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Snell & Wilmer



**CORPORATE COMMUNICATOR**

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Dear clients and friends,

In this issue we present a summary of the Securities and Exchange Commission's (the "SEC") proposed rules to enact the *Dodd-Frank Act's* heightened independence requirements for compensation committee members and compensation advisers. The SEC's rules, proposed in March 2011, are expected to be finalized this summer with implementation by the national securities exchanges between 90 and 365 days thereafter.

We are also including an article summarizing the laws, rules and regulations that companies should consider when engaging in sweepstakes and promotional giveaways. Sweepstakes, drawings, prizes, raffles and giveaways have long been popular promotional tools. These promotions continue to be used by a wide variety of companies and their use has expanded significantly with the explosion of the Internet and social media. Structured properly, these promotions can be efficient and effective advertising tools. Companies need to be careful though to comply with various federal and state regulations governing sweepstakes and similar promotions because the line between a permitted sweepstakes and a prohibited gambling activity can be "fuzzy."

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**Final Rules from the SEC Coming Soon – Compensation Committee Member Independence and the Use of Independent Compensation Consultants**

By Matt Feeney and Brandon Batt

On March 30, 2011, the Securities and Exchange Commission (the "SEC") proposed rules to implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). Section 952 of the Act amended the Securities Exchange Act of 1934 by adding Section 10C, which directs the SEC and the U.S. securities exchanges and associations (the "national exchanges") to enact laws concerning the independence of an issuer's compensation committee. Subject to limited exceptions, the proposed rules and the Act prohibit the national exchanges from listing any equity security of an issuer that does not comply with the requirements of Section 10C.

The proposed rules, discussed below, would require that:

1. each member of a compensation committee meet a new standard of "independence" to be defined by the national exchanges;
2. a compensation committee be empowered to retain, compensate and oversee outside compensation consultants, legal counsel and other advisers ("compensation advisers"); and
3. an issuer must disclose if it "retained or obtained" a compensation consultant during the issuer's last completed fiscal year.

The SEC's extended comment period of the proposed rules expired May 19, 2011. The final rules are expected to be issued by the SEC this summer. For a comprehensive review of Section 952 and the other provisions of the Act, please see our [Summer 2010 issue of the Corporate Communicator](#).

### **Independence of Compensation Committee Members**

*How Does a Board Determine Who is an "Independent" Compensation Committee Member?*

Akin to the Sarbanes-Oxley Act of 2002, heightened independence requirements for audit committee members and their advisers, the proposed rules would require that each board member of a compensation committee meet a heightened standard of "independence." This new definition of independence applicable to compensation committee members and compensation advisers will be defined and implemented by the national exchanges. The Act requires the national exchanges to consider the following two factors when defining "independence:"

1. the source of compensation of the compensation committee member, including any consulting, advisory or other compensatory fee paid by the issuer; and
2. whether the member is affiliated with the issuer, a subsidiary of the issuer or an affiliate of the issuer.

The heightened definition of independence would apply to the members of the issuer's compensation committee or, if no such committee exists, any other independent board committee overseeing executive compensation or performing the functions normally executed by a compensation committee. The required independence of non-compensation committee members performing compensation committee functions is probably more of a practical concern for issuers trading on NASDAQ and other public exchanges that do not require the existence of a compensation committee.

*What Happens if a Compensation Committee Member Ceases to be "Independent?"*

The proposed rules would require the national exchanges to establish procedures that provide an issuer with a "reasonable opportunity" to cure any independence-related defect prior to delisting the issuer from a national exchange. The proposed rules also allow a compensation committee member, who is no longer independent for reasons outside the member's control, to remain on the compensation committee until the earlier of one year from the event that resulted in non-compliance or the next annual meeting of the issuer. We expect the criteria for what qualifies as "outside the member's control" to be stringent and limited.

**Independence Requirements for the Retention of Compensation Advisers; Additional Disclosures Related to Compensation**

## Consultants

### *How Do Issuers Determine if a Compensation Adviser is "Independent?"*

The proposed rules (to be implemented through each national exchange's listing standards) provide that the compensation committee may, in its sole discretion, engage, compensate and oversee independent compensation advisers. While the proposed rules do not require a compensation adviser to be independent, the proposed rules do require that a compensation committee must consider five factors in assessing the independence of a potential compensation adviser and the independence of the potential compensation adviser's employer. It is important to note that these factors may not be exhaustive as the proposed rules allow the national exchanges to specify additional factors for a compensation committee's consideration. The proposed rules require a compensation committee to consider the following factors:

1. whether the employer of the compensation adviser provides other services to the issuer;
2. the amount of fees received from the issuer by the employer of the compensation adviser as a percentage of its total revenue;
3. the policies and procedures of the compensation adviser's employer that are designed to prevent conflicts of interest;
4. any business or personal relationship of the compensation adviser with a member of the compensation committee; and
5. whether the compensation adviser owns any stock of the issuer.

Issuers are required to provide adequate funding for the compensation committee's utilization of compensation advisers. The compensation committee must employ its own judgment in fulfilling its duties and is not required to follow the advice or recommendations of its compensation advisers.

### *What Disclosure Obligations Does an Issuer Have with Regard to its Compensation Consultants?*

The proposed rules would require additional disclosure by an issuer related to its compensation consultants (versus the broader group of compensation "advisers") in its proxy or information statement for an annual meeting. Currently, Item 407(e)(3) of Regulation S-K requires the disclosure of "any role" a compensation consultant has in recommending the amount or form of executive and director compensation. The proposed rules would amend Item 407(e)(3) to:

1. require the issuer to disclose when the compensation committee "retained or obtained" the advice of a compensation consultant during the issuer's last completed fiscal year (compared to the "any role" standard under the current Item 407(e)(3));
2. broaden Item 407(e)(3) by eliminating the current disclosure exemption for consultants who advise solely on broad-based plans that do not discriminate in scope, terms or operation in favor of executive officers or directors of the issuer and that are available generally to all salaried employees; and
3. require an issuer to disclose whether any conflicts of interest arose during the engagement, and, if so, the nature of the conflict of interest and how the issuer is addressing the conflict of interest (current Item

407(e)(3) contains various exemptions to this disclosure requirement).

The SEC's proposed instructions to Item 407(e)(3) would require an issuer to consider the five "independence" factors listed above when determining whether a conflict of interest exists that needs to be disclosed in response to the amended Item 407(e)(3).

### **Exemptions to the Proposed Rules**

The proposed rules allow the national exchanges to exempt certain categories of issuers as they deem appropriate from the revised listing standard requirements related to compensation committee member independence, the independence of compensation advisers and the compensation committee's authority to retain, compensate and oversee compensation advisers.

The proposed rules would exempt the following types of listed companies from *all* new listing standards: (1) controlled companies, (2) issuers of securities futures products cleared by a registered clearing agency or a clearing agency exempt from registration and (3) registered clearing agencies that issue standardized options. For purposes of the proposed rules, a "controlled company" is any listed issuer of which more than 50 percent of the voting power is held by an individual, a group or another issuer.

In addition to the three exemptions listed above, the following categories of listed issuers are not subject to the heightened independence requirements for compensation committee members:

1. limited partnerships;
2. issuers in bankruptcy proceedings;
3. open-ended management investment companies registered under the Investment Company Act of 1940; and
4. foreign private issuers that provide annual disclosure to shareholders of the reasons why the foreign private issuer does not have an independent compensation committee.

Under the proposed rules, the national exchanges are permitted to implement rules that exempt certain relationships with committee members from the independence requirements if the national exchanges deem it appropriate based on the size of the issuer.

### **What Issuers Should Expect and Accomplish in the Months Ahead**

As noted above, the SEC expects to issue final rules by this summer. The national exchanges are required to provide the SEC with their proposed rules or rule amendments within 90 days after publication of the SEC's final rules. Each national exchange's proposed rules or rule amendments must be approved by the SEC within one year after publication of the SEC's final rules. It is unclear at this point whether the new listing standards will be in effect for the 2012 proxy season.

Moving forward, companies should carefully review their existing internal "independence" determinations regarding past, current or future members on the compensation committee or a committee performing similar functions. After the issuance of the final rules, each listed company should consider:

1. reviewing and tracking all sources of committee member compensation and each member's relationships with other members of the board and third parties for potential conflicts of interest;
2. reviewing its current "retained or obtained" compensation advisers for purposes of evaluating if those engagements trigger disclosure requirements;
3. reviewing its compensation committee charter, bylaws and other governance documents to confirm whether the compensation committee has the requisite authority to retain, compensate and oversee advisers; and
4. working with counsel to monitor the release of the SEC's final rules and the applicable exchanges' resulting listing standards.

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## ***Tweet to Win!* Practical Pointers for Using Social Media to Run Online Promotions**

By Eric Kintner

Many companies have begun to capitalize on the power of social media platforms, such as Facebook and Twitter, to run online promotions, including sweepstakes, contests and giveaways. However, it is important to remember that online promotions that are open to United States residents may be subject to various federal and state laws, which can vary widely from minimal requirements to specific registration and bonding requirements. In addition, many social media platforms have now adopted specific guidelines for running an online promotion through the platform. These laws and guidelines can be a minefield for the unwary online promoter. This article highlights several of the issues.

### **Avoid Promotion Becoming an Illegal Lottery**

Engaging in the business of gambling (such as operating lotteries or other games of chance) is a serious criminal offense if not permitted under federal and state laws. This is why the operation of an online promotion must be structured properly in order to avoid inadvertently becoming an illegal lottery. Generally, only state governments and licensed casinos can legally operate a lottery, although some states permit (typically subject to strict requirements and limitations) charitable organizations to operate raffles or bingos, which are similar to a lottery. A lottery consists of three essential elements:

- *Prize* - Anything of value offered to participants in a promotion.
- *Chance* - Prize winners are determined at random.
- *Consideration* - The payment or provision of anything of value for the opportunity to participate.

Consideration can be *monetary*, such as an entry fee or product purchase, or *nonmonetary* (such as an expenditure of substantial time or effort, or disclosure of highly personal, sensitive information). Nonmonetary consideration will generally *not* include "nominal" consideration, such as the costs needed to send an email or mail a post card to enter the promotion.

Therefore, a "no purchase necessary" sweepstakes typically avoids being deemed an illegal lottery because it has eliminated the consideration element of a lottery. Note, however, that it is important for sweepstakes to

treat free entries with "equal dignity" relative to entries earned with a purchase. In other words, the sweepstakes must be structured in such a way that entrants who use a free method of entry have the same general chance and opportunity to win a prize as those that enter using a purchase method of entry. For example, free entries and purchased entries should have the same entry periods and receive the same number of entries into the sweepstakes. If free entries are not treated similar to purchased entries, a regulator might argue that the so-called free entry is really not free.

### **Determine Entrant Eligibility**

Online promotions, by their nature, are open to anyone in the world with an Internet connection. Therefore, it is important to establish the set of "eligible entrants," such as all legal residents of, and physically located in, any of the 50 United States. Such national promotions are subject to both federal and state regulations regarding their operation. Potential federal statutory schemes include the Federal Trade Commission ("FTC") advertising guidelines if the promotion will be advertised in print, TV or on radio; the Children's Online Privacy Protection Act ("COPPA") if the online promotion is directed to children; the Controlling the Assault of Non-Solicited Pornography and Marketing Act (the "CAN-SPAM Act") if the online promotion uses email or text messages to promote the purchase of products or services; and the Deceptive Mail Prevention and Enforcement Act if the online promotion plans to use the postal service to mail promotional materials. A detailed discussion of potential federal regulations is beyond the scope of this article; however, knowledgeable legal counsel can help determine whether any federal regulations might apply to an online promotion.

If the online promotion is open to residents of Florida or New York and the aggregate total prize value is more than \$5,000, the promotion will need to be registered and bonded with such states. This not only requires the expenditure of time, effort and money for the bond, but it requires planning ahead. New York law requires that the registration application and bond be filed at least 30 days prior to the commencement of the sweepstakes and Florida law requires that the registration application and bond be filed seven days prior to the commencement of the sweepstakes. Both states require that a copy of the official rules be filed with the registration application.

Rhode Island requires registration for games of chance offered by "retail establishments" in which the total announced value of prizes is in excess of \$500. It is unclear whether merely making available an online store to Rhode Island residents constitutes a "retail establishment" under Rhode Island law. Arizona requires registration for intellectual skill contests that require a purchase to enter.

### **Be Careful With Third-Party Prizes**

As the demand for the Apple iPad and iPhone has skyrocketed in recent years, a growing number of businesses have looked to capitalize by offering promotions promising free devices. However, according to a recent article in *Fortune* magazine, Apple recently began a more aggressive campaign to enforce its [Guidelines for Third Party Promotions](#) in order to protect its brand. The current guidelines specifically state that without permission from Apple, an "iPad, iPhone and the iPhone Gift Card may not be used in third-party promotions." In addition, the guidelines prohibit use of "free" as a modifier for any Apple product reference in a prominent manner. Finally, promoters must submit all marketing materials related to the promotion of Apple products to Apple for review.

Apple is not the only company that imposes restrictions on the use of their products in another company's promotion. For example, some retailer's gift cards expressly prohibit their use in connection with a third-party promotion without the retailer's consent or require a minimum purchase or license to use the gift cards in such a promotion. Therefore, it is important to review the types of prizes being offered in a promotion in order to determine whether such prizes can even be offered and, if so, on what terms.

Finally, trademark law may prohibit the use of the third-party's brand name or trademarks in a promotion without such party's consent, unless such use is deemed "fair use." An explanation of the "fair use" doctrine is beyond the scope of this article. But, promoters should proceed cautiously before using another company's name or trademarks without the consent of the owner. At the very least, promotional materials should include a statement that the trademark is owned by a third party, the trademark owner is not affiliated with the promotion and the trademark owner does not sponsor, approve, endorse or have any responsibility for the promotion.

### **Prepare Official Rules, Abbreviated Rules and Affidavit of Eligibility/Publicity Release**

Many states require that certain statements be included in the promotion's official rules. These items generally include:

- "No purchase necessary" statement
- Statement of the odds, and if the odds are not calculable, a statement that the odds depend on the number of entries received
- "Void where prohibited by law" statement
- Dates of promotion, including deadline for entry
- Eligibility and instructions for entry
- Number, description and approximate retail value of each prize
- Location and date on which the determination of the winner will be made
- Information on how to request a winners' list
- Sponsor name and address

In addition to the foregoing items, it is usually prudent for the official rules to include the requirement that the winner must complete and return an affidavit of eligibility/publicity release as a condition to awarding a prize. Note, however, that Tennessee prohibits conditioning receipt of a prize on obtaining a publicity release. The IRS may require that the sponsor submit a Form 1099-Misc or W2-G (depending on the type of promotion) if the prizes awarded exceed certain monetary amounts. This winner's affidavit/release then is helpful for the sponsor to obtain the winner's tax information in order for the sponsor to make the necessary tax filings.

Additionally, it is also usually prudent for the official rules and promotion entry forms to include a provision that binds the entrants to agree to the terms and conditions of the official rules. Likewise, a promoter may want to include ordinary contract provisions in the official rules, such as indemnification and a release of the sponsor from harms caused by the promotion or its prizes as well as governing law and a forum for disputes.

Finally, the FTC and many states require that any promotion advertisements include all "material terms" of the promotion. Therefore, promotions typically

should have a set of "abbreviated" rules that can be included on any print, TV or radio advertisements that include the following:

- "No purchase necessary" statement
- Dates of promotion, including deadline for entry
- Eligibility for entry
- Instructions on where official rules, odds of winning and prize values can be found
- Sponsor name and address
- If applicable, trademark "fair use" language

### ***Tweet to Win! And other Social Media Issues***

As Facebook and Twitter continue to grow, more and more businesses have started to use these social media platforms to connect with customers and find new ones through the use of online promotions. However, in addition to the federal and state laws discussed above, both Facebook and Twitter have adopted specific guidelines that must be complied with for a promotion to be run through these platforms.

On May 11, 2011, Facebook updated their [Promotion Guidelines](#) for running promotions on or related to Facebook. Some key points:

- *Definition of "Promotions"* – Facebook's guidelines define "promotion" broadly to include any contest, competition, sweepstakes or other similar offering using Facebook. Therefore, the guidelines will likely apply regardless of the type of promotion and regardless of whether entrants enter the promotion through Facebook, or the sponsor's Facebook page merely provides a weblink to the promotion on a third-party web site.
- *Apps on Facebook* – Promotions on Facebook must be administered within "Apps on Facebook.com," either on a Canvas Page or an app on a Page Tab. Apps on Facebook.com are web apps that are loaded in the context of Facebook and allow users to better access core Facebook features, such as use of the "Like" button or the ability to post on a wall.
- *Entry, Voting and Notification Restrictions* – Promotions on Facebook cannot use Facebook features – such as liking a page or checking in to a place – as a way to *automatically* enter a promotion or as a voting mechanism for the promotion. Also, promotions can't notify promotion winners through Facebook, such as with messages, chats, or posts on profiles or pages.
- *Conditions to Entry* – Promotions on Facebook may condition entry on the user being required to first like a page, check into a place or connect to an app. However, a promotion on Facebook cannot condition registration or entry on other Facebook functions, such as requiring that the user like a wall post, or comment or upload a photo on a wall.
- *Release and Disclosures* – Promotions on Facebook must include a complete release of Facebook by each entrant or participant, an acknowledgment that the promotion is in no way sponsored, endorsed or administered by, or associated with, Facebook, and disclosure that the participant is providing information to the promotion sponsor and not to Facebook. Facebook prohibits use of its name, trademarks or other intellectual property in connection with a promotion, except as



part of the release and disclosure requirements discussed above.

Like Facebook, Twitter also has rules that govern promotions conducted through Twitter, including the [Guidelines for Contests on Twitter](#) and the [Automation Rules and Best Practices](#). Here are three key points:

- *Avoid Repetition of Tweets* – The Twitter guidelines state that the posting of duplicate, or near duplicate, updates or links is a violation of Twitter's rules. Twitter discourages promotions that award prizes based on the number of tweets, and encourages sponsors to limit promotion tweets to one per day.
- *Tweets to @Reply or Use Specific Hashtag to Track* – Promotion sponsors will want to be sure they can see all the Twitter entrants in order to be able to select the correct winner. Therefore, sponsors may want to require that Twitter entrants include an @reply to the sponsor so the sponsor can follow all updates. In addition, some sponsors require that the Twitter entrant include a specific hashtag with the entrant's update (such as #[name of promotion]).
- *Issues with Automation of Tweets* – The Twitter guidelines prohibit the posting of updates automatically to a user's Twitter account. Twitter promotions can be structured to allow a user's tweets to be sponsored by a third party if the user is required to manually post or approve each sponsored tweet.

### Start Early and Keep it Simple

As Benjamin Franklin once reportedly stated: "An ounce of prevention is worth a pound of cure." In the context of promotions, before a company's creative marketing team gets too far down the road with their next great idea for a company promotion, it may be good to make sure they understand that there are several hurdles that need to be cleared. A quick tutorial on the various legal requirements for promotions (along with a few horror stories) beforehand can help immeasurably with avoiding the "you-can't-do-it-that-way" discussion *after* all of the creative materials have been drafted and printed.

In addition, it is generally true that the simpler the promotion, the easier it will be not only when drafting the official rules, but also with respect to the practical operation of selecting winners. Remember that the official rules are a binding contract enforceable against both the promotion's entrants *and* the promotion's sponsor.

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