Snell & Wilmer


# CORPORATE COMMUNICATOR


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**WINTER 2012**

## 2012 Annual Meeting Season

Dear clients and friends,

We present to you our traditional year-end issue of Snell & Wilmer's *Corporate Communicator* to help you prepare for the upcoming annual report and proxy season. This issue highlights key SEC reporting and corporate governance considerations that will be important during this annual meeting season as well as in the upcoming year. In this issue, we are including our customary articles on recent SEC, NYSE/Nasdaq and general corporate law developments. We believe this year companies will continue to see investors focus on executive compensation (say on pay) and the SEC will continue its focus on "trend" disclosures in MD&A relating to loss contingencies and other aspects of a company's business.

In this issue, we also bring you an article on the latest developments relating to Dodd-Frank's whistleblower rules (aka the Federal government's bounty program), an insightful piece addressing social media considerations in the securities and investor relations arena and a brief overview about the California Transparency in Supply Chains Act of 2010.

During 2012, members of our Business & Finance Group will continue to publish the Corporate Communicator, host business presentations, participate in seminars that address key issues of concern to our clients and sponsor conferences and other key events. First on the calendar is our Fourth Annual Public Company Proxy Season Update, which will be held in our Phoenix office on January 12, 2012. Finally, we are pleased to present our 2011 Tombstone, which highlights selected deals that Snell & Wilmer's Business & Finance Group helped our clients close during the year. As always, we appreciate your relationship with Snell & Wilmer and we look forward to helping you make 2012 a successful year.

Very truly yours,
Snell & Wilmer L.L.P.
Business & Finance Group

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## RECENT BUSINESS & FINANCE TRANSACTIONS

### Debt Offerings and Credit Agreements

- Swift — **$250 million** *Receivables Securitization*
- DriveTime — **$140 million** *Inventory Facility*
- DriveTime — **$215 million** *2011-1 Securitization*
- DriveTime — **$250 million** *2011-2 Securitization*
- DriveTime — **$250 million** *2011-3 Securitization*
- DriveTime — **$49 million** *Exchange and Resale of Senior Secured Notes*
- ON — **$325 million** *Senior Revolving Credit Facility*
- ON — **$200 million** *Subordinated Convertible Notes Exchange*
- Standard Pacific Homes — **$210 million** *Unsecured Revolving Credit Facility*
- Quidel Corporation — **$120 million** *Amended Secured Revolving Credit Facility*
- DriveTime — **$150 million** *Senior Secured Revolving Facility*
- DriveTime — **$150 million** *Senior Secured Revolving Facility*
- Meritage Homes Corporation — **$35 million** *Secured Letter of Credit Facility*
- AFS Technologies — *Credit Facility with Texas Pacific Group*
- LiveDeal — *Everest Group, LLC Credit Facility*

### Mergers and Acquisitions

- Caveo — **$84 million** *Acquisition of Palm Harbor Homes*
- OneNeck IT Services — **$95 million** *Sale of Company*
- Pinnacle West — *Sale of APS Energy Services, Inc.*
- Matrix — *Sale of Company to Wonder Holdings (Tender Offer/Merger)*
- AFS Technologies — *Acquisition of Synectics Group Inc.*
- AFS Technologies — *Acquisition of Ross Computer Systems*
- AFS Technologies — *Acquisition of Genesis Group, Inc.*
- Accuride — **$35 million** *Sale of Fabco Automotive*
- Accuride — **$22 million** *Acquisition of Forgitron Technologies*
- apthera — *Merger with RXi Pharmaceuticals Corp.*
- MedTrust — *Sale of Company*
- Sempra U.S. Gas & Power — *Acquisition of Membership Interests Copper Mountain Solar 2 Project*
- Allegro Medical — *Sale of Company*
- Limelight Networks — *Acquisition of Clickability, Inc.*
- hrmall — *Acquisition of the Assets of I.Q. BackOffice, LLC*
- Cross Spear Mine — *Sale of Company*
- Machine Solutions — *Sale of Company*
- HR Solutions International, Inc. — *Sale of Company*
- VaultWare — *Sale of Company*
- GHD — *Acquisition of Winzler & Kelly*

### Equity and Venture Capital Transactions

- AFS Technologies — *Recapitalization by Goldman Sachs Private Equity Group*
- Grayhawk — *Counsel on Raise of New Venture Fund*
- Innovative Biosciences, Inc. — *Stock Sale to Thermo Fisher Scientific Inc.*
- *Venture Financing*
- GlobalTranz — **$10 million** *Series A Venture Financing*
- Regenesis Biomedical — *Series C Venture Financing*
- Oxford Life Insurance — **$5 million** *Equity Investment in Puritan Financial*
- Four Winds Health — **$12 million** *Equity Investment*
- Clear Energy — *Private Placement Common Stock*
- LiveDeal — **$2 million** *Private Placement*

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## Mandatory Proxy Access is Dead—Now What?

By Jeff Beck

### Proxy Access Rules Vacated

In July 2011, the U.S. Court of Appeals for the D.C. Circuit vacated the SEC's proposed proxy access rule 14a-11. Rule 14a-11 would have granted stockholders the right (subject to certain share ownership and holding period requirements) to force public companies to include director nominees in the company's proxy materials. Without this benefit, stockholders wanting to nominate their director candidates effectively must run an expensive proxy contest and prepare their own proxy statement. The D.C. Circuit held that the SEC acted "arbitrarily and capriciously for having failed *once again* … adequately to assess the economic effects of a new rule." The D.C. Circuit Court stated that the SEC:

- Inconsistently and opportunistically framed the costs and benefits of the rule;
- Failed adequately to quantify the certain costs or explain why those costs could not be quantified;
- Neglected to support its predictive judgments;
- Contradicted itself; and
- Failed to respond to substantial problems raised by commenters.

One memorable quote for the D.C. Court's opinion is "The Commission anticipated frequent use of Rule 14a-11 when estimating benefits, but assumed infrequent use when estimating costs."

The SEC has indicated that it remains committed to proxy access and the SEC is studying the court decision in order to determine the best path forward. Based on comments by the SEC in various speeches, our view is that the SEC continues to believe that mandatory proxy access is a good thing; but, after the rebuke by the D.C. Circuit and the SEC's focus on completing its *Dodd-Frank* rulemaking, mandatory proxy access is on hold for the foreseeable future.

### Private Ordering of Proxy Access

Shortly after the D.C. Circuit Court's decision vacating Rule 14a-11, the SEC lifted its stay on its changes to Rule 14a-8. The SEC had stayed these changes (that were not subject to the litigation) pending resolution of the challenges to Rule 14a-11. The changes to Rule 14a-8 require companies to include in their proxy materials shareholder proposals addressing the director nomination process. The new rules allow stockholders to seek to implement proxy access on a company-by-company basis (rather than through the SEC's proposed mandatory approach). This company-by-company approach is referred to as "private ordering" of proxy access. Prior to the changes, Rule 14a-8(i)(8) allowed companies to exclude from its proxy statement any proposal that related to a nomination or election to the board of directors, or procedures for such nomination or election. In short, the provisions allowing companies to *exclude* these types of proposals have been *eliminated*.[1] The changes to Rule 14a-8 are effective for the upcoming proxy season.

### Practical Implications

As amended, Rule 14a-8 practically means that, subject to state law restrictions, stockholders can submit a shareholder proposal to establish director nomination and election procedures.

Such a proposal may be drafted either as an advisory (also referred to as "precatory")[2] resolution or, if permitted under state law,[3] a binding bylaw amendment. (A discussion of the differences between precatory and binding proposals is important, but beyond the scope of this article.) Although stockholders would generally prefer a binding proposal over a precatory resolution, a binding bylaw amendment can be more difficult to thread through the Rule 14a-8 needle and thus precatory proposals are more common in the Rule 14a-8 arena.

Adopting proxy access procedures is, of course, only half the equation. If proxy access procedures are adopted (either voluntarily at a company's initiative or at the "request" of stockholders), this only means that stockholders have a tool to require a specific nominee be included in the company's proxy materials. If such procedures are actually adopted, a nomination still must be made in accordance with those procedures and the director nominee must run for election and, finally, win that election.

Under Rule 14a-8, shareholder proposals must be submitted to a company no later than 120 days before the anniversary of the release date of the prior year's proxy. For calendar year companies, this date typically falls in November or December. Therefore, if a company has not yet received a proxy access proposal for its 2012 annual meeting, it is unlikely that it will need to deal with it this year.[4] Nevertheless, depending on the company's fiscal year and the timing of its annual meeting, it is possible that the company's 14a-8 deadline has not passed and there is always 2013 and beyond to consider.

It remains to be seen the extent to which stockholders will take advantage of the new Rule 14a-8 and the form that proposals will take. Many in the governance community have indicated that stockholders are ready and willing to make proxy access proposals. In any event, the 2012 proxy season will at least provide the initial testing group for proxy access proposals, particularly as to how common they will be, what share ownership and holding period requirements will be proposed/implemented and how stockholders will vote in response to proposals. It will likely be 2013 before we get any meaningful color how private ordering actually plays out in an actual director election (i.e., even if proxy access is adopted in 2012, the earliest it can be used as a tool by stockholders to nominate and elect directors will likely be the 2013 proxy season).

**How to Proceed**

As a result, we believe many companies will take a wait-and-see approach on proxy access. If, however, a company receives (or has received) a proxy access proposal, its options will depend on several factors, including the following:

- Is the proposal precatory or binding?
- If the proposal is precatory and receives a favorable vote, how will the board of directors respond?
- Are there procedural grounds to exclude the proposal under Rule 14a-8?
- What are the proposed share ownership and holding requirements?
- What is the Board's desire to negotiate with the proposing stockholder to preempt the

proposal by adopting a mutually acceptable proxy access mechanism?

- What are the company's current governance practices and stockholder base?

As an alternative, a company could enact its own proxy access mechanism (presumably through amendment of its bylaws). This approach would hopefully allow a company to fend off pending or future shareholder proposals as having been "substantially implemented."

At a minimum, companies should consider the following steps in light of the changes to Rule 14a-8:

- Educate its board of directors by discussing (i) the preemptive alternatives available before a shareholder proposal is made and (ii) the company's strategy if it were to receive a proxy access nomination (or, if proxy access is in place, a stockholder director nomination).

- Review the company's corporate governance documents, particularly its advance notice bylaw provisions and director nomination and qualification procedures and standards.

Even companies without a formal proxy access mechanism in place should pay particular attention to existing director nomination procedures. Many companies currently have in place policies providing that the board of directors will *consider* nominations from directors. In this new era of heightened focus on the nomination and election process, even in the absence of a formal proxy access regime, if a company receives a stockholder nomination, the board (or the committee charged with the nomination process) should ensure they follow the procedures, policies and considerations they already have in place and publicly advertised to their stockholders.

**Notes:**

[1] Proposals to include specific nominees (or remove a sitting director prior to expiration of their term) may still be excluded under Rule 14a-8(i).

[2] A precatory proposal is one that requests the board of directors take steps to implement the requested action. Thus, the precatory proposal is a *request* for the board of directors to do something, which the board may or may not follow in the board's discretion.

[3] Generally permitted in Delaware.

[4] The first proxy access proposals under Rule 14a-8 were filed in November 2011.

**Jeff Beck's Quarterly Tidbit of Interest:**

The Bureau of National Affairs reported that a Manhattan Institute Center for Legal Policy study showed that just 2 percent of shareholder proposals offered for votes at annual meetings of the largest 150 U.S. public companies were from institutions *without* a social, religious or labor affiliation and about two-thirds of all shareholder proposals filed at those meetings were filed by one of four individuals (or their family members or foundations).

## Latest Disclosure and Governance Developments

By Jeff Beck and Jeff Scudder

The 2011 proxy season saw all companies for the first time asking their stockholders to vote on an advisory basis to approve or disapprove the compensation of the company's named executive officers. In addition, all public companies for the first time asked stockholders to cast a second advisory vote on how frequently stockholders should be allowed to cast the say-on-pay vote. Following is a summary of key results and lessons learned:

- Less than 2 percent of companies experienced a failed say-on-pay vote in 2011.
- Although many companies recommended a biennial or triennial say-on-pay frequency vote, shareholders overwhelmingly supported annual votes. We believe this result is due in part to the annual vote being preferred and advocated by ISS. As a result, an annual vote is the norm[1] and accordingly, most companies will again be holding a say-on-pay vote in 2012.
- A very high percentage of companies that received a negative say-on-pay recommendation reported either a failed say-on-pay vote, or, at the least, a substantially lower favorable percentage than companies receiving a favorable ISS recommendation.
- The leading reasons for negative say-on-pay recommendations include problematic practices such as tax gross-ups on golden parachutes, single trigger change-in-control payments, excessive severance pay or excessive relocation payments and disconnects between company performance and executive pay.
- The influence of proxy advisory firms continues to increase. Some commentators expect the number of negative say-on-pay recommendations to increase in 2012. We expect proxy advisory firms (and shareholders and the SEC) to pay particular attention to a company's disclosure about how it considered the results on the 2011 say-on-pay vote and how those considerations affected the company's executive compensation decisions and policies.
- At least six companies have been sued in shareholder derivative suits relating to failed say-on-pay votes. Most commentators do not believe these cases will have much staying power in light of *Disney*, but companies should stay tuned as judicial standards change or suits are decided in courts outside of Delaware.

As companies prepare their 2012 proxy statements, they should continue to refine the proxy to best tell the company's story. In this regard, a summary or overview section to the Compensation Discussion and Analysis section is becoming more and more common. Companies should carefully evaluate their 2011 say-on-pay vote to determine the message their stockholders are sending. Remember, just because your say-on-pay proposal "passed" does not mean stockholders are happy. There is a difference between a 55 percent favorable vote and a 95 percent favorable vote.

**Dodd-Frank Rulemaking Status/Update**

It has been almost 18 months since President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) into law. Since that time, the SEC and other federal agencies have been working (with mixed success) to keep pace with the aggressive rulemaking schedule prescribed by the 2,300-plus page bill. Following is a brief summary of certain final rules that were recently adopted, as well as the current status of other rules prescribed by Dodd-Frank that have yet to be proposed or adopted.

- *New "Accredited Investor" Net Worth Standard.* On December 21, 2011, the SEC amended the definition of "accredited investor" under Regulation D to exclude the value of a person's home from net worth calculations used to determine whether an individual may invest in certain unregistered securities offerings. The SEC also clarified the treatment of debt secured by a primary residence for purposes of the net worth calculation. Dodd-Frank also requires the SEC to review (and revise, if appropriate) the "accredited investor" standard in 2014 and every four years thereafter.

- *Conflict Minerals Disclosure.* The SEC has proposed, but not yet adopted, its final conflict minerals disclosure rules. Dodd-Frank requires the SEC to adopt rules for companies that use conflict minerals. Such entities must disclose whether these conflict minerals originated from the Democratic Republic of Congo or a surrounding country. Affected companies will also have to furnish a separate report describing diligence measures taken by the company on the source and chain of custody of its conflict minerals. The SEC's proposed rule has generated significant objections and questions about how to practically comply with its provisions because of the difficulty in tracing the origin of conflict minerals, which are used by a wide variety of companies in a wide variety of products. The SEC's rulemaking calendar called for final rules to be adopted in December 2011.

- *Clawback Policy.* The SEC has yet to propose rules that would require companies to develop policies for the clawback of incentive compensation. The SEC's rulemaking calendar called for proposed rules to be issued in December 2011 and such rules are scheduled to be adopted in the first half of 2012.

- *Pay/Performance and Pay Disparity Disclosures.* The SEC has yet to propose rules calling for the disclosure of (a) a comparison of executive compensation against the company's financial performance and (b) the ratio of median total annual compensation for all employees against the CEO's annual compensation (commonly called the "pay disparity ratio"). The SEC's rulemaking calendar called for proposed rules to be issued in December 2011 and such rules are scheduled to be adopted in the first half of 2012.

- *Hedging Policy.* The SEC has yet to propose rules calling for the disclosure of a company's hedging policy with respect to company equity securities owned by directors and employees. The SEC's rulemaking calendar called for proposed rules to be issued in December 2011 and such rules are scheduled to be adopted in the first half of 2012.

**SEC Proposed Rule Re Enhancements to MD&A (Short-Term Borrowings)**

As we reported last year, in September 2011 the SEC proposed rules that call for a new separately captioned subsection of MD&A comprised of a comprehensive explanation of the company's short-term borrowings, including both quantitative and qualitative information. The proposed disclosures about short-term borrowings are modeled after rules that are currently applicable to bank holding companies.[2] The required disclosures would apply equally to Form 10-Ks and Form 10-Qs. In other words, there is no short form or abbreviated disclosure for Form 10-Qs.[3]

The focus of the proposed rules is on liquidity risk and inter-period variations not reflected in the balance sheet as the result of window dressing, whether strategic or cyclical. The proposed release identifies the following five categories of short-term borrowings:

- federal funds purchased and securities sold under agreements to repurchase;
- borrowings from banks;
- commercial paper;
- borrowings from factors or other financial institution; and
- any other short-term borrowings reflected on the company's balance sheet.

For *each* specified category of short-term borrowings, companies would have to disclose in tabular form the following information:

- The amount of short-term borrowings at the end of the reporting period and the weighted average interest rate on those borrowings;
- The average amount of short-term borrowings outstanding for the reporting period and the weighted average interest rate on those borrowings;
- For financial companies, the maximum daily amount outstanding during the reporting period; and
- For all companies other than financial companies, the maximum month-end amount outstanding during the period.

The proposed rules define a "financial company" as a company engaged to a significant extent in the business of lending, deposit taking, insurance underwriting or providing investment advice, or that is a broker or dealer. Thus, the definition will capture many companies outside the traditional "banking" industry. Companies that are engaged in financial and non-financial businesses may provide separate short-term borrowings disclosure for their financial and non-financial business operations.

In addition to these tabular disclosures, companies would be required to include a narrative discussion of the following:

- A general description of the company's short-term borrowing arrangements (including any key metrics or other factors that could reduce or impair the company's ability to borrow under the arrangements and any collateral posting arrangements) and the business purpose of each arrangement;
- The importance to the company of its short-term borrowings to its liquidity and capital resources; and
- The reasons for the maximum amounts reported during the period and the reasons for differences between the average short-term borrowings and period end short-term borrowings.

In the proposing release, the SEC also requested the public comment on the need for disclosure of leverage ratio(s). The SEC is requesting comment about whether to require leverage ratio disclosure and, if so, how such leverage ratio(s) should be calculated.

In summary, the SEC's proposed new disclosure rules are designed to provide additional transparency about a company's capital resources and short-term borrowings. Obviously, the SEC is concerned about window dressing practices through which companies obscure much larger outstanding inter-period borrowings than reported at the end of a period and identify for investors with more transparency short-term liquidity risks facing a company.

The proposed release remains on the SEC's agenda, although there was no movement on it in 2011. Based on comments from the SEC, we believe that final rules will be adopted in 2012.

**"Engaging" Proxy Advisory Firms**

To the chagrin of many public companies, the influence of proxy advisory firms (most notably, ISS and Glass Lewis) only seems to be growing as "say on pay" and other corporate governance initiatives continue to evolve. The frustration that many companies experience with ISS, in particular, is no secret to the advisory firm, and its representatives have said that ISS enjoys the "engagement" it sees from companies on these issues (including in follow-up proxy soliciting material filed on Form DEFA14A, which has sometimes bordered on adversarial). Set forth below are four tips that companies can keep in mind as they "engage" proxy advisory firms like ISS:

1. *Educate Itself*. If not already done, a company can educate itself on the proxy voting policies and guidelines issued by the proxy advisory firms and consider those guidelines in the context of determining appropriate policies and proxy recommendations for the company. Both ISS and Glass Lewis publish their proxy voting guidelines on an annual basis. ISS and Glass Lewis have also published materials describing how their respective firms evaluate "pay for performance" alignment.

2. *Tell the Company's Story*. Use the proxy statement and other public filings to make a compelling case for proxy recommendations and why those recommendations are appropriate for the company. If the proposals are aligned with the proxy advisory firms' policies and guidelines, consider highlighting that. If the company believes those policies and guidelines are inappropriate, explain the company's position clearly and be prepared for further "engagement" to make the company's case. In all events, consider how to make the company's public filings more persuasive (and therefore strategic). Including a summary or overview section in your Compensation Discussion and Analysis that is at least partially keyed toward ISS and Glass Lewis' guidelines (e.g., pay for performance) is a prime example.

3. *Be Proactive*. Consider working with ISS in advance of the proxy solicitation to get feedback on the company's policies and recommendations that can help avoid an adverse recommendation. If institutional shareholders make up a material portion of the voting base, consider engaging with them directly. Some companies have been conducting "roadshows" or additional analyst-type calls with institutional investors to provide

additional information about their corporate governance and/or executive compensation policies and practices. These strategies can be effective but require significant resources—and companies need to be careful to conduct such activities in compliance with applicable proxy laws (e.g., the solicitation of votes in favor of the company's proposals constitutes a proxy solicitation and requires that related solicitation materials be filed with the SEC) and the disclosure of material non-public information must be made in compliance with Regulation FD.

4. *Respond To Adverse Recommendations*. In some cases, an adverse recommendation is inevitable despite a company's proactive engagement with the proxy advisory firms. For example, in 2011, some companies felt strongly (and made a compelling case) that holding say-on-pay votes every two or three years would be more appropriate than holding such votes annually, as ISS and Glass Lewis universally recommended without regard to circumstances specific to the company. And, on occasion, the proxy advisory firms also just plain "get it wrong" in conducting the analysis that leads to their recommendation. Companies can respond to these adverse recommendations in a variety of ways, including the following:

    a. *"You're wrong, ISS, now fix it."* If the adverse recommendation was the product of a clear error (e.g., in the proxy advisory firm's quantitative analysis or interpretation of a company's policies and practices), consider engaging directly with the firm to point out the mistake and seek a revised recommendation.

    b. *The Public Appeal*. In other circumstances, a company might consider further (public) engagement with its shareholder base to respond to the proxy advisory firm's adverse recommendation and reiterate its case. This would typically take the form of filing follow-up proxy soliciting material on Form DEFA14A. Several DEFA14A filings were made during the 2011 proxy season and anecdotal evidence indicates that many were effective. Certain surveys indicate that proxy advisory firms recommended "no" say-on-pay votes in approximately 12-13 percent of cases, while fewer than 2 percent of companies had failed say-on-pay votes. Some observers anticipate that more "pre-emptive" DEFA14A filings will be made in 2012 as companies attempt to use the device as a way to communicate key messages from their CD&A in a concise manner.

    c. *Rounding Up the Votes*. At the end of the day, stockholders cast votes, not ISS or Glass Lewis. Accordingly, companies could engage directly with key stockholders in the event of an adverse recommendation. Keep in mind, however, that communications following the filing and distribution of a proxy statement may need to be filed with the SEC pursuant to the proxy rules. Examples of communication materials that may need to be filed include letters, website pages, email messages, presentations and scripts.

**Loss Contingencies**

During 2011, the SEC began a campaign to push companies to enhance their disclosure of loss contingencies. In speeches, the SEC has questioned whether companies are complying with existing disclosure standards relating to loss contingencies. The existing disclosure standards are set forth in ASC 450 (formally known as FAS 5).

As background, the FASB proposed amendments to its loss contingency reporting standards in 2008. The 2008 proposal was met with significant objections and the FASB issued a revised draft in July 2010. This revised draft was also met with vigorous objections (primarily from the legal community). In a nutshell, FASB's proposed amendments to ASC 450 would not have altered significantly the existing standards for when a contingency is *accrued*, but they would have expanded significantly the required *disclosures* about loss contingencies. The FASB has officially postponed its adoption of the proposal pending further deliberations. We believe this project is indefinitely on hold.

| Probability that loss will be realized? | Does the company have the ability to reasonably estimate the potential loss? | Accrue loss? | Disclose contingency?* | Disclose loss estimate, or range of possible loss?* |
|---|---|---|---|---|
| Probable | Yes | Yes** | Yes | Yes** |
| Probable | No | No | Yes | No |
| Reasonably possible | Yes | No | Yes | Yes*** |
| Reasonably possible | No | No | Yes | No |
| Remote | Yes or no | No | No | No |

* Subject to materiality.

** If reasonable estimate is a range, accrue best estimate or, if no best estimate, accrue at the low end of the estimated range.

*** Disclose estimated amount of loss or range of loss. Note: The SEC has stated that in certain situations it may be acceptable to disclose the range of possible losses in the aggregate (for multiple losses/events). A discussion of this aggregation concept is beyond the scope of this summary.

Despite the fact the current standards (in place for the last 35 years or so) have not changed, the SEC continues to pressure companies to disclose more about loss contingencies because it does not believe that all companies are complying with the standards already in place. Following is a brief summary of the existing accrual/disclosure standards.

The focus of the SEC is on those loss contingencies where it is "reasonably possible" that a loss will be realized (vs. those deemed probable or remote). The SEC has questioned the adequacy of disclosures that do not set forth estimates of possible losses or explain why such losses cannot be provided. A common example is where a company discloses information about an ongoing litigation action for several consecutive periods and consistently discloses that it is not possible to determine the amount of the loss. This disclosure can be called into question where a large settlement or award is then reported in an immediately subsequent period.

Adding to the tension is the American Bar Association's Statement on Policy Regarding Lawyers' Responses to Auditors' Requests for Information (also known as the "treaty"), which states that lawyers should refrain from estimating potential losses unless the probability of inaccuracy of the estimate of the amount or range of potential loss is "slight." The SEC has publicly stated that the treaty does not trump GAAP's disclosure requirements and companies cannot avoid their disclosure obligations by standing behind the treaty. In short, ASC 450 calls for disclosure where, among others, it is reasonably possible a loss will be realized and you can reasonably estimate the amount or range of loss. This standard is not necessarily harmonious with treaty standard that discourages loss estimation by the attorney unless the risk of inaccuracy is "slight."

We believe the SEC's focus on loss contingencies will continue in 2012.

### ***Matrixx Initiatives v. Siracusano*: Clarifications on Materiality**

In the context of a public company's SEC reporting obligations, materiality is often the omnipresent factor for most disclosures (for example, in Management's Discussion and Analysis). Unfortunately, materiality is often judged in hindsight and easily subject to second-guessing.

In 2011, the United States Supreme Court again took up the issue of materiality in *Matrixx Initiatives v. Siracusano*.[4] The case involved Matrixx's alleged failure to disclose adverse reports that its cold drug, Zicam Cold Remedy (Zicam), could cause anosmia (the loss of sense of smell).[5] Matrixx argued that these reports were statistically insignificant and, accordingly, the Court should adopt the so called "bright-line rule" that the adverse reports cannot be material absent a sufficient number of such reports to establish a statistically significant risk that the product is in fact causing the harm in question.[6] The district court had previously dismissed the plaintiff's claim on the grounds it failed to plead adequately the essential element of materiality because it did not allege that Matrixx knew of a statistically significant number of adverse events that would have required disclosure of a link between Zicam and anosmia.[7] The Ninth Circuit Court of Appeals, reversing the decision of the district court, held that the district court had erred in requiring an allegation of statistical significance to establish materiality.[8] The Supreme Court, affirming the decision of the Ninth Circuit Court of Appeals, concluded that the materiality of the adverse reports cannot be reduced to a bright-line rule.[9]

The Court also affirmed the continued use of the long-standing materiality standard set forth by the Supreme Court in *Basic v. Levinson*.[10] The standard articulated by *Basic v. Levinson* is whether a reasonable investor would have viewed the undisclosed information as having significantly altered the "total mix" of information made available.[11] Importantly, the Court also confirmed that Section 10(b) of the Securities Exchange Act of 1934 (the '34 Act), and the related Rule 10b-5 do not create an affirmative duty to disclose any and all information.[12] Rather, the duty to disclose is required when necessary to make the statements made, in the light of the circumstances under which they were made, not misleading.[13] The specific factual allegations in the *Matrixx* case that are alleged to have altered the "total mix" of information included that Matrixx had disclosed that its revenues were going to rise 50-80 percent and that adverse reports about its Zicam product were unfounded.[14] Thus, taking the plaintiff's allegations as factually true for purposes of its analysis, the Court ruled that Matrixx had a duty to disclose the adverse reports in order to make the total mix of information not misleading.[15]

Although the "no duty to speak" doctrine remains alive (i.e., silence by itself, absent a duty to disclose, is not misleading), blind reliance on this doctrine is perilous for public companies because of the affirmative disclosure duties imposed by the '34 Act (e.g., MD&A). Combined with the murky issue of whether there exists a duty to update prior disclosures that may have changed, the affirmation of the Supreme Court's long standing materiality principles in *Matrixx* will probably not provide much comfort to public companies faced with challenging disclosure questions.

Companies need to be mindful that the concept of materiality for purposes of MD&A disclosure is not necessarily the same as the principles articulated by the courts (e.g., *Basic v. Levinson*) for purposes of determining liability under the '34 Act. As discussed above, the *Basic v. Levinson* standard is whether a reasonable investor would have viewed the undisclosed information (or misstatement of disclosed information) as having significantly altered the "total mix" of information made available.[16] When analyzing the total mix of information under *Basic v. Levinson*, courts tend to employ a balancing test (i.e., the *probability* that the event or loss will occur against the *magnitude* of the event or loss in the light of the company as a whole). In a balancing analysis, where there exists an unknown trend or uncertainty, it is entirely possible to conclude that disclosure is not necessary if that event, trend or uncertainty is unlikely to occur. This balancing aspect is not necessarily appropriate in its pure form when evaluating whether disclosure is necessary in MD&A.

Companies need to also be mindful that Regulation S-K, Item 303(a)(3)(i) requires the disclosure of "any *known* trends or uncertainties that have had or that the company reasonably expects will have a material *favorable or unfavorable* impact on net sales or revenues or income … [and] if the registrant *knows* of events that will cause a material change in the relationship between costs and revenues (such as *known* future increases in costs of labor or materials or price increases or inventory adjustments), the change in relationship shall be disclosed." SEC guidance[17] suggests that companies need to apply the following two-step process when evaluating disclosures about trends and uncertainties:

- Is the known trend, commitment, event or uncertainty likely to come to fruition? If it is not reasonably likely to occur, no disclosure is required. This step is generally considered consistent with the *Basic v. Levinson* model.
- If management cannot make this determination, however, management must

> evaluate the consequences of the known trend, commitment, event or uncertainty on the assumption that it will come to fruition. Disclosure is then required *unless* management determines that a material effect on the company's financial condition or results of operation is not reasonably likely to occur. This step requires an enhanced analysis beyond *Basic v. Levinson*.

At the least, the *Matrixx* decision informs that public companies that rely on statistical information to evaluate the safety or effectiveness of their products (e.g., in the pharmaceutical industry) will need to give serious consideration to whether statistically insignificant or related subjective information should be disclosed. In other words, do statistically insignificant occurrences need to be disclosed to make the "total mix" of information not misleading? In answering this question, companies need to consider (from the perspective of the hypothetical "reasonable investor") both quantitative and qualitative facts in assessing materiality. In this regard, it remains important that public companies review and refresh their cautionary language/forward-looking statement disclosures, as well as the content of their risk factors disclosure in Form 10-K.

**Notes:**

[1] There are very, very few exceptions where companies adopted a frequency policy that was inconsistent with the shareholder preference.

[2] Industry Guide 3, Statistical Disclosure by Bank Holding Companies.

[3] As proposed, Small Reporting Companies would not be required to provide the quarterly disclosures unless material changes occurred during the interim period.

[4] *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1313-14 (2011).

[5] Id.

[6] Id. at 1318-19.

[7] *Siracusano v. Matrixx Initiatives, Inc.*, 2005 WL 3970117 at*6 (D. Ariz. Dec. 15, 2005) (relying on two federal circuit court decisions, the district court found that a defendant "must have statistically significant information before statements related to a product's drug safety become material").

[8] *Matrixx*, 131 S. Ct at 1317.

[9] Id. It is worth noting, however, that the Supreme Court did make clear that statistical evidence is not irrelevant, rather, the *Matrixx* decision stands merely for the proposition that it is not dispositive of the materiality analysis. In fact, the Court stated that adverse events in and of themselves are not per se material, rather "something more is needed, but that something more is not limited to statistical significance and can come from the source, content, and context of the [adverse event] reports." Unfortunately, the Court does not define what that "something more" is. Id. at 1321.

[10] Id. at 1318.

[11] Id.

[12] Id. at 1321.

[13] Id.

[14] Id. at 1323.

[15] Id. To be clear, the Supreme Court did not hold that Matrixx in fact made any material misstatements. Rather, the Supreme Court merely held that the statistical significance standard advanced by Matrixx in support of its motion to dismiss the case was not the appropriate standard. The case was remanded to the trial court for further proceedings.

[16] See id. at 1318.

[17] SEC Release No. 33-6835 (May 18, 1989).

## Latest on Dodd-Frank's Whistleblower Rules

By Matt Feeney and Eric Kintner

Section 21F of the Securities Exchange Act of 1934 (the Exchange Act), which was added by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), directs the SEC to provide monetary awards to whistleblowers, subject to certain conditions and limitations, who voluntarily provide original information relating to a violation of the securities laws that leads to a successful enforcement action resulting in the imposition of over $1 million in monetary sanctions. Awards are to be made in amounts between 10 percent and 30 percent of the monetary sanctions, depending on factors set forth by the SEC.

According to the SEC, it has received 334 whistleblower tips since August 2011, when the SEC's final rules implementing Section 21F became effective. The most common complaint categories were market manipulation (16.2 percent), corporate disclosures and financial statements (15.3 percent) and offering fraud (15.6 percent). The SEC already has set aside $452 million for whistleblower compensation. Although no whistleblower awards have been announced to date, the SEC's Office of the Whistleblower has posted notice of over 200 applicable enforcement judgments and orders issued from July 21, 2010 (when Dodd-Frank became law) through December 1, 2011. The expectation is that the first awards will be made early in fiscal year 2012.

This article discusses a few of the significant items included in the SEC's final rules implementing Section 21F, the anti-retaliation program included in Section 21F and some steps companies can take now to address these new whistleblower rules.

### Section 21F Final Rules

On August 21, 2011, the SEC's final rules implementing Section 21F[1] (the Final Rules) became effective. The Final Rules contain a number of significant items, two of which are briefly discussed below.

### Incentives, but No Requirement, to First Use Internal Compliance Process

The SEC's proposed rules requested public comment on whether a whistleblower would be required to report through the company's internal compliance processes as a prerequisite to award eligibility. Over some commentators' objections, the Final Rules do not include a requirement that whistleblowers report internally. Instead, the Final Rules include additional incentives for whistleblowers to utilize a company's internal compliance system. For example, with respect to the criteria for determining the amount of an award, the Final Rules expressly provide that a whistleblower's voluntary participation in an entity's internal compliance systems is a factor that can increase the amount of an award, and a whistleblower's interference with internal compliance and reporting is a factor that can decrease the amount of an award.

In addition, the Final Rules contain a provision under which a whistleblower can receive an award for reporting original information to a company's internal compliance system where the company later reports the information to the SEC. In this way, the whistleblower gets "credit" for an award if the whistleblower utilizes the internal compliance system. Finally, the Final Rules provide 120 days for a whistleblower to report to the SEC after first reporting internally and still be treated as if the whistleblower had reported to the SEC at the earlier reporting date.

**Exclusions from Eligibility – Auditor Issues**

Section 21F contains several exclusions that expressly exclude certain types of individuals from eligibility, including, among others, persons associated with certain regulatory and law enforcement authorities, persons convicted of criminal violations that are related to the SEC action or a related action, or "to any whistleblower who gains the information through the performance of an audit of financial statements required under the securities laws and for whom such submission would be contrary to Section 10A of the Exchange Act."[2]

Similarly, the Final Rules provide that "original information" excludes information that is obtained (a) through an attorney-client privileged communication; (b) in connection with the legal representation of a client; (c) by an officer, director, trustee or partner of an entity, if such person learned the information from another person or in connection with the entity's processes for identifying, reporting and addressing possible violations of the law; (d) by an employee whose principal duties involve compliance or internal audit responsibilities or an employee of a firm retained to perform compliance, internal audit or internal investigation functions; (e) by an employee of a public accounting firm, if the information is obtained through the performance of an engagement required under the federal securities laws that relates to a possible violation by the audited entity or its directors, officers or employees; or (f) in a manner that is determined by a federal court to violate applicable federal or state criminal law. The SEC's rationale in adopting these prohibitions is to address the possibility that company personnel with compliance responsibilities could try to "front-run" internal investigations for their own benefit.

However, the Final Rules include exceptions to these exclusions for compliance personnel (but not for attorney-client privileged communications), including if the person has a "reasonable basis to believe that disclosure … is necessary to prevent the relevant entity from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors," or the person has a "reasonable basis to believe that the relevant entity is engaging in conduct that will impede an investigation of the misconduct." Therefore, the SEC has effectively created a "back door" through which certain outside compliance personnel or auditors can blow the whistle on their engagement client without any obligation to first report through the company's internal compliance system and in potential violation of duties of confidentiality to the client. How effective or common this exclusion will be remains to be seen.

In addition, the Final Rules' adopting release states that an auditor is not prohibited from making a "specific and credible submission alleging that [the auditor's public accounting firm] violated the federal securities laws or professional standards" because such a submission is not contrary to Section 10A of the Exchange Act. Section 10A requires the auditor to take certain actions in response to becoming aware that illegal acts have or may have occurred. The SEC believes that this rule could help ensure that public accounting firm violations are timely reported, which is especially important given the SEC's view of the auditor's role as a gatekeeper.

**Anti-Retaliation Program**

Section 21F also includes an anti-retaliation program that prohibits employers from taking action to retaliate against whistleblowers by creating a new cause of action for whistleblowers who suffer employment retaliation after sharing information with the SEC. This cause of action allows whistleblowers to sue directly in federal court, without first exhausting the administrative procedures that were required by other statues, such as the Sarbanes-Oxley Act. In addition, the statute of limitations for these claims can be much longer – up to 10 years for some whistleblowers. Whistleblowers that prevail on their retaliation claims are entitled to reinstatement, attorneys' fees and double back pay with interest. Finally, employers may not require that employees waive their anti-retaliation rights under Section 21F pursuant to Section 29(a) of the Exchange Act, which voids any provision that binds a person to waive compliance with the Exchange Act.

The anti-retaliation rules apply irrespective of whether the whistleblower is ultimately entitled to an award. Recently, in *Egan v. TradingScreen, Inc.*,[3] the plaintiff sought relief against the company and its chief executive officer for, in part, retaliatory discharge under Section 21F. The federal district court ruled that an individual does not need to personally report to the SEC in order to qualify for anti-retaliation protection, provided that a report is made to the SEC by someone with whom the individual is "acting jointly." The plaintiff in *Egan* contended that, by initiating and participating in an investigation by outside counsel retained by the independent directors of the company as a result of his allegations, he acted jointly with outside counsel in providing information to the SEC. The court partially agreed, holding that the plaintiff had adequately alleged that he acted jointly with outside counsel. However, in order to prove the retaliation claim, the court granted leave to the plaintiff to amend his complaint in order to sufficiently allege that outside counsel had, in fact, reported the information to the SEC. In a subsequent decision, the court dismissed the plaintiff's amended complaint after it was shown that the outside counsel did not, in fact, report the information to the SEC.[4]

**What Can Companies Do Now?**

Generally, companies should reexamine and reevaluate their internal compliance procedures and policies to ensure consistency with the new whistleblower rules and to encourage compliance by making the company's internal compliance procedures as user-friendly as possible. Specifically, companies may want to take steps to increase the likelihood that employees will use the company's internal compliance system before reporting to the SEC. Companies also may want to develop a response plan that includes the formation of a compliance committee to handle serious allegations. Finally, companies that haven't done so already should consider adopting an anti-retaliation policy with respect to employees that report potential violations to the company or the SEC.

*Increase Likelihood that Employees Use Internal Compliance System*

Companies often want to maintain some control over the investigative process and the potential benefits of self-reporting violations if an issue arises. As noted above, however, there is no requirement under Section 21F that a whistleblower first utilize a company's internal compliance system. Indeed, a company is prohibited from requiring that an employee report any problem first to the company. Nevertheless, as discussed above, in the Final Rules the SEC did include certain incentives to encourage whistleblowers to do so.

Employees tend to use a company's internal compliance system if the employees are aware of the compliance system and they feel that it results in fair outcomes. In order to increase the likelihood that an employee will use a company's internal compliance system, a company should take steps to ensure that its compliance program is visible and available, such as utilizing internal company newsletters and training. Training, in particular, should teach supervisors how to be sensitive to employees who might lodge complaints and what steps are appropriate in response to complaints. In addition, it is important that the compliance program have the public support of management and the board so that it is viewed as credible by employees.

*Establish a Compliance Committee*

In some cases, companies may want to establish a compliance committee to investigate a whistleblower complaint. Generally, a compliance committee would be called into action only for credible complaints that allege substantial or widespread harm or misconduct. The members of a compliance committee could include senior members of the company's legal department, finance and/or audit divisions, investor relations and human resources. The goal is for the compliance committee to be able to evaluate the allegations raised, perform any triage to mitigate the damage and to address the proper reporting, if necessary, to the SEC or law enforcement.

*Adopt Anti-Retaliation Policy*

If a company hasn't done so already, these new whistleblower rules provide additional incentive for companies to adopt anti-retaliation policies. An anti-retaliation policy should reiterate the company's general commitment to complying with the law and include specific language to protect employees from unlawful retaliation. Whistleblower anti-retaliation policies often include, in every-day terms, what "retaliation" means so supervisors and employees are clear about what is considered retaliatory conduct and what is not. Employee training may also be helpful, especially for supervisors, since many types of conduct can be deemed "retaliation," not just an employee's termination or demotion.

A whistleblower anti-retaliation policy can also identify the company's procedures for investigating and responding to potential whistleblower complaints. Employees should be informed where to report concerns and companies need to explain what the individuals who receive complaints will do with the information. The company should make clear, however, that the anti-retaliation policy is not a license to disgruntled employees to steal confidential information or break contracts. Notwithstanding the anti-retaliation policy, employers are permitted to take appropriate action against whistleblowers that violate legitimate company policies. In order to help justify the company's actions, companies should carefully document their adverse employment actions and maintain such documents during the relevant statute of limitations period.

**Notes:**

[1]17 CFR §§ 240.21F-1—21F-17.

[2]Section 21F(c)(2) of the Exchange Act.

[3]2011 U.S. Dist. LEXIS 47713 (S.D.N.Y. May 4, 2011).

[4]2011 U.S. Dist. LEXIS 103416, *9 – *14 (S.D.N.Y. Sept. 2, 2011).

## Play by the Rules and Stay Out of Trouble: Some Tips for Public Companies Engaging in Social Media

By Brandon Batt

Social media has always been "fun" but it is only in the past few years that companies are taking advantage of the ability it gives them to communicate with their investors on a day-to-day basis. While companies may not have the Twitter© followings of Ashton Kutcher or Kim Kardashian, social media is being used by companies today like never before. As of December 27, 2011, for example, Pearson PLC (NYSE: PSO) had posted 4,043 tweets to 1,823 followers, Nordstrom (NYSE: JWN) had posted 15,335 tweets to 156,797 followers, and at the top of the Twitter© following for a public company, Whole Foods Markets (NASD: WFM) had posted 23,655 tweets to 2,151,172 followers. Whole Foods' numbers effectively mean it is able to communicate with and inform over 2.1 million people and organizations on a daily basis free of charge. That's pretty powerful.

While websites like Twitter© and Facebook© allow public companies to reach a large audience almost instantly, it is important to be aware that written communications via social media websites are subject to the same securities regulations and other applicable laws as any other written communications. The tips below can help a company benefit from social media while complying with laws applicable to public companies.

### Tip: A Company's Social Media Communications are Regulated

*Regulation FD*

Regulation FD is the SEC's "fair disclosure" rule that generally applies to all communications made by a public company (including via social media). Regulation FD stands for the proposition that an issuer's disclosure of material nonpublic information must be broad, effective and non-exclusionary. The traditional recognized channels of distribution for broad and non-exclusionary disclosure include filings with the SEC and widely disseminated paid wire services such as BusinessWire. Regarding the use of other non-traditional media for disseminating information, the SEC will apply a facts and circumstances test that analyzes whether the company is reasonable to believe its chosen medium (e.g., the company's website) is a recognized channel of distribution. To avoid inadvertent disclosure of material nonpublic information through social media, companies should ensure that their social media communications are subject to the same review and control processes as any other public communication.

*Endorsements and the Federal Trade Commission (FTC)*

Social media communications are also regulated by the FTC. The FTC is concerned with endorsements or testimonials made by a user about its products or services. The FTC's rules require that when a person publicly makes an endorsement, the person making the endorsement must identify any material connection between themselves and the seller of the products that may affect the credibility of the endorsement.[1] If the statements are being made by an employee of a company, that employee should identify him or herself, the name of their employer and if they are receiving special compensation for the endorsement. The same guidance applies when an employee is discussing an employer's client in public communications. It is important to note that even if that employee was not specifically instructed by his employer to make an endorsement, the existence of the employment relationship may qualify their statements as endorsements. To combat this potential for liability, companies should adopt corporate policies (discussed in more detail below) that advise employees about these issues and their responsibilities with regards to social media.

*Other Legal Considerations*

A company's "social media guru" or outside legal counsel should also consider[2] if a proposed communication triggers any of the following issues:

- Rule 10b-5: Rule 10b-5's anti-fraud provisions apply to written or oral communications. Social media communications are subject to these regulations.
- Insider trading laws: Confidential information transmitted via social media may subject an employee to insider trading claims, regardless of whether that employee trades on such information.
- Disclaimers: Consider including customary disclaimers as done with any written communication. For example, if the message contains forward-looking statements or non-GAPP measures, a company should include the necessary disclosures or a hyperlink to those items.

Given the myriad issues, it is important to consider requesting review by legal counsel or trained personnel before communicating the message of potentially sensitive information.

**Tip: Actively Enforce Corporate Policies and Properly Train Employees**

Written policies regarding social media are incredibly useful. Written policies help companies avoid potential issues, educate employees and help companies to combat problems after they have occurred.[3] Companies that carelessly engage in social media are more likely to encounter damage to the company's brand, violate securities laws, or lose control of the company's confidential information, to name a few. Depending on a company's social media usage, there are many different types of corporate policies that may need to be adopted to govern the company's conduct (e.g., social media policy, privacy policy or general code of conduct).

All employees should be aware of the company's social media rules, guidelines and "best practices," who is responsible for transmitting social media communications on behalf of the company, and the consequences for making unauthorized public communications. Even if only one person is in charge of communicating on behalf of the company, training of all employees is recommended because it may not be practical to completely restrict social media activities to just a few individuals in a large organization. Proper training for employees includes providing regular updates to all parties regarding current issues as well as the reinforcement of standing policies.

**Tip: Have Social Media Communications Reviewed by Legal Counsel or Trained Personnel (a "Social Media Supervisor") before Transmission**

It is a good practice to have employees seek approval from a social media supervisor prior to transmitting any communications about the company. Social media supervisors are better able to spot the myriad of issues that may be present with even a simple communication. Oftentimes companies task their marketing and/or advertising departments with this responsibility. These non-legal departments are excellent at presenting the company in a creative and positive light, but the communication's compliance with applicable laws should be given due consideration. Further, a company can better coordinate its preparation and release of any required SEC filings or press statements that must be made in conjunction with the social media communication. Having a structure in place also helps to ensure that any applicable disclaimers or disclosures are made at the correct times.

For additional social media news and other related business issues, you can follow Brandon on Twitter© under the name @SocialLawNews.

**Notes:**

[1]16 C.F.R. § 255.5.

[2]The laws and regulations discussed in this article do not propose to be inclusive of all laws applicable to social media. Readers should consider consulting with an attorney as the issues and applicable laws change depending on the proposed communication.

[3]The FTC has indicated that well-drafted social media policies will benefit a company should an employee fail to follow applicable regulations. Furthermore, the existence of corporate policies and proper training for all employees can provide the company with a better foundation to avoid and defend any litigation created by a "rogue" employee.

## California Transparency in Supply Chains Act of 2010

By Katy Annuschat

The California Transparency in Supply Chains Act of 2010 (the Supply Chains Act) will go into effect January 1, 2012. The Supply Chains Act imposes disclosure requirements on retailers and manufacturers and will apply to many California businesses and non-California businesses alike. All business owners with connections to California need to be aware of the Supply Chains Act so they can understand whether it applies to them and know how to best prepare for compliance with the new law.

**Businesses Subject to the California Transparency in Supply Chains Act of 2010**

The Supply Chains Act applies to any business that:

1. Is a retail seller or manufacturer;
2. Does business in California; and
3. Has annual worldwide gross receipts that exceed $100 million.

Annual gross receipts are measured worldwide, and not just in the state of California. If a business falls under the Supply Chains Act, the law requires that the business make certain public disclosures about its efforts to eradicate slavery and human trafficking from its direct supply chain as well as inform consumers on how to avoid indirectly supporting slavery and human trafficking.

The first factor is whether a business is a retail seller or manufacturer. The Supply Chains Act states that a business is a retail seller or a manufacturer only if it lists either retail sales or manufacturing as its principal business activity on its tax return.

The next factor is whether a business does business in California. Doing business in California, according to the Supply Chains Act, means the business meets one of the four following tests: (1) is organized or commercially domiciled in California; (2) has sales within California that exceed $500,000 or 25 percent of its total sales, whichever is less; (3) has property (real or tangible) in California that exceeds $50,000 or 25 percent of its total real and tangible property, whichever is less; or (4) pays compensation in California in excess of $50,000 or 25 percent of total compensation paid, whichever is less.

Non-California businesses should pay close attention to the final three parts of the doing business in California tests, as they have the potential to ensnare many businesses organized outside of California.

**What the Supply Chains Act Requires**

Generally, to comply with the Supply Chains Act, the business must make certain disclosures on its web site. These disclosures are intended to show its efforts, if any, to eradicate slavery and human trafficking from its direct supply chain. The good news for businesses is that the Supply Chains Act does not otherwise impose any substantive regulation on the supply chain or any affirmative obligations on the business to perform diligence on its supply chain. As a matter of corporate social responsibility and to promote a positive public image, however, companies subject to the Supply Chains Act may wish to implement policies or procedures to mitigate the risk of human trafficking and slavery as they will be required to disclose these policies, or lack thereof, on their web sites.

The required disclosures must be posted on the business's web site, with a "conspicuous and easily understood link" to this information on its homepage. For businesses that do not have a web site, the disclosures must be provided in writing within 30 days of receiving a written request from a consumer.

The disclosures must provide, at a minimum, to what extent, if any, the business does the following:

1. Engages in verification of product supply chains to evaluate and address risks of human trafficking and slavery, specifying if the verification was not conducted by a third party;
2. Conducts audits of suppliers to evaluate compliance with company standards for trafficking and slavery in supply chains, specifying if the verification was not done by an independent, unannounced audit;
3. Requires direct suppliers to certify that materials incorporated into the product comply with the laws regarding slavery and

human trafficking of the country (or countries) in which they are doing business;

4. Maintains internal accountability standards and procedures for employees or contractors failing to meet company standards regarding slavery and trafficking; and
5. Provides company employees and management, who have direct responsibility for the supply chain, training on human trafficking and slavery, particularly with respect to mitigating risks.

Businesses should note that the Supply Chains Act requires the business to disclose its efforts, "if any," which does provide for some flexibility in the content of the disclosures.

The sole remedy for a violation of the Supply Chains Act is injunctive relief in an action by the Attorney General and the Supply Chains Act provides no private right of action.

The California Franchise Tax Board will also make available to the Attorney General a list of companies that are classified as retail sellers and manufacturers subject to the requirements of the Supply Chains Act.

**Steps to Take to Prepare for the Supply Chains Act**

Even though the Supply Chains Act only imposes disclosure requirements and not any substantive requirements, some businesses may wish to implement internal policies to ensure that its disclosures will reflect that the business is taking steps to prevent slavery and human trafficking in its supply chain. Some steps a business may consider are noted below.

1. Review internal policies and standards applicable to the product supply chain and human rights issues, looking at whether the policies address slavery and human trafficking, how suppliers are informed of the policies and whether procedures are in place to evaluate the risk of trafficking and slavery with the manufacturing of its products.
2. Review and/or implement company procedures to ensure suppliers comply with human rights policies and have a mechanism for auditing suppliers.
3. Review and/or implement internal procedures to monitor as well as train employees involved with the supply chain, so that all are informed of and capable of carrying out the policies.

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