Client Alert | Capital Markets

Reminders for Public Companies for the 2016 Annual Reporting and Proxy Season

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Authors: Colin Diamond, David Johansen, Irina Yevmenenko

This memorandum summarizes key developments that public companies should consider in drafting their disclosures and reviewing their existing corporate governance policies and procedures in preparation for the 2016 annual reporting and proxy season.

PART I of this memorandum sets forth "New Considerations and Action Items for the 2016 Reporting Season," PART II of this memorandum outlines "Recent Trends and Developments in Corporate Governance and Regulatory Matters," and PART III of this memorandum summarizes "Rulemakings: Looking Ahead."

PART I. NEW CONSIDERATIONS AND ACTION ITEMS FOR THE 2016 REPORTING SEASON

ISS and Glass Lewis 2016 Proxy Voting Guidelines

Despite expectations, the ISS and Glass Lewis 2016 proxy voting guidelines did not focus on proxy access, but rather on director overboarding, unilateral board action and exclusive forum provisions.

Overboarding

Citing an "explosion" in the time commitment required for service on a company's board, both ISS and Glass Lewis have lowered from 6 to 5 the maximum number of directorships a director may hold before being considered "overboarded." For a CEO, ISS has kept the ceiling at 3 (excluding subsidiary boards) and Glass Lewis has lowered it to 2 (it should be noted that Glass Lewis distinguishes between executive and non-executive directors, rather than CEO and non-CEO directors). In the case of an overboarded director, both advisory firms will include cautionary language in the proxy voting report in 2016 and issue a negative recommendation in 2017. Furthermore, in the case of overboarded CEOs, ISS will recommend against the CEO only for election to outside boards. Therefore, companies should evaluate whether their directors, including their CEO, could be at risk of breaching the revised policies and should consider implementing procedures to ensure prompt self-reporting of changes in employment or directorships.

Unilateral Board Actions

ISS's 2016 proxy voting guidelines also focus on protecting shareholders from unilateral board action. In 2014, ISS instituted a policy of recommending against directors if the board amended a company's bylaws or charter without shareholder approval, so as to materially diminish shareholder rights or adversely impact shareholders. Among several factors that ISS considers in making its recommendation is whether the amendment was made prior to or in connection with the company's IPO. While this general policy remains in place, ISS now has a separate methodology for evaluating amendments adopted in the IPO context.

Directors of newly public companies are susceptible to negative recommendations if, prior to or in connection with an IPO, the company's board adopts charter or bylaw amendments that ISS believes materially diminish shareholder rights. However, the factors to be considered in the IPO context afford the board of a recently public company slightly more latitude than they previously did and include (i) the provision's impact on shareholders' ability to change the governance structure in the future (such as supermajority vote requirements to amend the charter or bylaws), (ii) whether there is a classified board, and (iii) whether there is a public commitment to put the provision to a shareholder vote within three years of the IPO.

Importantly, ISS now explicitly states that it will continue to consider unilateral adoption of bylaws or charter amendments which materially diminish shareholder rights when making vote recommendations for director nominees (for both established and recently public companies) until the amendments are reversed or submitted to a binding shareholder vote. Companies that are considering whether to amend their charter or bylaws in a manner that could be viewed as adversely impacting shareholders should carefully consider the impact of such amendments on director elections, but should continue to make decisions in the best interest of the company.

Exclusive Forum Provisions

Glass Lewis's existing policy recommends voting against the chairman of a nominating and governance committee of a company that has adopted an exclusive forum provision (any provision in a company's charter or bylaws that limits a shareholder's choice of legal venue to a certain jurisdiction). Its recent guidance upholds this policy, but refines the approach by distinguishing between an established company and a newly public company. For newly public companies, Glass Lewis will review exclusive forum provisions alongside other bylaw terms, such as supermajority vote requirements and classified boards, when determining whether to make a negative voting recommendation. This is in contrast to the automatic negative recommendation a board will receive if it unilaterally adopts such a provision outside of a spin-off, merger or IPO. As discussed above, ISS will recommend a vote against the board if it unilaterally adopts a bylaw amendment that "materially diminishes shareholder rights." ISS generally takes the view, however, that provisions establishing the state of incorporation as the exclusive forum are not materially adverse to shareholders.

Director Equity Grants and Related ISS Voting Guidelines

Companies seeking approval of a new equity plan should consider including a sublimit for grants to directors. Even if a new plan is not being adopted, companies may wish to amend their plans to provide for a sublimit for share grants and obtain shareholder approval of any action bearing specifically on the magnitude of compensation being paid to non-employee directors. This is to avoid the outcome in *Calma v. Templeton et al*, where the court held that grants of restricted stock units (RSUs) to directors were subject to an "entire fairness" standard of review because the compensation committee that approved the grants also received the RSU awards and thus it was a "conflicted decision." The court rejected the defendants' position that prior shareholder approval of the plan ratified the grants at issue, because the company did not seek or obtain shareholder approval of the actual amount of equity compensation paid to non-employee directors and the plan did not contain any "meaningful" or specific limits on such grants.

In addition, companies intending to present new, restated or amended equity compensation plans in their proxy statement should consider ISS's voting guidelines for such proposals, which were restructured for 2015. ISS's Equity Plan Scorecard approach aims to be a more holistic analysis based on the following weighted factors:

- Plan Cost (45%) – compares the total potential cost of the company's plan relative to its industry/market cap peers.
- Plan Features (20%) – evaluates the features of the plan, including single-trigger vesting, discretionary voting authority, liberal share recycling features and minimum vesting periods for grants.
- Grant Practices (35%) – considers the company's equity grant practices, including burn rate relative to peers, the estimated duration of the plan, whether the company has established a clawback policy, whether the company has established post exercise/vesting share-holding requirements and features of recent grants to the company's CEO.

A high score in one area can offset a low score in another area and a company can boost its score by adopting a clawback policy or shareholding requirement. It is anticipated that ISS will introduce a consulting service related to this system through its consulting arm.

Section 162(m)

Section 162(m) of the Internal Revenue Code limits the amount of annual compensation that may be deducted by most public companies for each of the company's top four executives to $1 million. Certain types of compensation, including compensation that is qualified performance-based compensation, are excluded from the compensation subject to the Section 162(m) limit. However, to maintain and preserve the exclusion, the material terms of the plan must be disclosed to and approved by the shareholders before the compensation is paid and then reapproved by the shareholders every five years. Therefore, companies should assess whether shareholder reapproval is required and if so, should include the relevant disclosures in their proxy materials.

Say-When-On-Pay

Issuers must hold a say-on-pay frequency vote every six years. For most public companies the next vote will be required in 2017.

Director and Officer (D&O) Questionnaire Updates

Because no rulemaking or regulatory developments during 2015 triggered any required updates to disclosures for the 2016 reporting season and most of the relevant outstanding Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) rulemaking remains pending, there are no required updates to D&O questionnaires for 2016. However, public issuers should note that the adoption of Auditing Standard No. 18 (AS 18), discussed below in more detail, may trigger requests from the company's independent accountants to include additional questions in the D&O questionnaire forms used by the company in connection with its annual reporting process. Further, companies may wish to clarify a definition of "spouse" in light of the new SEC guidance which confirms that the term includes same-sex spouses.

Last year, the Public Company Accounting Oversight Board adopted AS 18, which is effective for audits of fiscal years beginning on or after December 15, 2014. This standard, which requires auditors to evaluate a company's identification of, and accounting for, "related party transactions," may require changes to existing internal controls and procedures. While company disclosure requirements under Regulation S-K Item 404 have not changed, independent auditors may specifically request that companies consider whether their D&O questionnaire adequately captures related parties for their required review under AS 18. While AS 18 is designed to facilitate the evaluation of transactions with the company, as part of this inquiry it directs the auditor to obtain from management the names of all related parties, even when no transaction has occurred or is contemplated. The resulting compilation of information regarding all of the company's affiliates, its directors and officers, and their immediate family and affiliated entities can be used to help ensure that any future transactions involving these parties are properly reviewed by management and properly disclosed in the financial statements, which is the mandate of AS 18, and a D&O questionnaire is one way to obtain this information without significant duplicative efforts.

NYSE's Amended Material News Release Rules

On September 28, 2015, the NYSE amended the provisions of its Listed Company Manual concerning dissemination of material news by listed companies and the circumstances under which the NYSE may halt trading in listed securities. Some of the key points of the amendments include:

- Prior to disseminating material news between 7:00 and 9:30 a.m. ET, listed companies must both call the NYSE's Market Watch Group and provide it with a written form of the announcement at least ten minutes prior to the release of such news. Under the prior rules, this requirement only applied during the NYSE's trading hours.

- Listed companies intending to release material news after the close of trading are advised to wait until the earlier of (i) the publication of the security's official closing price on the NYSE or (ii) 15 minutes after the close of trading, to allow for the NYSE's close process.

- If the NYSE deems necessary, it may halt trading in a listed security pending receipt and evaluation of additional information from the company relating to (i) material news, (ii) the listed company's compliance with the NYSE's continued listing requirements or (iii) any other information which is necessary to protect either investors or the public interest. Listed companies releasing material news should be prepared for potential requests for additional information by the NYSE.

Nasdaq subsequently issued similar guidance, advising that companies which release material information after the close of the regular market should wait until at least 4:01 pm and preferably until 4:05 pm, unless there are specific circumstances where the company needs to act immediately.

PART II. RECENT TRENDS AND DEVELOPMENTS IN CORPORATE GOVERNANCE AND REGULATORY MATTERS

Proxy Access

Increased Incidence of Proxy Access Proposals in 2015

The 2015 proxy season saw a substantial increase in the number of social, political, governance and compensation-related Rule 14a-8 shareholder proposals received by public companies. Most of the successful proposals related to governance issues, with a significant increase in proxy access proposals driving this trend. Proxy access refers to the right of shareholders to include in the company's proxy statement nominees for the board of directors, instead of having to prepare and mail their own proxy statement. According to the NYC Comptroller's 2015 Shareowner Initiatives Postseason Report (Postseason Report), 115 companies received such proposals in 2015, compared to 18 companies in 2014. The vast majority of these companies included the proposal in their 2015 proxy statement with no competing management proposal or preemptive adoption of a proxy access bylaw. Approximately 60% of all proxy access proposals passed, and those that failed often received meaningful support from shareholders. Large-cap companies continued to be the primary focus of shareholder proposals across all categories; however, a substantial number of smaller companies also received proposals. This trend has persisted heading into the 2016 proxy season. Between October and December 2015, the Postseason Report indicates that 78 companies adopted proxy access bylaws, either in response to a shareholder proposal or proactively, and in early January of this year, the NYC Comptroller announced that the NYC Pension Funds had filed 72 new shareholder resolutions calling on companies to adopt meaningful proxy access bylaws.

Most of the recent shareholder proxy access proposals contained virtually identical provisions, requiring nominators to hold at least 3% of the company's shares for a minimum period of three years in order to gain access to the company's proxy statement, and providing that a maximum of 25% of the board may be elected by proxy access. In 2015, it was uncommon for shareholder proposals regarding proxy access to contain any additional restrictions or provisions aside from these three terms. As a result of the high success rate of proposals with these terms, the "3%-3 year-25%" format is now considered standard.

SLB 14H: "Directly Conflicts" and "Ordinary Business" Exclusions of Rule 14a-8

Historically, companies have utilized Rule 14a-8(i)(9) of the Securities Exchange Act of 1934, as amended (the Exchange Act), to exclude shareholder proxy access proposals. Under Rule 14a-8(i)(9), a company may exclude a shareholder proposal from its proxy statement "[i]f the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting." On October 22, 2015, the Division of Corporation Finance of the SEC issued Staff Legal Bulletin No. 14H (SLB 14H), which effectively limits exclusions of shareholder proposals, including those for proxy access.

With SLB 14H, the staff articulated a new, heightened standard for exclusion under Rule 14a-8(i)(9), requiring shareholder and management proposals to be in *direct conflict* in order to be excludable. SLB 14H provides examples to illustrate when exclusion under Rule 14a-8(i)(9) is permitted:

- In direct conflict and excludable under Rule 14a-8(i)(9):
  - A company seeks shareholder approval of a merger, and a shareholder proposal asks shareholders to vote against the merger.

- A company seeks shareholder approval of a bylaw requiring the CEO to be the chairperson of the board of directors, and a shareholder proposal seeks separation of the CEO and chairperson positions.

- Not in direct conflict and therefore not excludable under Rule 14a-8(i)(9):

  - A shareholder proposal seeks shareholder approval of a bylaw permitting shareholders holding at least 3% of the company's outstanding stock for at least 3 years to nominate up to 20% of the board, and a management proposal seeks shareholder approval of a bylaw permitting shareholders holding at least 5% of the company's stock for at least 5 years to nominate up to 10% of the board.

  - A shareholder proposal recommends that the compensation committee implement a policy imposing a minimum 4-year annual vesting schedule for all equity awards and a management proposal seeks shareholder approval of an incentive plan that would authorize the compensation committee to use its discretion to set the vesting schedule for equity awards.

This stricter standard has made it significantly more difficult for companies to rely on Rule 14a-8(i)(9) to exclude shareholder proposals. As a result, a company considering including a competing management proposal alongside a shareholder proposal may also consider engaging the submitting shareholder in negotiations aimed at crafting a single proposal acceptable to both parties. If a company chooses to include competing management and shareholder proposals in its proxy statement, it may also have to explain the differences between the two proposals and how it plans to treat the voting results. SLB 14H does not provide guidance on how a company should respond if both proposals pass and it is unclear whether proxy advisory firms will automatically recommend a vote in favor of the shareholder proposal and against the management proposal in such instances. In light of the number of proxy access shareholder proposals that are expected in the 2016 proxy season, some commenters have suggested this could impact corporate governance practices by accelerating the adoption of proxy access bylaws.

It should be noted that SLB 14H also reaffirmed the view that shareholder proposals that focus on a significant policy issue are not excludable under Rule 14a-8(i)(7) "because the proposals would transcend the day-to-day business matters and raise policy issues so significant that it would be appropriate for a shareholder vote...even if the significant policy issue relates to the 'nitty-gritty of [the company's] core business.'" SLB 14H reiterates that a company should only seek to exclude shareholder proposals that relate to the company's ordinary business and that do not address a significant policy issue.

ISS and Glass Lewis Positions on Proxy Access

In a recent release, ISS gave insight into how it will evaluate a board's implementation of proxy access in response to a majority-supported shareholder proposal. ISS will look at whether the major points of the shareholder proposal are being implemented and will examine whether any additional provisions that were not included in the shareholder proposal unnecessarily restrict the use of a proxy access right. ISS may issue an adverse recommendation if a proxy access policy implemented or proposed by management contains material restrictions more stringent than those in a majority-supported shareholder proposal, particularly with respect to the following:

- ownership thresholds above 3%;
- ownership duration longer than 3 years;
- aggregation limits below 20 shareholders; and
- a cap on nominees below 20% of the board.

In instances where the cap or aggregation limit differs from what was specifically stated in the shareholder proposal, lack of disclosure by the company regarding shareholder outreach efforts and engagement may also warrant negative vote recommendations.

If an implemented proxy access policy or management proxy access proposal contains restrictions or conditions on proxy access nominees, ISS will review these on a case-by-case basis. ISS noted two types of restrictions it considers so restrictive as to effectively nullify the proxy access right:

- counting individual funds within a mutual fund family as separate shareholders for purposes of an aggregation limit; and
- the imposition of post-meeting shareholding requirements for nominating shareholders.

In addition, ISS outlined the framework it will use to evaluate candidates nominated via proxy access, which employs the same factors currently used to evaluate nominees in a proxy contest as well as "additional factors which may be relevant." These "additional factors" may be specific to the company, to the nominee(s) and/or the nominator(s), and/or to the nature of the election (such as whether or not there are more candidates than board seats).

Glass Lewis clarified that it will evaluate conflicting shareholder and management proposals by considering (i) the nature of the underlying issue, (ii) the benefit to shareholders of implementing the proposal, (iii) the materiality of the differences between the shareholder and management proposals, (iv) the appropriateness of the provisions considering the company's shareholder base, corporate structure and other relevant circumstances, and (v) the company's overall governance profile, particularly its responsiveness to shareholders, as evidenced by the company's response to previous shareholder proposals and its adoption of progressive shareholder rights provisions.

How to Respond to Proxy Access Proposals

As a matter of preparedness, the board should be aware of proxy access developments and the different strategies available to the company. Companies that anticipate including in their proxy statement management and shareholder proposals on the same topic should review the factors enumerated by ISS and Glass Lewis, as well as the new SEC guidance in SLB 14H. In addition, the board should consider whether it is in the company's best interests to attempt to negotiate a settlement with the shareholder proponent (almost 20% of companies that received a shareholder proxy access proposal in 2015 successfully negotiated a settlement and withdrawal of the proposal in advance of the annual meeting) or to preemptively adopt a proxy access bylaw in a form that is acceptable to the company if such negotiations are unfruitful.

In evaluating these options, the board should consider the pros and cons of proxy access, industry and peer company standards, the potential impact on the company, the likelihood that the proposal will receive shareholder approval, the potential risks and costs of litigation if the proposal is excluded and the risk that proxy advisory firms will make adverse recommendations against the board or individual directors if the proposal is excluded.

Shareholder proxy access proposals in 2016 and beyond are expected to contain additional shareholder-friendly provisions, such as terms removing restrictions on aggregation in meeting ownership thresholds, eliminating post-meeting ownership requirements for nominators, allowing for the greater of 25% of the board or two directors to be elected by proxy access and removing prohibitions on a nominee having compensation arrangements with third parties.

Cybersecurity

Regulatory Actions

A steady stream of high-profile cybersecurity related cases and settlements as well as recent SEC and DOJ action in hacking and securities fraud schemes illustrate that cybersecurity risk assessment and management is becoming a significant focus of corporate boards and senior executives alike. The SEC, DOJ, Financial Industry Regulatory Authority and the National Institute for Science and Technology of the U.S. Department of Commerce have all issued guidance intended to aid companies in determining "best practices" in cybersecurity. Generally, this body of regulatory guidance directs companies to proactively establish processes to combat potential cyber attacks that allow them to (i) identify and assess sensitive data, (ii) develop information security policies and procedures, and (iii) keep the key parties, including the board of directors and appropriate committees, apprised of compliance efforts and risks. Some of the guidance also addresses suggested actions in the event of a cyber attack, including involving outside parties as necessary.

Some agencies have taken further action to require cybersecurity protection measures. For example, the National Futures Association's (NFA) "Cybersecurity Interpretive Notice," which will become effective on March 1, 2016, requires all NFA members to adopt written cybersecurity policies and implement proactive measures to secure customer data and access to electronic systems. In addition, in November 2015, the New

York State Department of Financial Services released a memorandum to federal and state banking, securities and insurance regulators containing a comprehensive list of potential new cybersecurity requirements that would apply to New York financial institutions and specifically highlighted the benefits of coordinating efforts with relevant federal and state agencies to develop a comprehensive cybersecurity framework.

On December 17, 2015, the U.S. Congress introduced the "Cybersecurity Disclosure Act of 2015," a bill designed to ensure that public companies "provide a basic amount of information about the degree to which a firm is protecting the economic and financial interests of the firm from cyber attacks." The bill seeks to strengthen and prioritize cybersecurity by encouraging the disclosure of the cybersecurity expertise of a company's board. If passed, the bill would mandate that the SEC issue rules requiring a public reporting company to disclose in its proxy statement or annual report the cybersecurity expertise or experience of each of its directors. If no director has expertise or experience, the rules would require the company "to describe what other cybersecurity steps…were taken into account" by the board's nominating committee in nominating directors.

Disclosure Considerations

The SEC made it clear in its 2011 Disclosure Guidance Topic No. 2 that cybersecurity disclosures may be required in risk factors, management's discussion and analysis (MD&A), business and legal proceedings sections and in the notes to the financial statements. The SEC has been active in recent years in commenting on public company periodic reports regarding cybersecurity issues. A review of publicly available comment letters to registrants indicates the SEC staff's focus on making sure investors are informed about cybersecurity risks, including requiring companies to disclose whether they have experienced cyber attacks (whether or not these attacks had a material impact on operations), requesting a separate discussion of risks posed by cyber attacks and seeking disclosure of expenditures for cybersecurity protection measures.

In the near term, existing law and SEC pronouncements, including Disclosure Guidance Topic No.2, should continue to guide public companies in satisfying their disclosure obligations. Companies are also required to disclose the role of the board in risk oversight in their proxy statements and may want to include disclosure on cybersecurity oversight in that section as well. Consideration should be given to whether cybersecurity risks warrant their own risk factor and whether oversight of cybersecurity should be addressed specifically.

Iran Sanctions Relief and Disclosure Issues when Dealing with Iran

On October 18, 2015, the U.S. and the EU officially adopted the Joint Comprehensive Plan of Action (JCPOA), establishing the foundation for Iranian sanctions relief. This relief became effective in the U.S. on January 16, 2015 on what is known as "Implementation Day."

U.S. sanctions against Iran largely fall into two categories. "Primary" sanctions are the traditional sanctions generally applicable to transactions involving U.S. persons, which restrict most activities involving U.S. persons and Iran. "U.S. person" is broadly defined to include U.S. citizens and permanent residents, wherever located, entities organized under U.S. law (including foreign branch offices), and persons located within the United States. This definition includes a very large number of financial institutions operating internationally. Prior to Implementation Day, the sanctions extended to foreign entities owned or controlled by U.S. persons, however a new general license issued on Implementation Day authorizes foreign persons owned or controlled by U.S. persons to engage in transactions with Iran consistent with the JCPOA (such as transactions that do not involve designated parties, transactions that do not involve Iran's military or law enforcement and transactions that do not involve U.S. persons). Nearly all primary sanctions remain in effect in spite of the relief provided on Implementation Day, though licenses are available for the import of Iranian foodstuffs and carpets as well as transactions involving civil aviation.

"Secondary" sanctions are measures the U.S. imposes against non-U.S. persons for engaging in certain "sanctionable activity" involving Iran. These sanctions prevent U.S. persons (including U.S. financial institutions) from conducting business with non-U.S. persons engaging in "sanctionable activity." The enforcement of most secondary sanctions has been suspended as of Implementation Day through waivers of relevant statutory authorities and termination of underlying executive orders. The U.S. has also delisted a number of parties from the various prohibited parties lists. Further delisting will come in later stages of the JCPOA process. Because U.S. primary sanctions will remain in effect, however, transactions with a U.S. person or having some other U.S. nexus will still be prohibited if they also involve Iranian parties, even if those Iranian parties are not listed.

The EU and UN have implemented a similar easing, and eventual termination, of their sanctions against Iran. EU sanctions, however, apply only to EU persons worldwide and thus have a different scope than the sanctions maintained by the U.S.

In light of these developments, the following considerations for dealings with Iran may be relevant:

- **"Snapback" provisions** – OFAC has suggested that any agreements made with Iranians include termination provisions in the event that U.S. or EU sanctions are reinstated. OFAC has indicated in guidance that it will not retroactively impose sanctions for legitimate activity undertaken after Implementation Day. However, in the event of a "snapback," transactions could be sanctionable "to the extent they implicate activity for which sanctions have been re-imposed. The JCPOA does not grandfather contracts signed prior to snapback."

- **Iranian regulatory environment** – Due to the imposition of sanctions, Iran's regulatory environment has significantly deviated from international standards. In anticipation of sanctions relief, Iranian regulations are undergoing significant changes which must be monitored before engaging in any business in Iran. For example, in order to establish operations in Iran, financial institutions are required to obtain a regulatory license from the government. Companies should also be aware that many of Iran's key businesses are subject to state control. As such, negotiations will likely involve public officials, which will increase the risk of a company's exposure to the U.S. Foreign Corrupt Practices Act and the UK Bribery Act.

- **Financial institutions subject to the laws of more than one jurisdiction** – U.S.- and EU-based financial institutions may also have to comply with any Iran-related sanctions imposed by other jurisdictions, even after U.S. and EU sanctions are lifted.

- **No impact on terrorism and human rights related sanctions** - The U.S. will maintain sanctions (including secondary sanctions) on Iran related to terrorism and human rights violations. Significant U.S. sanctions on Iran remain in effect.

Despite recent diplomatic advances, SEC disclosure requirements generally have not been impacted. SEC-reporting companies contracting, transacting or otherwise dealing with Iran will continue to be required to report such interactions on Form 10-K, Form 20-F, Form 40-F and/or Form 10-Q, as applicable, pursuant to the Iran Threat Reduction and Syrian Human Rights Act of 2012. If an SEC-reporting issuer reports in its annual or quarterly report that it or an affiliate has knowingly engaged in any of the specified activities, the issuer is required to file separately with the SEC a notice (on a form referred to as IRANNOTICE) that disclosure of that activity has been included in the company's annual or quarterly report, as applicable. There is no *de minimis* exception or materiality threshold to the disclosure rules. The level of detail provided by issuers in response to this requirement has varied, but many have disclosed very minor activities. To analyze the need for disclosure, detailed assessment of the activity in question in light of the relevant statutes, executive orders and regulations is required. To ensure ongoing compliance, a company needs to regularly gather relevant information from their affiliates. It is important to implement and document formal procedures for gathering such information. Additional disclosures in other sections of the annual report may be required as a result of these diligence efforts.

PART III. RULEMAKINGS: LOOKING AHEAD

While some of the Dodd-Frank Act's executive compensation and corporate governance provisions will not be in effect for the upcoming 2016 reporting season, companies should be aware of the SEC's rulemaking agenda for the rest of the year to assess whether early actions in preparation for compliance may be warranted.

Pay Ratio Disclosure

On August 5, 2015, the SEC adopted a final rule requiring the disclosure of (i) the median of the annual total compensation of all of the company's employees (excluding the CEO or equivalent position); (ii) the annual total compensation of the CEO or equivalent position; and (iii) the ratio of the two amounts. The new pay ratio disclosure will be required in annual reports or proxy statements beginning in the spring of 2018, covering compensation for the fiscal year on or after January 1, 2017, with transition periods for newly public

companies. Foreign private issuers, emerging growth companies and smaller reporting companies are exempt from the pay ratio disclosure requirements.

Although many companies are putting this issue on the back burner, the pay ratio disclosure rule is complex and gives companies a great deal of flexibility in their calculations. Starting the process early can help companies evaluate the various options the rule provides and address any issues that arise in applying those options. Preparing early will also enable management to consider how to draft disclosure that provides useful information and puts the company's pay ratio in the proper context.

There are several initial steps a company could take before delving into the details of the rule, including assembling a team to spearhead compliance (including representatives from HR, compensation, payroll and legal), drafting a work plan and timeline, identifying and gathering data and preparing the board or compensation committee. Companies may also wish to consider hiring an outside advisor and reviewing the disclosures of early adopters of the requirements.

Management may consider doing a "dry run" of calculating the company's estimated pay ratio for 2015 to help identify elements of the calculation that remain unknown or that must be further refined to prepare for the required disclosures and to allow sufficient time to resolve any administrative and technical issues. In addition, this may give the company a better sense of how its estimated ratio compares to those of peer companies so it can evaluate whether supplemental disclosure may be necessary or whether its calculation methodology should be modified. Companies may want to consider updating their timetable for the proxy statement and annual meeting to account for the time required for compliance with the rule.

Proposed Clawback Rules

On July 1, 2015, the SEC proposed new Rule 10D-1, which would require any company with securities listed on the NYSE, Nasdaq or other national securities exchanges, to have a policy to "claw back" incentive-based compensation paid to current and former executive officers in the event the company restates its financial statements to correct a material error. Foreign private issuers, smaller reporting companies, emerging growth companies and companies that list only debt or preferred securities would be subject to the clawback listing standards to the extent that they have securities listed on a national securities exchange or association. As proposed, the rule provides that if a current or former executive officer received erroneously-awarded incentive-based compensation within three fiscal years preceding the date of determination that a restatement is required, the company would have to recover the excess incentive-based compensation on a "no-fault" basis. Proposed Rule 10D-1 defines incentive-based compensation as any compensation (including stock options and other equity awards) that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure. The proposal also specifies disclosure requirements relating to clawback policies and actual clawbacks.

Even without a regulatory mandate, there has been a strong trend favoring the adoption of clawback policies. Between 2006 and 2013 the number of Fortune 100 companies with publicly-disclosed clawback policies grew from 17.6% to 89.4%, and currently approximately three-quarters of S&P 500 companies (including 90% of the top 250 such companies) already disclose a clawback policy covering one or more named executive officers, with most of these policies addressing both cash and equity incentive compensation. Given the attention clawbacks have gained from a governance perspective, companies may want to consider whether, prior to the finalization of the applicable listing standards, to adopt new clawback policies or amend their existing claw-back policies, in light of proposed Rule 10D-1. In addition, companies that currently have clawback policies should consider enhancing disclosures related to such policies in their 2016 proxy statements.

Pay vs. Performance Disclosure

On April 29, 2015, the SEC proposed rules which would require disclosure of the relationship between executive compensation actually paid and the financial performance of a company. The rules would require the inclusion of a new pay versus performance table showing, for each of the company's last five fiscal years (three in the case of smaller reporting companies):

(i) the compensation of the principal executive officer (PEO), on an annual basis (including a new metric of compensation "actually paid" and the total compensation as reported in the summary compensation table) (if more than one person has served as PEO in any year

included in the table, the compensation of all persons serving in that capacity would be aggregated);

(ii) the average compensation, on an annual basis, for the named executive officers (other than the PEO) (again, including both the average compensation "actually paid" and the total average compensation as reported in the summary compensation table); and

(iii) the cumulative total shareholder return (TSR) of the company and its peer group.

The disclosures would be required in any annual report, proxy statement or registration statement that would otherwise require executive compensation disclosure under Item 402 of Regulation S-K. As proposed, the rules would apply to all SEC reporting companies, with the exception of foreign private issuers, registered investment companies and emerging growth companies. The rule's phase-in would require disclosure for the past three years in the first proxy or information statement in which such disclosure is required; in each of the two subsequent years, another year of disclosure would be added. Smaller reporting companies would only need to provide information for two years initially, adding the additional year in their next annual proxy or information statement. Newly reporting companies would not need to include pay versus performance information for fiscal years prior to their last completed fiscal year.

Although the rules will not be in effect for the 2016 reporting season, one aspect of the proposed rules warrants consideration by compensation committees. The proposed rules unambiguously rely on TSR as the basis for reporting the relationship between executive compensation and financial performance. Therefore, readers are likely to focus on the company's actual and relative TSR regardless of whether that metric is used to determine executives' pay. While the reliance on this measure has been critiqued as putting investors' desire for comparability across companies ahead of the use of performance metrics that make the most sense for a particular company, it seems likely that the focus will remain on TSR. Therefore, companies that do not currently use relative TSR as a metric in executive pay might consider (i) switching to TSR as a performance measure, or (ii) providing an explanation to shareholders in the compensation discussion and analysis section as to why a different performance metric is used to determine executive pay.

Employee and Director Hedging Disclosure

On February 9, 2015, the SEC proposed rules which would require each issuer to disclose, in any proxy or consent solicitation materials, if any employees or members of the board are permitted to purchase financial instruments designed to hedge their equity securities of the company. While the rule has not been finalized and will not impact 2016 proxy disclosures, anti-hedging positions of proxy advisory and corporate governance rating firms have prompted some companies to prohibit directors and executive officers (and sometimes employees in general) from engaging in hedging transactions with respect to their company's stock. Companies should prepare for the requirement by analyzing whether to permit hedging of company stock. Because there is no universally accepted best practice approach to hedging/pledging policies, some companies may elect to prohibit all types of hedging and pledging altogether, while others may elect to allow for greater flexibility and allow hedging and/or pledging in certain specific circumstances (such as permitting pledging so long as the insider demonstrates an ability to repay the loan and subject to appropriate pre-clearance requirements). It is important to analyze what type of policy is in the best interest of the company, taking into account the needs of its insiders, and what types of features could be incorporated into the policy to mitigate risk.

Payments by Resource Extraction Issuers

In August 2012, the SEC adopted rules under Section 13(q) of the Exchange Act that would require a "resource extraction issuer" to include in an annual report information relating to any payment made by the issuer, the issuer's subsidiaries, or entities under the issuer's control to a foreign government or the U.S. government for the purpose of the commercial development of oil, natural gas, or minerals. The U.S. District Court for the District of Columbia vacated these rules in 2013 and on December 11, 2015, the SEC issued a new set of proposed rules. The new rules would require disclosure on Form SD of certain payments (including royalties, bonuses, taxes, dividends, and licensing fees) made to the federal government and foreign governments. There is an exclusion for *de minimis* payments (defined as a group of payments totaling less than $100,000 during the same fiscal year) and the rule also provides that the SEC can grant exemption on an instance-specific basis for certain circumstances, such as prohibition of disclosure by foreign law. The proposed rule also allows issuers to provide complying disclosure via reports that are prepared for foreign

regulators or the U.S. Extractive Industries Transparency Initiative if the requirements of those bodies are determined by the SEC to be "substantially similar to the proposed rules." It is expected that the information required to be gathered under the final rules will closely mirror the requirements of the originally proposed rules, though the information that is ultimately required to be made public may be more limited. Therefore, resource extraction issuers that make such payments may wish to make preliminary preparations for disclosure of information about such payments to the SEC.

Conflict Mineral Rules

Any company that files reports with the SEC under the Exchange Act is required to disclose annually whether it uses "conflict minerals" (as defined in the Dodd-Frank Act) that are "necessary to the functionality or production" of a product that they either manufacture or contract to be manufactured that originate from the Democratic Republic of the Congo or adjoining countries (Covered Countries). A company that uses any of the designated minerals is required to conduct a reasonable "country of origin" inquiry into the source of such minerals. If a company is able to conclude that the designated minerals did not originate in the Covered Countries, it must disclose this determination on Form SD. Otherwise, the company must file a Conflict Minerals Report as an exhibit to its Form SD.

In response to an April 2014 U.S. Court of Appeals for the District of Columbia (the Court) ruling that the conflict mineral rules violated the First Amendment to the extent that they required certain disclosures, SEC guidance has clarified that no company is required to label its products as "DRC conflict free," having "not been found to be 'DRC conflict free,'" or "DRC conflict undeterminable." Instead, a company that is not required to file a Conflict Minerals Report should describe the reasonable country of origin inquiry it undertook, while a company that is required to file a Conflict Minerals report should describe its due diligence efforts and disclose the facilities used to produce the conflict minerals, the country of origin of the minerals and the efforts to determine the country of origin the mine or location of origin, if applicable.

The rules provide for a two-year transition period (four years for smaller reporting companies). During this transition period (which expires for filings due by May 31, 2016), no independent audit is required unless a company elects to designate its products as "DRC conflict free" in its Conflict Minerals Report. The rules have been challenged and remain the subject of ongoing litigation at this time. The Court has upheld its earlier decision and rejected the SEC's petition for rehearing. The SEC has until February 7, 2016 to appeal. It is unlikely that litigation will be resolved before the next disclosures become due on May 31, 2016. While further guidance regarding the interplay between the Court's opinions and the rule's two-year transition period would be helpful, because the transition period provided for in the rule is predicated on the same "labeling" language that was struck down on constitutional grounds, and because the SEC has not revised its 2014 statement, it is understood that no private audit will be required for the filings due on May 31, 2016, even though the transition period provided for in the rule will have expired at that time.

Audit Committee Practices and Disclosures

On July 1, 2015, the SEC issued a concept release soliciting comments on possible revisions to its existing audit committee disclosure requirements, specifically with respect to an audit committee's reporting of its responsibilities for the oversight of independent auditors. This release is responsive to requests from a number of groups for improvements in disclosures in this area.

Possibly in response to these requests, an increasing number of companies are including expanded voluntary disclosures about their audit committees and audit committee practices in their annual meeting proxy statements. According to a November 2015 report from the Center for Audit Quality and Audit Analytics, growing numbers of audit committees are responding to evolving market needs by providing more meaningful information around the audit committee's role in overseeing the external auditor. This is consistent with the findings of a September 2015 report by Ernst & Young, which reviewed proxy statements filed by Fortune 100 companies from 2012 to 2015. These companies have significantly increased the information available about how they appoint, compensate and oversee their external auditors. Given the continued interest in audit committee disclosures and the SEC's recent focus on this topic, companies should consider possible improvements to audit committee communications and discuss the possibility of expanding current proxy statement disclosures with their audit committee members.

White & Case LLP
1155 Avenue of the Americas
New York, New York 10036-2787
United States

T +1 212 819 8200

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