisis, offshore fund boards are becoming increasingly professional, with individual directors being appointed with risk management, portfolio management, legal and auditing experience, and the majority of whom are independent both of the investment manager and of any other service providers. This new breed of director should be able to devote sufficient time and attention to the governance of the fund to satisfy investors' requirements. Apocryphally, there have been stories of fund directors with 500 or more directorships in the past, who, clearly, could never have begun to devote sufficient time to the particular companies of which they were directors.

Investors are now focused on ensuring that directors devote sufficient time to their fund, including ideally attending four board meetings a year, rather than necessarily limiting the number of directorships that they take. Nevertheless, a fund director with more than 30 directorships would find it difficult to devote sufficient time to each of the funds within his or her portfolio, given a working assumption of one working week per fund with time to spare for crises.

Other fund governance developments include requirements by some investors that each director be subject to reappointment every two or three years (or even be subject to a term limit), that annual general meetings be webcast, and that given their increased responsibility in light of today's regulatory environment, directors should be able to command higher fees. Seed investors increasingly expect a fund's service providers, such as administrators, lawyers and auditors, to be names recognized in the industry.

From a legal perspective, directors owe fiduciary duties to the fund's shareholders. Specifically in terms of protecting investors, the expectation of directors is that they will resolve problems and ensure appropriate disclosure to investors, that the fund is run according to its investment strategy and does not suffer from style drift, and that there is no unauthorized profit. In the case of a private equity fund established as a limited partnership, there is an increasingly popular view that the general partner should have independent directors on its board to provide active oversight, to ensure a fair balance and check on the manager.

In terms of the directors' own protection, it is usually the case that the fund's articles of association, in the case of a company, will indemnify the director, and the fund itself will purchase the directors' and officers' insurance, so that (provided the director has acted in the best interests of the fund and has not behaved dishonestly, fraudulently or by way of willful misconduct) he or she will be fully insured and indemnified.

There is also an increasingly popular belief that information about fund directorships should be publicly available, whether required by regulators or otherwise. According to advocates of greater transparency, including major investors in alternative investments, that information should include the number of directorships the individuals hold, the names of the companies on whose boards they sit, biographical information, professional and other qualifications and any regulatory or other sanctions in respect to the individuals.

It is that point in particular that the new Cayman Islands requirements referred to at the beginning of this article address.

Proponents of better corporate governance have banged their drum for much of the past decade, and only now are global developments in this area catching up to their expectations, catalyzed by the financial crisis and some of its scandals.

Cayman Islands Proposals

Within its corporate governance consultation, the Cayman Islands Monetary Authority (CIMA) will require individuals, wherever based, who act as a director of a Cayman Islands fund and do so on a paid basis for six or more entities to be registered with CIMA and hold a license to act as a director. Directors of fewer than six Cayman funds must also be registered if any of those funds is a regulated fund (which most Cayman hedge funds are, albeit lightly). The intention is to "to better design and regulate directorship services" and to provide assurance that directors have a sound financial background and are sufficiently competent and experienced to act in that role.

Echoing the requirements of the advocates of transparency referred to above, registration will entail that a proposed director provide personal and contact details, information regarding the particular role, the director's experience and knowledge of the sector he or she will be overseeing, and information regarding any previous or ongoing regulatory or judicial enforcement action against the director.

These will be significant changes, given that there are currently no qualification, residency or performance requirements for a director of a Cayman Islands hedge fund. It is believed that there are more than 10,000 directors currently serving on Cayman funds, but only around 200 of them are resident in the Cayman Islands.

CIMA has also published guidance on corporate governance. This guidance is a useful summary of the key attributes of corporate governance, and emphasizes that the board is responsible for the effective, prudent and ethical oversight of a fund and for "setting the strategy and risk appetite" of the fund. That is an interesting point, since normally that would be done by the investment manager and approved by the board. Also, CIMA suggests that the role and responsibilities of the board and a conflicts of interest policy should be clearly documented, something that is not necessarily done currently.

To Conclude

Proponents of better corporate governance have banged their drum for much of the past decade, and only now are global developments in this area catching up to their expectations, catalyzed by the financial crisis and some of its scandals. Professional corporate governance of offshore funds has now come of age and the influence of fund managers and promoters is now more effectively checked. We can therefore expect to see fund boards becoming more proactive and inquisitive, and managers challenged more frequently on their strategies and operations.

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Buyer Beware: The Reporting Implications of Buying (and Selling) a Significant Amount of Public Securities

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Sections 13 and 16 of the Securities Exchange Act of 1934, as amended (the Exchange Act), require certain holders of public company securities to file reports with the Securities and Exchange Commission (SEC). These reports range from simple forms that require merely the disclosure of the holder's identity and details around such person's holdings to more complex forms that require, among other things, the source and amount of funds used in purchasing the securities and descriptions of any contracts regarding any securities of the issuer. The deadlines for these forms are often tight, so it is important to understand which forms you may be required to file in order to prepare the form by the deadline.

This article lists each type of security holder that may be required to file a report based on ownership of a public issuer's securities pursuant to Sections 13 and 16 of the Exchange Act and details the deadlines for these forms. The rules pertaining to each report are complex, and this article is only meant to provide a summary of those reports that *may* be applicable to you. If you believe that you may be obligated to file a report summarized in this article, please contact your lawyer for further information.

Significant Beneficial Owners

A Note Regarding Beneficial Ownership

The deadlines for these forms are often tight, so it is important to understand which forms you may be required to file in order to prepare the form by the deadline.

As discussed in more detail below, significant beneficial owners must make filings under Sections 13 and 16 of the Exchange Act. For Section 13 purposes (and for the determination of a 10 percent holder under Section 16), "Beneficial Ownership" has two components: voting power and investment power. Voting power includes the power to vote, or to direct the voting of, the security. Investment power includes the power to dispose of, or to direct the disposition of, the security. Beneficial ownership can be shared by security holders (including through any contracts or arrangements) and can arise directly or indirectly. In addition, when calculating the number of securities beneficially owned, a person must include that person's right to acquire beneficial ownership of that class of securities within 60 days (through, for example, the exercise of an option or a warrant).

The determination of "beneficial ownership" is sometimes a complex determination, subject to specific provisions and interpretations under Rule 13(d)-3. In order to determine whether a security acquisition will trigger one of the detailed filings below, an analysis of what constitutes holder's beneficial ownership must be analyzed in advance of the security acquisition (if possible) or immediately thereafter.

Beneficial Owners of More Than 5 Percent of an Issuer's Securities

A beneficial owner of more than 5 percent of an outstanding class of equity securities of an issuer is required, pursuant to Section 13(d) of the Exchange Act, to file either a Schedule 13D or 13G with the SEC. The Schedule 13G is a short-form statement that certain investors are permitted to use. The Schedule 13D contains significantly more information than the Schedule 13G. Both forms are time-consuming forms to complete, particularly if the reported beneficial ownership chain is complex. If you anticipate that a transaction will result in ownership of more than 5 percent of an outstanding class of equity securities of an issuer, it is best practice to start preparing the form *before* the transaction occurs to have ample time to complete the form.

"Beneficial Ownership" has two components: voting power and investment power.

Determining Schedule 13G Eligibility

In order to qualify to use the Schedule 13G, a holder must fit into an exemption contained in either Rule 13d-1(b), (c) or (d).

Rule 13d-1(b) is the "Institutional Investor" exemption and provides that certain Institutional Investors (defined below) that acquire securities in the ordinary course of its business and not with the purpose nor with the effect of changing or influencing the control of the issuer (nor in connection with or as a participant in any transaction having such purpose or effect) may file a Schedule 13G in lieu of a Schedule 13D; provided that such person promptly notifies any other person on whose behalf it holds, on a discretionary basis, securities exceeding 5 percent of the class, of any acquisition or transaction on behalf of such other person that might be reportable by that person under Section 13(d) of the Exchange Act. "Institutional Investors" include certain (1) broker dealers; (2) banks; (3) insurance companies; (4) registered investment companies; (5) registered investment advisers; (6) ERISA plans; (7) parent holding companies or control persons, provided the aggregate amount held directly by the parents or control persons, and directly and indirectly by their subsidiaries or affiliates that are not persons specified in this list of individuals, does not exceed 1 percent of the securities of the subject class; (8) savings associations; (9) church plans excluded from the definition of investment company; (10) a non-US institution that is the functional equivalent of any of the institutions listed above that is subject to a regulatory scheme that is substantially comparable to the regulatory scheme applicable to an equivalent US institution; and (11) any group whose members are all persons enumerated in this list.

Rule 13d-1(c) is the "Passive Investor" exemption and provides that holders who (1) have not acquired the securities with any purpose, or with the effect, of changing or influencing the control of the issuer (or in connection with or as a participant in any transaction having that purpose or effect), (2) are not an "Institutional Investor" defined in the "Institutional Investor" exemption and (3) are not directly or indirectly the beneficial owner of 20 percent or more of the class may file a Schedule 13G in lieu of a Schedule 13D. The determination of whether an investor is a "passive investor" is based on the specific facts and circumstances of the investment.

Rule 13d-1(d) is the "Exempt Investor" exemption and provides that a person who otherwise was exempt from filing a Schedule 13D, (1) because of an exemption provided by Section 13(d)(6)(A) or (B) of the Exchange Act, (2) because the beneficial ownership was acquired prior to December 22, 1970 or (3) because the person otherwise is not required to file a statement, must file a Schedule 13G with the SEC within 45 days after the end of the calendar year in which the person became obligated to report under this rule. The Section 13(d)(6)(A) or (B) exemptions from beneficial ownership reporting are available for acquisitions of securities that either (1) are made by means of a registration statement under the Securities Act of 1933, as amended or (2) together with all other acquisitions by the same person of securities of the same class during the preceding twelve months, do not exceed 2 percent of that class. This exemption applies to so-called "founders" who hold their securities prior to the company's initial public offering, subject to its conditions.

Schedule 13D Filing Deadlines

The initial Schedule 13D is due within 10 calendar days of becoming a 5 percent or more beneficial holder.

Amendments to Schedule 13Ds must be filed "promptly" after a material change occurs to the facts submitted in the previously filed schedule. While the determination of what constitutes a "material" change is based on the facts and circumstances of the transaction, the SEC deems acquisitions or dispositions of beneficial ownership equal to 1 percent or more of the class of securities as "material." In addition, while "promptly" has not been defined by the SEC and depends upon the facts and circumstances of the acquisition or disposition, in the case of a change of beneficial ownership equal to 1 percent or more of the class of securities the SEC has taken the position that "promptly" means "within 1 business day." For all other instances, "promptly" is generally interpreted by practitioners as "within 10 days." As with the original Schedule 13D filing, it is best practice to start preparing the amendment *before* the material change occurs to have ample time to complete the form.

Schedule 13G Filing Deadlines

The deadlines for the initial Schedule 13G filing is based on which exemption the holder claimed in order to be able to file a Schedule 13G.

- For holders relying on the Institutional Investor exemption or the Exempt Investor exemption, the initial Schedule 13G is due within 45 days after the end of the calendar year that the holder first became obligated to make a filing; however, if the beneficial ownership of a holder relying on the Institutional Investor exemption exceeds 10 percent of the class of securities during that triggering calendar year before the initial Schedule 13G is filed, it must file a Schedule 13G within 10 days after the end of the first month in which its interest exceeded 10 percent.

- For holders relying on the "Passive Investor" exemption, the initial Schedule 13G must be filed within 10 days after the acquisition of more than 5 percent of a class of securities.

Amendments to Schedule 13Gs to report any changes to information reported in a prior schedule must be filed within 45 days after the end of the calendar year. In addition to this annual amendment, (1) for filers relying on the "Institutional Investor" exemption, amendments must be filed within 10 days after the end of the month that their aggregate beneficial ownership exceeded 10 percent of the class of securities as computed on the last day of that month; and (2) for filers relying on the "Passive Investor" exemption, amendments must promptly be filed when their aggregate beneficial ownership exceeds 10 percent of a class of equity securities, without regard to the end of the calendar month. As with the Schedule 13D, while "promptly" has not been defined by the SEC and depends upon the facts and circumstances of the acquisition or disposition, in the case of a change of beneficial ownership equal to 1 percent or more of the class of securities the SEC has taken the position that "promptly" means "within 1 business day." For all other instances, "promptly" is generally interpreted by practitioners as "within 10 days. For these "Institutional Investors" and "Passive Investors," once their ownership exceeds 10 percent and triggers this amendment they must continue to make amended filings (with the same deadlines described in the preceding sentence) any time their beneficial ownership increases or decreases by 5 percent.

Beneficial Owners of More Than 10 Percent of an Issuer's Securities

As discussed above, a beneficial owner of more than 5 percent of an outstanding class of equity securities of an issuer is required, pursuant to Section 13(d) of the Exchange Act, to file either a Schedule 13D or 13G with the SEC; however, a beneficial owner of more than 10 percent of an issuer's securities is also required, pursuant to Section 16 of the Exchange Act to file Forms 3, 4 and/or 5 with the SEC.[1]

Upon acquiring Section 13 "Beneficial Ownership" (as discussed above) of more than 10 percent of an issuer's securities, the holder has 10 calendar days to file a Form 3 with the SEC. However, a 10 percent or more beneficial owner of an issuer that is registering securities for the first time under Section 12 of the Exchange Act must file the Form 3 no later than the effective date of the registration statement.

Whenever such holder has a change in beneficial ownership (for example, the holder sells securities of the registrant or exercises a derivative security), the holder will be required to file a Form 4 with the SEC by the second business day following the day on which a transaction resulting in a change in beneficial ownership has been executed.

The holder will also be required to file a Form 5 annually with the SEC by the 45th day after the end of the issuer's fiscal year *if* there was a change in the holder's beneficial ownership during the course of the fiscal year that was not reported on a Form 4 (either because it was incorrectly omitted or because it was not required to be reported on a Form 4). For example, purchases of company equity securities in one or more transactions in a total amount that is less than $10,000 do not need to be reported on a Form 4. Instead, the holder can wait until the end of the year to report those transactions on a Form 5 (note, however, that a Form 5 will not be required if all transactions otherwise required to be reported therein have already been reported).

While Section 13 "Beneficial Ownership" of more than 10 percent of an issuer's securities triggers these Section 16 filings, note that a beneficial owner does *not* report its Section 13 "Beneficial Ownership" in these filings under Section 16! Instead, pursuant to Rule 16a-1(a)(2), in Section 16 filings the beneficial owner reports its pecuniary interest (or economic interest) in the issuer's securities or, put another way, such owner's right to receive or share in, directly or indirectly, profits from a transaction in the securities. For example, a person's interest in securities held by a trust and a general partner's proportionate interest in the portfolio securities held by a general or limited partnership are considered indirect pecuniary interests in the underlying securities and must be reported on Forms 3, 4 and 5.

If a person has beneficial ownership in securities, but not a pecuniary interest, those securities would be included in the determination of the person's Section 13 "Beneficial Ownership" and would be reported on a Schedule 13D or 13G, but would not be reported on Forms 3, 4 and 5. For example, if Person A is party to a voting agreement with Person B, Person A may be deemed a beneficial holder of the securities held by Person B because Person A has voting control over those securities; however, since Person A has no pecuniary interest in those securities, those securities would not be included in Person A's Forms 3, 4 and 5 filings.

Although Forms 3, 4 and 5 are short forms, because of the very short deadline for Form 4 (two business days), it is important that the holder is aware of its reporting obligation before or at the time of the triggering event so that it has ample time to prepare and file the form.

Institutional Investment Managers Exercising Discretion More Than $100 Million of Securities

An institutional investment manager that exercises investment discretion over $100 million or more in Section 13(f) securities (explained below) must, pursuant to Section 13(f) of the Exchange Act, file a Form 13F with the SEC within 45 days of the end of a calendar quarter.

The SEC deems the following persons "institutional investment managers": (1) an entity that invests in, or buys and sells, securities for its own account; or (2) a natural person or an entity that exercises investment discretion over the account of any other natural person or entity. Institutional investment managers can include investment advisers, banks, insurance companies, broker-dealers, pension funds and corporations.

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[1] Directors and officers of public companies are also required to file Forms 3, 4 and 5 with the SEC *regardless of whether they own any securities of such company*.

Section 13F securities generally include equity securities that trade on an exchange (including the Nasdaq National Market System), certain equity options and warrants, shares of closed-end investment companies and certain convertible debt securities. Shares of open-ended investment companies (mutual funds) are not Section 13F securities. The SEC publishes a list of Section 13F Securities quarterly on its website at www.sec.gov/divisions/investment/13flists.htm.

Large Traders

An individual or entity who, directly or indirectly, exercises investment discretion over one or more accounts and effects transactions for the purchase or sale of specified exchange-listed securities, by or through one or more registered broker-dealers, in an aggregate amount equal to or greater than (1) two million shares or $20 million during any calendar day or (2) 20 million shares or $200 million during any calendar month, must, pursuant to Section 13(h) of the Exchange Act, file a Form 13H with the SEC "promptly" after the "Large Trader" effects aggregate transactions at or above these trigger levels. "Promptly" has not been defined by the SEC, but is generally interpreted as "within 10 days." If you anticipate that a transaction will result in you being classified as a Large Trader, it is best practice to start preparing the form *before* the transaction occurs to have ample time to complete the form.

The SEC will assign to each Large Trader a unique identification number, which Large Traders must provide to their broker-dealers who will be required to maintain transaction records and report such information to the SEC upon request.

Once a person files a Form 13H as a Large Trader, it will be required to file an Annual Filing on Form 13H within 45 days after the end of each full calendar year. If any of the information contained in a Form 13H filing becomes inaccurate, a Large Trader must file an amended filing no later than promptly following the end of the calendar quarter in which the information became stale. If, during a full calendar year, a Large Trader has not effected aggregate transactions in an amount equal to, or greater than, the threshold identifying the activity level, the Large Trader can file for "Inactive Status" through a Form 13H submission. A person on Inactive Status who effects aggregate transactions that are equal to or greater than the identifying activity threshold must file a "Reactivated Status" Form 13H promptly after effecting such transactions. In certain circumstances, a person may also file a "Termination Filing" if such person has terminated its operations and has no chance of re-qualifying for large trader status.

It is important that Edgar codes are applied for as soon as you become aware that a report may be due with the SEC.

A Note Regarding Edgar Filing Codes

The reports discussed in this article generally must be filed on the SEC Edgar system. In order to file a report on Edgar, the filer must have Edgar codes. To obtain Edgar codes, the filer must file a Form ID with the SEC. Once the form is completed and signed, it is submitted to the SEC. The SEC can take as little as 24 hours to provide a code after a Form ID application is properly submitted. But, if there are issues with the application, this process can take longer. Not having an Edgar code will not extend the deadlines for a report. Therefore, it is important that Edgar codes are applied for as soon as you become aware that a report may be due with the SEC. If you already have Edgar codes because you previously filed a beneficial ownership report with the SEC and you lose them, you cannot apply for new codes. There is a separate process to obtain lost codes (which will also take time). Please note, the password used with a filer's Edgar codes will need to be changed annually.

Conclusion

The reporting process for holders of public company securities is not necessarily a hard or difficult process if a holder is aware of what reports it has to file and the time in which the forms are due. Problems arise when a holder is unaware of its reporting requirements until after the reporting trigger occurs, resulting in the holder having to scramble to meet the reporting deadline. If you own, or anticipate that you will own as a result of a transaction, a significant number of public company shares, and think you may have reporting obligations as discussed in this article, we would be happy to discuss with you the reports and to plan for these filings so they are made as efficiently as possible.

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2013 Changes to ISS and Glass Lewis Proxy Voting Policies

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The proxy advisory firms Institutional Shareholder Services (ISS) and Glass Lewis have both made important revisions to their 2013 proxy voting policies. The voting recommendations of these proxy advisors often influence the outcome of shareholder voting. For example, statistics show that in 2012, shareholder support was approximately 30 percent lower at companies that received a negative ISS recommendation. It is important for companies to understand the 2013 policy changes and the practical impact they will have on the proxy advisors' recommendations.

Board Responsiveness

ISS: Currently, ISS may recommend a vote against the *entire* board of directors if ISS determines that the board failed to act on a shareholder proposal. Beginning in 2014, ISS may also provide focused votes against *individual* directors or committee members. Further, ISS is broadening its view of when, and to what extent, board response is required. ISS may view a board as non-responsive if it fails to act on a shareholder proposal that receives a majority of shares cast (rather than shares outstanding) at a single meeting (rather than requiring repeated failures to act). When a board responds to a shareholder proposal with less than full implementation, ISS will consider on a case-by-case basis whether the board's actions constitute a "failure to act." ISS will take into account factors such as the subject matter of the proposal and the level of outreach by the board to shareholders following the vote.

Glass Lewis: The new board responsiveness guidelines at Glass Lewis extend to situations where 25 percent or more shareholders vote: (1) against a management recommendation on any proposal or (2) in favor of any shareholder proposal. The previous policy only measured board responsiveness in situations where shareholders voted at those levels against say-on-pay proposals.

Implications for you: To avoid being caught in a negative vote, engaging with shareholders in the face of a proposal and implementing effective proxy solicitation efforts will become even more important. If a shareholder proposal receives enough votes to trigger scrutiny by either ISS or Glass Lewis, a company may want to carefully consider the implications of inaction when determining whether and how the proposal should be implemented. The boards will also want to clearly state in the periodic filing (e.g., a Form 8-K or following year's proxy statement) how they have responded to shareholder proposals.

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Peer Group Methodology

ISS: Discarding their prior practice of assigning a company to a peer group based on the company's six-digit Global Industry Classification Standard (GICS) industry group, ISS will now consider a number of factors in selecting peer groups, including a company's self-selected peer group, together with a more defined eight-digit GICS industry group. ISS will prioritize peers that (1) maintain the company near the median of the peer group, (2) are in the company's self-selected peer group and (3) have chosen the company as a peer.

Glass Lewis: When determining peer groups, Glass Lewis, in addition to continuing its practice of considering (1) enterprise value, (2) two-digit GICS classification, (3) eight-digit GICS classification and (4) geography, will now also consider the company's self-selected peers and the peers disclosed by the company's self-selected peers.

Implications for you: First, be sure to choose carefully a self-selected peer group that reflects the most important aspects of your company as nearly as possible, including financial metrics that perform similarly to those of your company. Second, review your existing compensation disclosure as compared to the new peer group. Continue to monitor peer group selections and keep track of those companies that choose yours as a peer. Third, update ISS and Glass Lewis promptly when you make changes to your peer group.

Pay-for-Performance

ISS: To address the lack of uniformity among methodologies used to calculate realized pay, ISS will incorporate a comparison of realizable pay to grant-date compensation for large cap companies.

Implications for you: Although ISS has not yet released details on how exactly it will perform these calculations, companies may want to attempt to analyze their realizable pay levels using ISS's definition in order to determine how it will affect the qualitative assessment of the company. Companies may also want to monitor ISS reports as the firm begins implementing the new policy.

Say-on-Golden Parachutes

ISS: ISS will continue to analyze advisory votes on golden parachutes on a case-by-case basis, but will no longer grandfather legacy change-in-control severance agreements.

Implications for you: Companies may want to review current change-in-control agreements, including ones already in existence, to assess possible vulnerabilities under ISS's new policy, and consider drafting future employment agreements to omit provisions that ISS views as problematic. Renewals of employment agreements may permit an opportunity to review problematic provisions.

Be sure to choose carefully a self-selected peer group that reflects the most important aspects of your company as nearly as possible, including financial metrics that perform similarly to those of your company.

Hedging and Pledging of Company Stock by Directors and Executives

ISS: ISS will recommend a negative vote for a director reelection if the director has hedged *any* amount of company stock. ISS will also consider a negative recommendation at companies where there has been a "significant" amount of stock pledging. In making its determination of whether to recommend a negative vote, ISS will consider multiple factors, including the aggregate pledged shares in terms of total common shares outstanding and efforts and policies to restrict stock pledging.

Implications for you: Companies may want to consider ways to implement pledging and hedging prohibitions or limits. Companies that already have these prohibitions or limits in place may want to review and strengthen them and disclose such policies in their proxy statements.

"Overboarding" Methodology

ISS: For the purpose of counting the number of boards on which individual directors sit, ISS will now consider all publicly traded subsidiary boards as separate from the boards of their parent companies. Previously, a parent company and its publicly traded subsidiary were counted as a single board. ISS will recommend a vote against a director who sits on more than six public company boards.

Glass Lewis: When a director who serves as an executive officer of a public company also serves on more than two other public company boards, Glass Lewis will recommend a vote against that director at the other public companies where he or she serves on the board, but not at the company where he or she is an executive officer.

Implications for you: Companies should consider reviewing their D&O Questionnaires for clarity to insure that directors are providing complete information about their board commitments and the new methods for counting public companies.

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