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## SEC Issues Guidance on Cybersecurity Disclosures



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On October 13, 2011, the Securities and Exchange Commission (SEC) released guidance regarding disclosure obligations of public companies relating to cybersecurity risks and cyber incidents.

The SEC noted that as companies have become more dependent upon digital technologies, the risks relating to cybersecurity have also increased, resulting in more frequent and severe cyber incidents. Examples of these incidents include gaining unauthorized access to digital systems for purposes of misappropriating assets or sensitive information, corrupting data or causing operational disruption, and causing denial-of-service attacks on Web sites. Companies may incur substantial costs and suffer other negative consequences, such as remediation costs, increased cybersecurity protection costs, lost revenues, litigation, and reputational damage.

Public companies have the obligation to provide disclosure of timely, comprehensive, and accurate information about risks and events that a reasonable investor would consider important to an investment decision. The SEC's guidance covers a number of existing disclosure requirements that may impose an obligation on registrants to disclose risks and incidents relating to cyber issues and does not create new disclosure rules or categories. The SEC noted that material information regarding cybersecurity risks and cyber incidents is required to be disclosed when necessary in order to make other required disclosures, in light of the circumstances under which they are made, not misleading.

The SEC acknowledged that companies may have concerns that detailed disclosures on these issues would compromise cybersecurity efforts; for example, disclosures could provide a "roadmap" to those seeking to infiltrate a company's network. The SEC emphasized that such disclosures are not required.

The following is a summary of the SEC's guidance:

### RISK FACTORS

Companies should disclose the risk of cyber incidents if these issues are among the most significant factors that make an investment in the company risky. As with other potential risk areas, companies should evaluate their cybersecurity risks and take into account all available relevant information, including prior cyber incidents and the severity and

frequency of those incidents. In addition, companies should consider the probability of future cyber incidents occurring and the potential magnitude of those risks. The specific factors described in risk factors covering cybersecurity risks will vary depending on each company's particular risks, but companies should not include risk factors that could apply to any issuer or any offering and should avoid generic risk factor disclosure.

### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (MD&A)

The MD&A section should address cybersecurity risks and cyber incidents if the costs or other consequences associated with known incidents or the risk of potential incidents represent a material event, trend, or uncertainty that is reasonably likely to have a material effect on the company's results of operations, liquidity, or financial condition or would cause reported financial information not to be necessarily indicative of future operating results or financial condition.

### DESCRIPTION OF BUSINESS

A company should include disclosure regarding cyber incidents in its "Description of Business" section if cyber incidents materially affect the company's products, services, relationships with customers or suppliers, or competitive conditions.

### LEGAL PROCEEDINGS

A company would need to disclose information regarding any material pending legal proceeding that involves a cyber incident.

### FINANCIAL STATEMENT DISCLOSURES

A company's financial statements may be impacted by cyber risks and incidents in various ways. For example, a company may need to incur costs to prevent or remediate cyber incidents, and in some cases provide customers with incentives to maintain business relationships following a cyber incident. Cyber incidents may result in losses from claims, such as warranty, breach

of contract, product recall and replacement, and indemnification. Companies would need to provide disclosures relating to losses from asserted and unasserted claims that are reasonably possible. Cyber incidents may result in diminished future cash flows, which would require a company to consider impairment of certain assets, and companies may be required to make estimates of costs of the impact of a cyber incident before those costs are fully known. Finally, companies should consider whether subsequent event disclosure of a cyber incident that occurs after the date of the financial statements is necessary.

### DISCLOSURE CONTROLS AND PROCEDURES

Companies are required to disclose their conclusions on the effectiveness of disclosure controls and procedures on a quarterly basis. If cyber incidents create a risk to the company's ability to record, process, summarize, and report information that is required to be disclosed in SEC filings, there may be deficiencies in the disclosure controls and procedures that would render them ineffective, which the company would need to disclose.

### ONGOING DISCLOSURE

A company with an effective shelf registration should consider whether material cyber incidents would need to be disclosed on a Form 8-K (or Form 6-K, in the case of foreign issuers) in order to maintain the accuracy and completeness of the information in the shelf registration statement.

### CONCLUSION

Going forward, public companies should review, on an ongoing basis, the adequacy of their disclosure relating to cybersecurity risks and cyber incidents. Please contact a member of our Securities Group for further information.

*Alexander Rosenstein is a shareholder in the Corporate and Securities Groups and co-chair of the Media and Entertainment Group.*

## SEC Approves New Rules Regarding Listing Standards for Reverse Merger Companies



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On November 9, 2011, the Securities and Exchange Commission (SEC) approved new rules of the New York Stock Exchange (NYSE), the NYSE Amex Exchange

(Amex), and NASDAQ that toughen the standards that companies that have gone public through a reverse merger must meet to become listed on those exchanges.

In a reverse merger, a private operating company merges with an existing public reporting shell company, resulting in the operating company becoming a public reporting company without having conducted a traditional initial public offering. Previously, companies that go public through a reverse merger can apply for listing on a stock exchange, provided they meet the exchange's initial listing standards applicable to all companies seeking initial listing. Under the new rules, NYSE, Amex, and NASDAQ will impose more stringent listing requirements for companies that become public through a reverse merger than the current rules require. Specifically, under the new rules, a reverse merger company must wait to apply for a listing until:

- The company has completed a one-year "seasoning period" by trading in the U.S. over-the-counter market or on another regulated U.S. or foreign exchange following the reverse merger.
- The company has timely filed all required reports with the SEC, including at least one annual report containing audited financial statements for a full fiscal year commencing on a date that is after the date of filing all information required to be filed about the reverse merger.

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SEC APPROVES NEW RULES  
REGARDING LISTING STANDARDS  
FOR REVERSE MERGER COMPANIES  
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- The company has maintained the requisite minimum share price (\$4 for NYSE and NASDAQ, and either \$2 or \$3 for Amex, depending on the applicable standard under which listing is sought) for a sustained period, but in no event less than 30 of the last 60 trading days, immediately prior to its listing application and the exchange's decision to list the company's shares.

In addition, the NYSE and Amex rules give those exchanges the discretion to impose more stringent listing requirements in the case of a particular company if there is an inactive trading market in the company's securities, there is a low number of publicly held shares that are not subject to transfer restrictions, the company has not had a Securities Act registration statement subject to a comprehensive SEC review, or the company has disclosed that it has material weakness in its internal controls that have been identified by management and/or the company's independent auditors but the company has not yet implemented an appropriate corrective action plan.

A reverse merger company generally would be exempt from these special requirements if it is listing in connection with a substantial firm commitment underwritten public offering with proceeds to the company of at least \$40 million, or if it has filed with the SEC at least four annual reports with audited financial information as of the application for listing.

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## Exclusive Forum Selection Clauses



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Most press releases announcing that a public company has entered into an agreement to sell the company are quickly followed by press releases from various plaintiffs' law firms announcing "investigations" of potential claims on behalf of target company shareholders of breach of fiduciary duty and/or lack of adequate disclosure. The competition among plaintiffs' law firms to be lead counsel often results in several lawsuits being filed in multiple jurisdictions. Corporations should consider amending their articles of incorporation or bylaws to require that any shareholder lawsuits alleging derivative or breach of fiduciary claims be brought in the jurisdiction of the company's incorporation. Although the enforceability of such exclusive forum selection clauses is not yet well-established, there appears to be little downside risk of their adoption.

An exclusive forum clause is a provision in the company's articles of incorporation or bylaws that requires any lawsuit against the company or its directors or officers alleging a breach of fiduciary duty, or shareholder derivative suit on behalf of the company, to be brought in the state of the company's organization unless the company otherwise consents. Regardless of where incorporated, a requirement that such lawsuits be brought in the state of incorporation should result in more efficient coordination and possible consolidation of such cases in a court familiar with the applicable corporate law. For companies organized in Delaware, the Chancery Court's expedited procedures and (at least perceived) unwillingness to award attorneys' fees for meritless claims is another advantage.

Exclusive forum selection clauses that are contained in the company's articles of incorporation should be enforceable on the theory that each shareholder is deemed to have accepted the provisions thereof. An exclusive forum selection clause should be on any company's pre-IPO (initial public offering) checklist for consideration. After a company is publicly traded, it will be more difficult to amend its articles of incorporation to add such a provision. Although the New York Stock Exchange treats adoption of an exclusive forum selection clause as a routine matter upon which broker-nominee holders may vote without receiving specific direction from beneficial owners, Institutional Investors Services will not recommend in favor of such a clause unless it is coupled with the adoption of various other unrelated corporate governance "best practices." Thus it is not a foregone conclusion that an exclusive forum selection clause will receive shareholder approval, and results among public companies proposing adoption of such provisions in 2011 has been mixed.

On the other hand, adding a forum selection clause to the company's bylaws is normally easy because most bylaws provide that they may be amended by the board of directors without shareholder approval. However, the enforceability of an exclusive forum selection clause added to the company's bylaws without shareholder approval is less clear. A Federal District Court in California refused to enforce such a bylaw provision adopted by Oracle's board of directors. However, the court noted that the bylaw provision was adopted after the alleged breach of fiduciary duty and abuse of control by the same directors accused of such misconduct. Therefore, exclusive forum selection clauses added to the company's bylaws without shareholder approval may still be effective on a prospective basis.

Because shareholder lawsuits challenging a corporate sale transaction have become routine, companies should consider adding an exclusive forum selection provision to their articles or bylaws before becoming involved in any sale or other change of control transaction. Such a provision should minimize the costs and distraction that multiple shareholder lawsuits in numerous different jurisdictions can create.

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# SEC Provides New Guidance on Rule 14a-8 Shareholder Proposals



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**O**n October 18, 2011, the Securities and Exchange Commission (SEC) issued Staff Legal Bulletin No. 14F (the Bulletin), which provides guidance on issues arising under Rule

14a-8 of the Securities Exchange Act of 1934. Rule 14a-8 contains guidelines for the submission of security holder proposals to be considered at public company shareholder meetings, including shareholder eligibility to submit proposals and the form, content, and procedures for submission of such proposals. The Bulletin clarifies the SEC staff's view on who constitutes a record holder for purposes of submitting proposals, provides guidance to shareholders on submission of revised proposals and common errors that shareholders can avoid in presenting proof of ownership to companies, and introduces the new process by the SEC's Division of Corporation Finance (the Division) for transmitting Rule 14a-8 no-action responses by email.

## RECORD HOLDER GUIDANCE

Under Rule 14a-8, a shareholder is eligible to submit a shareholder proposal if the shareholder has continuously held at least \$2,000 in market value or 1 percent of the company's securities entitled to be voted at the shareholder meeting for at least one year as of the date the shareholder submits the proposal, and must continue to hold the securities through the date of the meeting. The shareholder must also provide the company with a written statement of the shareholder's intent to hold the securities through the date of the meeting. Most public company shareholders hold shares in "street name," meaning that shares are held in book-entry form through a broker or bank. Rule 14a-8 provides that a beneficial owner can show proof of ownership by giving a written statement from the record holder of the shares verifying that the street name holder held the required number of shares continuously for at least one year.

Most brokers and banks deposit clients' shares with and hold shares through the Depository Trust Company (DTC), which is a clearing agency that acts as a securities depository. The names of brokers and banks, often referred to as "participants" in DTC, do not appear as the record holders of the shares deposited with DTC; rather, DTC's nominee, Cede & Co., appears on the shareholder list as the sole record holder of such shares. A company can request a "securities position listing" from DTC in order to identify which brokers and banks have a position in the company's securities as of a specific date. The bifurcated ownership structure can sometimes be confusing to a street name holder seeking to prove ownership in connection with submission of a shareholder proposal.

To further complicate the record holder issue, there are frequently two types of brokers that engage with street name holders. An "introducing broker" engages in sales and related activities that involve direct contact with clients, such as accepting orders and opening trading accounts. Introducing brokers are not permitted to maintain custody of client funds and shares, and thus engage another broker—a "clearing broker"—to maintain custody of funds and shares and execute trades. Introducing brokers generally are not DTC participants; clearing brokers generally are DTC participants.

Prior SEC staff guidance indicated that introducing brokers could be considered record holders for the purpose of verifying street name shareholder ownership and required companies to accept proof of ownership from brokers and banks in cases where the company could not verify ownership positions against DTC's securities position listing. The Bulletin reverses the prior guidance and establishes that, for Rule 14a-8 purposes, only DTC participants such as clearing brokers should be viewed as record holders of securities deposited at DTC. The Bulletin reiterates the SEC staff's view that a street name holder need not obtain proof of ownership from DTC or Cede & Co. in addition to proof of ownership from the DTC participant broker or bank.

## SUBMITTING REVISED PROPOSALS AND AVOIDING COMMON ERRORS

The Bulletin also provides guidance on procedures for shareholders to follow in submitting revised proposals to the SEC and avoiding common proposal submission errors. Under Rule 14a-8, in order for a shareholder proposal to be included in the company's proxy statement for the shareholder meeting, the shareholder must submit the proposal "timely," generally defined as not less than 120 calendar days before the one-year anniversary of the company's prior-year proxy statement mailing date. The Bulletin clarifies that if a shareholder submits a timely proposal and then submits a revised proposal that is also timely, the company must accept the revised proposal. The first proposal is deemed effectively withdrawn. Conversely, if a shareholder submits a timely proposal and then submits a revised proposal that is not timely, the company is not required to accept the revised proposal and can instead submit a no-action letter to the SEC stating its intention to exclude the proposal as untimely. The company can also choose not to accept the revised proposal and try to exclude the initial proposal by submitting a no-action letter to the SEC with its reasons for excluding the initial proposal. In the case of any revised proposal, the proponent must prove share ownership as of the submission date of the initial proposal.

With regard to avoiding common errors, the Bulletin highlights two frequently seen errors made by shareholders in submitting proof of ownership to companies. First, many shareholders fail to verify the shareholder's beneficial ownership of company stock for the entire one-year period preceding and including the submission date of the proposal. In some cases, the proof of ownership speaks as of a date before the proposal is submitted, leaving a gap of time prior to the submission date, and in other cases it speaks as of a date after the proposal is submitted, in some cases failing to comply with the one-year continuous holding period prior to the submission date. Second, many shareholders fail to satisfy the proof of continuous ownership requirement because

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## SEC PROVIDES NEW GUIDANCE ON RULE 14A-8 SHAREHOLDER PROPOSALS CONTINUED

the shareholder includes a broker letter that shows beneficial ownership only as of a specific date, but omits any reference to continuous ownership for a one-year period.

### EMAIL TRANSMISSION OF NO-ACTION RESPONSES

Finally, the Bulletin outlines the Division's new process for transmitting copies of Rule 14a-8 no-action letter responses by email. Previously, the Division transmitted its responses to no-action letter requests by U.S. Mail to companies and proponents. Going forward, the Division intends to transmit Rule 14a-8 no-action responses by email and encourages companies and proponents to include email contact information in any correspondence to the Division and to each other. In cases where email contact information is not given, the Division will provide a response through the U.S. Mail. The SEC will also post the Division's response and the related correspondence to the SEC's Web site shortly after issuance of the response.

#### TAKEAWAY

While the Bulletin is mostly applicable to shareholders, most notably brokers and banks, companies should be aware of its impact on the shareholder proposal process. The reversal of prior guidance regarding introducing brokers provides another avenue for companies to pursue in seeking to exclude shareholder proposals, if the proponent provides proof of ownership through an introducing broker. Also, companies should be aware of the Division's preference for email going forward and provide email contact information in any Rule 14a-8 correspondence with the Division. ♦

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## Update on the Ever-developing Landscape of Shareholder Proposals

On September 15, 2011, the Securities and Exchange Commission (SEC) issued a final rule to adopt amendments to the proxy access rules for shareholder proposals in Rule 14a-8, which was discussed in our September 2011 issue of FredNEWS: Corporate & Securities. In a related action, on September 27, 2011, the SEC published an amended Form 8-K that includes a new Item 5.08 requiring, in certain circumstances, companies to disclose applicable deadlines for shareholders to submit proxy access proposals. On November 17, 2011, Institutional Shareholder Services, Inc. (ISS) published its 2012 Corporate Governance Policy Updates and Process Executive Summary, which refined how it will address proxy access, among other policy changes.

### SEC ADOPTS NEW FORM 8-K RELATING TO PROXY ACCESS PROPOSALS

SEC Rule 14a-8 describes the SEC's requirements for shareholders of a public company to propose procedures to permit nomination of directors under the company's organizational documents or applicable state or foreign law. These procedures include the filing on Schedule 14N of a notice of the shareholder's desire to include one or more proposals in the company's proxy materials. If the company did not hold an annual shareholders meeting in the previous year, or if the meeting date changed by more than 30 days from the previous year, Item 5.08 of Form 8-K requires the company to provide the date on which a shareholder must submit the Schedule 14N. The Form 8-K with the Item 5.08 information must be filed within four business days after the company determines the anticipated annual meeting date.

Going forward, companies subject to shareholder proxy access procedures under their organizational documents or applicable state or foreign law should monitor their annual meeting dates to ensure that timely Form 8-K filings are made, if necessary.

### ISS SHAREHOLDER PROPOSAL POLICY FOR THE 2012 PROXY SEASON

ISS has indicated it will continue to take a case-by-case approach in evaluating shareholder and management proposals. It will consider company-specific factors and proposal-specific factors, including: (1) the ownership thresholds proposed in the resolution (i.e., percentage and duration); (2) the maximum proportion of directors that shareholders may nominate each year; and (3) the method of determining which nominations should appear on the ballot if multiple shareholders submit nominations. ISS analysts will begin applying the updated policy to all publicly traded companies with shareholder meetings on or after February 1, 2012. For more information on the ISS policy updates (including changes in the methodology for evaluating pay-for-performance, treatment of low shareholder support for management's say-on-pay proposals, treatment of say-on-frequency periods that were supported by less than a majority of shareholders, and support of political spending proposals), visit ISS' Web site (<http://www.issgovernance.com>) under its Policy Gateway.

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