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Securities Update

Enjoying Life's Little Perks: the NIC Inc. Enforcement Action

By Matthew M. McDonald and Peter J. Lively

In January 2011, the Securities and Exchange Commission (SEC) charged NIC Inc., Jeffrey Fraser (the former Chief Executive Officer of NIC), Eric Bur (the former Chief Financial Officer of NIC), and Harry Herington (the former Chief Operating Officer and current Chief Executive Officer of NIC), with violations of the antifraud provisions of the Securities Act of 1933 and multiple violations of the Securities Exchange Act of 1934. The charges are primarily based on the Commission's allegations that NIC repeatedly filed materially false and misleading proxy statements and annual reports that either omitted or materially understated a material portion of Fraser's overall compensation, particularly substantial perquisites that were paid to him by NIC.

According to the SEC's complaint, from 2002 to 2007, Fraser received perquisites totaling over $1.18 million, including: over $4,000 per month to live in a ski lodge in Wyoming; costs to commute by private aircraft from the ski lodge to his office at NIC's headquarters in Kansas; monthly cash payments for purported rent for a Kansas house owned by an entity set up and controlled by Fraser; vacations; flight training, hunting, spa, skiing and health club expenses; computers and electronics; a leased luxury SUV; and other day-to-day living expenses including groceries, liquor, tobacco, nutritional supplements and clothing. Despite these lavish benefits, the SEC's complaint states that prior to 2006, NIC's public filings falsely represented that Fraser received an annual salary of $1, indicating that he worked, as the Commission puts it, "virtually for free." Even after NIC began reporting certain perquisites paid to Fraser starting in 2006, the Commission alleges that the true amount of the benefits received was materially understated. In addition to the charges leveled at NIC, the Commission alleges Fraser, Bur and Herington -- all aware of the perquisites and the Commission's rules regarding the disclosure of executive compensation -- aided and abetted NIC's violations of the Exchange Act by not disclosing the perquisites.

Aside from the undisclosed perquisites, the Commission also alleges that Fraser falsely sought and obtained reimbursement from NIC for numerous other personal expenses. As with most companies, NIC maintains a Code of Business Conduct and Ethics to ensure

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full disclosure in SEC filings and to maintain control over its corporate assets. This Code of Conduct requires executives with business credit cards to use them solely for business expenses, to submit expense reimbursement vouchers and to provide evidence of business purpose for all such expenses. The Commission's complaint states that Fraser regularly disregarded these policies by using his company-issued credit card for personal expenses and then failing to provide evidence of business purpose for many expenses that NIC subsequently reimbursed. Rather than comply with NIC's policies, Fraser submitted monthly expense reimbursement vouchers claiming some credit card charges as personal expenses, but failing to identify many others. Even with respect to those charges Fraser identified as personal expenses, he avoided reimbursing NIC for some by offsetting them against claimed out-of-pocket expenses, which often matched, to the penny, the amount of personal expense identified on the credit card statement. Even after an internal review conducted by NIC's audit committee with the aid of outside counsel concluded that Fraser had intentionally misclassified his expenses, the majority of the improper expenses and perquisites were not disclosed or repaid, nor was the finding of intentional misclassification disclosed when NIC announced the results of the internal review.

Based on NIC's failure to accurately disclose Fraser's compensation, the Commission brought its enforcement action against NIC, Fraser, Bur and Herington for filing false and misleading proxy statements, annual reports and registration statements. The Commission also charges that Fraser, Bur and Herington, all aware of the SEC's rules regarding disclosure of executive compensation, aided and abetted NIC's violations of the Exchange Act and the antifraud provisions of the Securities Act by engaging in the conduct described above. Fraser and Bur are both charged with violating the certification requirements of the Exchange Act in connection with their required certifications that NIC's annual reports did not contain any untrue statements of material fact or omit to state a material fact necessary to make the statements made not misleading, and that each had evaluated NIC's controls and procedures and concluded that they were effective -- despite being aware of material misstatements and omissions in the company's public filings. The Commission also alleges that both Bur and Herington learned that Fraser was being reimbursed for personal expenses, yet failed to require him to provide evidence of a business purpose for the personal expenses and permitted NIC to reimburse those expenses, thereby causing NIC's books and records to falsely characterize the personal expenses as business expenses in violation of the Exchange Act.

This enforcement action, while certainly presenting egregious facts and circumstances, should serve as a reminder to issuers during this proxy season to be sure their proxy statements, annual reports and other SEC filings disclose all elements of executive compensation completely and accurately. The proxy rules require an issuer to disclose in its proxy statement the total compensation of its top-ranking and highest-paid officers in order to provide investors with a clearer and more complete picture of the compensation earned by these officers. The rules require that all elements of compensation be disclosed, including, among others, salary, bonus, stock and option awards, and all other compensation, including perquisites, unless the aggregate amount of all perquisites is less than $10,000. Disclosure of perquisites aids investors in determining and comparing the total compensation of the highest-paid officers with other officers in the company and within the issuer's industry.

While the rules seem straightforward, it can often be difficult to identify and quantify "perquisites" for the Commission's purposes. The Commission has resisted requests to define perquisites in its rules, but did provide some guidance to issuers in its Adopting Release for the new rules related to Executive Compensation and Related Person Disclosure in 2006. Under that guidance, an item is generally not considered a perquisite if it is integrally and directly related to the performance of the officer's duties. If the item, however, confers a direct or indirect benefit that has a personal aspect, without regard to whether it may be provided for some business reason or for the convenience of the company, unless it is generally available on a non-discriminatory basis to all employees, it qualifies as a perquisite.

In the end, it is important to remember that the issue in the NIC enforcement action is not that the perquisites that Fraser received, no matter how elaborate, violated the Exchange Act themselves, but rather that NIC failed to, and its officers failed to cause it to, accurately disclose those perquisites. Public companies should thoroughly review all elements of the compensation they provide their top officers to ensure full disclosure to their investors.

Update on Say-on-Pay and Say-on-Golden Parachute Voting

By Kimberly K. Rubel and Ena Marwaha Lebel

The Securities and Exchange Commission adopted rules implementing the "say-on-pay" and "say-on-golden parachute" provisions of Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act on January 25, 2011. The SEC adopting release is available at http://sec.gov/rules/final/2011/33-9178.pdf and our recent client alert on the release can be found at http://tinyurl.com/dbrsop.

This article summarizes the new Compliance and Disclosure Interpretations (CDIs) the Commission issued on February 11, 2011, with respect to the rules, discusses trends in say-on-frequency recommendations and highlights voting results thus far in the 2011 proxy season.

New CDIs

The new CDIs can be found here: http://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm. They offer further explanation of particular provisions of the rules, such as the form of resolution required, say-on-golden parachute disclosure and issues particular to smaller reporting companies.

Form of Resolution — In new CDIs 169.04 and 169.06, the SEC clarifies that the vote for say-on-frequency, as required by Rule 14a-21(b), does not need to be in the form of a resolution and that companies can use the words "every year, every other year, or every three years, or abstain" in lieu of "every 1, 2, or 3 years, or abstain."

Additionally, CDI 169.05 explains that companies can use a plain English equivalent instead of the words "pursuant to Item 402 of Regulation S-K" when describing the type of compensation disclosure the shareholders are voting on for the say-on-pay vote.

Say-on-Golden Parachute Compensation — New CDI 128B.01 presents a situation where a company has held a say-on-pay vote at its annual meeting and as part of the compensation disclosure, the company has included the disclosure required under new

Item 402(t) of Regulation S-K relating to golden parachutes for the executive officers named in the Summary Compensation Table. Now the company plans to prepare a merger proxy statement, but in the interim has also hired a new principal executive officer. The company wants to rely on Instruction 1 to Item 402(t) to exclude the new principal executive officer from the merger proxy statement's say-on-golden parachute compensation vote and the related Item 402(t) disclosure.

Instruction 1 provides that Item 402(t) disclosure is required for those executive officers who were included in a company's most recently filed Summary Compensation Table. The CDI states that the company is not permitted to exclude the new principal executive officer as Instruction 1 only applies to those executive officers who are included in the Summary Compensation Table under Item 402(a)(3)(iii) because they are the three most highly compensated executive officers *other than* the principal executive officer and the principal financial officer. Under Item 402 generally, the principal executive officer and the principal financial officer are, per se, named executive officers, regardless of compensation level. Consequently, Instruction 1 to Item 402(t)(2) is not instructive as to whether the principal executive officer or principal financial officer is a named executive officer.

The SEC also notes that its position applies to Instruction 2 to Item 1011(b), which is the corresponding instruction in Regulation M-A.

Smaller Reporting Companies — New CDIs 169.01, 169.02 and 169.03 discuss issues relevant to smaller reporting companies. In particular, the questions clarify that an issuer that is a smaller reporting company as of January 21, 2011, is entitled to rely on the delayed phase-in period for smaller reporting companies for the new say-on-pay and say-on-golden parachute rules. Additionally, the new CDIs provide example situations to help issuers determine their eligibility for smaller reporting company status for 2011 and for the new rules.

Frequency Recommendation Trends

As of March 25, 2011, companies had made the following frequency recommendations for say-on-pay vote:

- 521 companies (11 of which were smaller reporting companies) recommended an annual vote;
- 440 companies (36 of which were smaller reporting companies) recommended a triennial vote;
- 37 companies (two of which were smaller reporting companies) recommended a biennial vote; and
- 33 companies (six of which were smaller reporting companies) made no recommendation.

Commentators have posited that recommending anything other than an annual vote is a futile exercise as shareholders will just select an annual vote regardless of the company's recommendation. Furthermore, ISS has issued a new policy stating that it will only support annual frequency votes.

Nevertheless, there are advantages and disadvantages to each recommendation. An annual say-on-pay vote would be supported by ISS and may make the vote more routine to shareholders, and thus, make them less likely to find issue with the company's executive compensation policies, practices and decisions. However, companies may be challenged by an annual vote, as analyzing the vote results and deciding what aspects of executive compensation to change will be extremely difficult to complete before the next annual vote. Some of these challenges are alleviated with a biennial vote, but the concerns about not providing shareholders an annual voice on executive compensation remain. A triennial vote, while still not in line with ISS recommendations and avoiding concerns about good corporate governance, would put less time pressure on issuers and potentially institutional investors. Issuers would be able to process the results of the vote and have the time to make positive changes to their executive compensation programs before the next say-on-pay vote. Additionally, institutional investors would be given more time to evaluate the effectiveness of long-term incentive components of compensation and to formulate their views on the company's executive compensation generally.

While there is no "right" recommendation for companies to make with regard to the say-on-frequency vote, as the recommendations above indicate, many companies are moving towards an annual vote on executive compensation.

Voting Results Thus Far

As of March 25, 2011, of 203 companies that have reported their voting results from their annual meeting of shareholders, only four companies have had their say-on-pay proposals rejected by shareholders, including computer giant Hewlett-Packard. Shareholders appear to have rejected the executive compensation at these companies because of concerns about paying executives excessive compensation and their approach to performance-based compensation, while shareholders at Hewlett-Packard seem to be signaling a broader dissatisfaction with the company. In addition, a number of say-on-pay proposals have passed by a narrow margin, clearly indicating that those companies' shareholders as a whole are not satisfied with the current executive compensation programs.

In say-on-frequency votes, shareholders have overwhelmingly supported annual vote recommendations and are expressing a clear preference for an annual vote even when that is not the recommendation. Based on the results that have been reported thus far, of the 117 companies that recommended a triennial vote, 51 (or 44 percent) had their shareholders indicate a preference for annual votes. That percentage decreases to 41 percent if smaller reporting companies are excluded. Of the 12 companies that recommended a biennial vote, nine had their shareholders indicate a preference for annual votes. There have been eight companies that did not make any frequency recommendation, and for seven of them, shareholders indicated a preference for an annual vote.

SEC Proposes Amendments to Implement the Dodd-Frank Change to the Definition of Accredited Investor

By Neil K. Haimm, Walter J. Mostek, Jr., and Peter B. Wolf

In a release published January 25, 2011, the Securities and Exchange Commission proposed amending its rules to implement the change to the definition of "accredited investor" mandated by the Dodd-Frank Wall Street Reform and Consumer Protection

Act. Section 413(a) of the Dodd-Frank Act requires the value of an individual's primary residence to be excluded in calculating the individual's net worth in determining whether the individual qualifies as an accredited investor under the Securities Act of 1933, as amended.[1] While this change took effect upon the enactment of the Dodd-Frank Act, Section 413(a) also requires the SEC to amend its rules to reflect the new standard. The SEC's proposed amendment can be found at http://www.sec.gov/rules/proposed/2011/33-9177.pdf.

The new accredited investor standard will impact companies seeking to rely on Regulation D to offer and sell their securities without having to register the securities with the SEC. Regulation D contains three rules providing exemptions from the registration requirements of the Securities Act. The availability of two of Regulation D's rules, Rule 505 and Rule 506, depends, in part, on offering the securities to investors who qualify as accredited investors. Rule 501 sets the standards for accredited investor status under Regulation D.

One of the ways a person can qualify as an accredited investor under Rule 501 is to have individual net worth, or joint net worth with the person's spouse, in excess of $1 million at the time the securities are purchased. Rule 501 does not define net worth, but it has generally been interpreted as the difference between the value of a person's assets and the value of the person's liabilities. Under the previous standard, a person could include the value of the person's primary residence when calculating his or her net worth. The proposed amendment to Rule 501 would require the person's net worth to exceed $1 million, excluding the value of the person's primary residence, "calculated by subtracting from the estimated fair market value of the property the amount of debt secured by the property, up to the estimated fair market value of the property."

This change is certain to shrink the pool of accredited investors from whom companies are permitted to raise capital through private offerings under Regulation D. If too much of an investor's net worth consists of the value of his or her primary residence, a person who previously qualified as an accredited investor on the basis of having a net worth over $1 million might not qualify as such under the new standard. For example, an investor with a net worth of $1.5 million (calculated in the conventional manner by subtracting from the investor's total assets, including primary residence, the investor's total liabilities, including any mortgage on that residence) would not qualify as an accredited investor under the new standard if the investor's primary residence had an estimated fair market value of $1.2 million and a mortgage of $650,000. Before the enactment of Section 413(a) of the Dodd-Frank Act, the primary residence contributed a net amount of $550,000 to the investor's net worth. Under the proposed rule, the value of the investor's primary residence is excluded from the calculation, reducing the investor's net worth for purposes of Rule 501 by $550,000 to $950,000, which is $50,000 less than the amount necessary to qualify as an accredited investor under the rule's net worth test.

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1 The accredited investor standard is found in both Rules 501 and 215 under the Securities Act. The SEC proposes identical amendments to both Rules. Rule 501 defines accredited investor for purposes of Regulation D. Rule 215 defines accredited investor under Section 2(a)(15) of the Securities Act. Section 2(a)(15) and Rule 215 set the standards for accredited investor status under Section 4(5) of the Securities Act, which provides an exemption from the registration requirements of the Securities Act for certain limited offerings to accredited investors if there is no advertising or public solicitation by the issuer. Since exclusive reliance on this section is rare, this article focuses on the proposed amendment to Rule 501 and its impact on Regulation D.

SEC Delays Dodd-Frank Rule Making

By Troy M. Calkins

In January 2011, the SEC pushed back the schedule for rulemaking to implement four provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The SEC now plans to issue proposed rules by August December 2011, rather than April July 2011 as originally announced, for the following:

- §953 – Rules regarding disclosure of pay-for-performance;
- 954 – Rules regarding disclosure of ratio of CEO pay to average employee pay;
- §954 – Rules regarding policies on the clawback of compensation of current and former officers upon an accounting restatement; and
- §955 – Rules regarding policies on the ability of directors and employees to enter into hedging transactions.

More information on the Commission's Dodd-Frank rulemaking to date and its proposed schedule for future Dodd-Frank rulemaking can be found at: http://www.sec.gov/spotlight/dodd-frank.shtml.

For more information on matters discussed in this *Securities Update*, please contact our editor, authors, any of the Securities lawyers listed below or your regular Drinker Biddle Corporate & Securities Practice Group contact.

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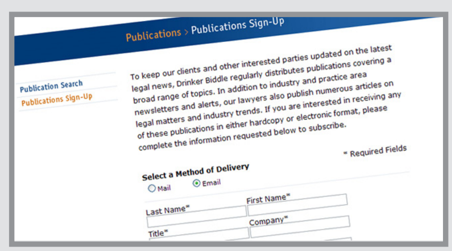

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