Reminders for US Public Companies for the 2018 Annual Reporting and Proxy Season

January 2018

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Executive Summary

This memorandum outlines certain considerations for US public companies in preparation for the 2018 annual reporting and proxy season. Part I of this memorandum discusses new developments and practical action items for the 2018 reporting season; Part II sets forth an overview of recent corporate governance and regulatory developments and trends; and Part III includes a brief discussion relating to upcoming regulatory developments and pending rulemaking initiatives.

Part I. New Considerations and Action Items for the 2018 Reporting Season

ISS and Glass Lewis Proxy Voting Guidelines[1]

Institutional Shareholder Services ("ISS") and Glass, Lewis & Co. ("Glass Lewis") published updates to their proxy voting policies applicable to shareholder meetings held on or after February 1, 2018.

Shareholder Proposals

- *Gender Pay Gap*—ISS will make case-by-case recommendations on shareholder proposals requesting a report on a company's pay data by gender or its policies and goals to reduce any gender pay gap, taking into account: (i) the company's current policies and disclosure related to both its diversity and inclusion policies and its compensation philosophy and practices; (ii) whether the company has been the subject of recent controversy, litigation or regulatory actions related to gender pay gap issues; and (iii) whether the company's reporting regarding gender pay gap policies or initiatives is lagging behind its peers.
- *Climate Change Risk*—ISS will generally recommend voting for resolutions requesting that a company disclose information on the financial, physical or regulatory risks related to the impact of climate change on its

1 ISS' 2018 Voting Guidelines can be found here. Glass Lewis' 2018 Policy Guidelines can be found here. Our alert on ISS' Voting Guidelines can be found here.

operations and investments or on how the company identifies, measures, and manages such risks. ISS will consider: (i) whether the company already provides current, publicly available information on the impact that climate change may have on the company as well as associated company policies and procedures to address related risks and/or opportunities; (ii) the company's level of disclosure compared to industry peers; and (iii) whether there are significant controversies, fines, penalties or litigation associated with the company's climate change-related performance.

Glass Lewis expanded and codified its policy on climate change-related shareholder resolutions, noting that it will generally recommend in favor of resolutions for companies in certain extractive or energy-intensive industries that request climate change scenario analysis.

Board Issues

- *Board Diversity*—ISS will specifically identify in its reports which boards have no gender diversity; however, it will not make adverse vote recommendations due to a lack of gender diversity.

  In 2018, board diversity will be one of many factors Glass Lewis considers when evaluating companies' oversight structures. Beginning in 2019, Glass Lewis will recommend voting against nominating committee chairs (and potentially other committee members) of boards with no female members, absent a sufficient rationale or a disclosed plan to address the lack of board diversity.

- *Board Independence*—ISS will recommend voting against or withholding from non-independent directors if any of the following circumstances exist: (i) independent directors comprise 50% or less of the board; (ii) the non-independent director serves on the audit, compensation or nominating committee; (iii) the company lacks an audit, compensation or nominating committee so that the full board functions as that committee; or (iv) the company lacks a formal nominating committee, even if the board attests that the independent directors fulfill the functions of such a committee.

Compensation Issues and Board Responsiveness

- *Say on Pay*—If a company's prior say-on-pay vote received less than 70% support, ISS will take into consideration any additional shareholder engagement disclosure provided by the company when deciding how to recommend on say-on-pay proposals and compensation committee members in the following year. Such disclosure elements may include: (i) the timing and frequency of the company's engagements with major institutional investors; (ii) whether independent directors participated in such engagement in forming its vote recommendation; and (iii) the specific concerns voiced by dissenting shareholders along with the specific and meaningful actions taken to address such concerns in evaluating the board's responsiveness.[2] ISS prefers independent director participation as it facilitates candid investor feedback and will be placing more emphasis on feedback the company receives from investors who voted against say-on-pay.

- *Responsiveness to Shareholder Votes*— ISS will vote case-by-case on members of the compensation committee (or, in exceptional cases, the full board) and the say-on-pay proposal if the board of directors implements an advisory vote on executive compensation on a less frequent basis than the frequency approved by the company's shareholders.

  Glass Lewis considers the board to generally have an imperative to respond to shareholder dissent from a proposal at an annual meeting of more than 20% of votes cast, particularly in the case of a compensation-related or director election proposal.[3]

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[2] ISS' revised FAQs, available here, provide additional details on the factors ISS' review will take into consideration. See question 16.

[3] If voting control is held through a dual-class share structure with disproportionate voting and economic rights, Glass Lewis will examine the level of approval or disapproval attributed to unaffiliated shareholders when determining whether board responsiveness is warranted. Where vote results indicate that a majority of unaffiliated shareholders supported a shareholder proposal or opposed a management proposal, it believes the board should demonstrate an appropriate level of responsiveness.

- *Non-Employee Director ("NED") Pay*—ISS will make recommend against board committee members who are responsible for setting or approving NED compensation when a "pattern of excessive NED pay" is identified in two or more consecutive years, absent a compelling rationale or other mitigating factors. While this will not impact voting recommendations in 2018, negative recommendations will be triggered in subsequent years if a pattern of excessive NED pay is identified.

- *Pay Ratio*—Both ISS and Glass Lewis will display pay ratio data in their research reports and proxy papers, respectively, but the pay ratio will not impact their vote recommendations in 2018.

Poison Pills

ISS will recommend against all board nominees, every year, at a company that maintains a long-term poison pill (one with a term greater than one-year) that has not been approved by shareholders. Commitments to put a long-term pill to a vote the following year will no longer be considered a mitigating factor. Boards with 10-year pills not approved by shareholders, which are currently grandfathered from 2009, will no longer be exempt. Short-term pill (those with a term of one year or less) adoptions will continue to be assessed on a case-by-case basis, but ISS will focus more on the rationale for their adoption than on the company's governance and track record.

Equity Plan Amendments

ISS' updated FAQs[4] indicate that ISS will evaluate equity plan amendment proposals on a case-by-case basis. ISS' recommendation will generally be based on the Equity Plan Scorecard (EPSC) evaluation/score if any of the following apply: (i) the proposal includes a material request for additional shares; (ii) the proposal represents the first time shareholders have had an opportunity to opine on the plan; (iii) the amendments include an extension of the plan's term; or (iv) the amendments include the addition of full value awards as an award type when the current plan authorizes only option/SAR grants. However, regardless of EPSC score, and if none of the above four scenarios apply, ISS will make a recommendation based on an analysis of whether the overall impact of the amendments is beneficial or contrary to shareholders' interests. In these cases, the EPSC score will be displayed for informational purposes, but it typically will not determine ISS' recommendation.

Additional Considerations

- *Pledging of Company Stock*—If a significant level of pledges of company stock by executives or directors raises concerns, ISS may recommend against all members of either a committee that oversees pledging or the full board, as applicable, taking into consideration: (i) the presence of an anti-pledging policy, disclosed in the proxy statement, that prohibits future pledging activity; (ii) the magnitude of aggregate pledged shares in terms of total common shares outstanding, market value and trading volume; (iii) disclosure of progress or lack thereof in reducing the magnitude of aggregate pledged shares over time; and (iv) disclosure in the proxy statement that shares subject to stock ownership and holding requirements do not include pledged company stock.

- *US Categorization of Directors*—ISS updated its US director categories to harmonize its categorizations across global markets.[5]

- *Dual-Class Structures*—Glass Lewis will consider the presence of dual-class share structures in its evaluation of a company's corporate governance practices, including in the year of its IPO or spin-off. At established companies, it will generally recommend in favor of proposals to eliminate dual-class share structures and against proposals to adopt a new class of common stock.

- *Virtual Shareholder Meetings*—In 2019, Glass Lewis will begin recommending against members of the governance committee at companies that plan to hold virtual-only shareholder meetings, unless they have

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4 The FAQs on compensation policies are available here. The FAQs on equity compensation plans are available here. Note that effective for meetings as of February 1, 2018, ISS made updates to its EPSC evaluations (see questions 35, 37 and 38).

5 Directors will be categorized as Executive Director, Non-Independent Non-Executive Director and Independent Director (replacing Inside Director, Affiliated Outside Director and Outside Director).

provided assurances that shareholders will be afforded the same rights and opportunities to participate as they would at an in-person meeting.

- *Director Commitments*—When evaluating whether its directorship limits for public company executives (currently two total board memberships) will be applied, Glass Lewis will consider the specific duties and responsibilities of a director's executive role in addition to the company's disclosure regarding that director's time commitments.
- *Removal of Shareholder Discretion on Classified Boards*—ISS will generally vote against or withhold from the entire board of directors (except new nominees, who should be considered case-by-case) if the company has opted into or failed to opt out of state laws requiring a classified board structure.
- *Pay-for-Performance Evaluation*—ISS will add "Relative Financial Performance Assessment" (RFPA) to its quantitative screening for 2018; this measure of alignment between CEO pay and company financial performance was first introduced as part of the qualitative evaluation in 2017. RFPA compares the company's rankings to a peer group selected by ISS with respect to CEO pay and financial performance in specified metrics (depending on industry), in each case measured over three years.[6]

Disclosure Considerations

Pay Ratio Disclosure[7]

The pay ratio disclosure rule (the "Rule") requires disclosure of how the median pay of a company's workforce compares to the compensation of its chief executive officer and applies to each of a company's registration statement, proxy and information statement and annual report that is required to disclose information on executive compensation pursuant to Item 402 of Regulation S-K.[8] The Rule is in effect and disclosure will be required in proxy statements or Form 10-Ks filed in 2018.

In September 2017, the SEC and the staff of the Division of Corporation Finance ("Corp Fin") issued interpretive guidance on the Rule[9], (collectively, the "Guidance"), to assist companies in preparing the required disclosure. The Guidance generally provides more flexibility for issuers in their compliance efforts, so long as their approach is reasonable.

While the Guidance should help reduce costs and streamline compliance efforts, preparation of the pay ratio disclosure can be time consuming and expensive, and companies should already be involved in the process of identifying the median employee and calculating annual total compensation. Companies should also prepare for the potential impact of the public dissemination of their pay ratio disclosure. Specifically, companies may have to address employee relations issues and may be subject to broader public and media scrutiny and critiques of the pay ratio number and possibly of the methodology used as well. Companies should: (i) carefully consider the methodologies they employ, as well as how this information will be disclosed in their proxy statement; (ii) be prepared to address questions and critiques; and (iii) consider proactively communicating with shareholders or other stakeholders to address their concerns and mitigate perception risks. Companies may provide supplemental disclosure to offset or explain a particularly skewed pay ratio, but this may not be more prominent than the required pay ratio disclosure.

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6 See ISS' FAQs, available here, for more information (questions 20 and 21).

7 The pay ratio rule can be found here.

8 For more information on the pay ratio rules, see our prior release, available here.

9 This guidance includes (i) an interpretive SEC release[9], (ii) separate guidance on the calculation of pay ratio disclosure, including guidance on the use of statistical sampling to identify the median employee, published by the staff of Corp Fin and (iii) two new Compliance and Disclosure Interpretations ("C&DIs") and a withdrawal of one C&DI. For more information on this guidance, see our prior release, available here.

New Revenue Recognition Accounting Standard

The new revenue recognition accounting standard, ASU No. 2014-09[10], went into effect for fiscal years beginning after December 15, 2017; therefore, public reporting companies will need to prepare their Form 10-Q for the first quarter of 2018 in accordance with the new standard. Companies transitioning to the new revenue recognition standard may use either a full retrospective method (i.e., applying it retrospectively to each prior period presented) or a modified retrospective method (i.e., applying it to contracts that are initiated after the effective date and contracts that have remaining obligations as of the effective date, without restating the prior period financials to reflect adoption of the new standard).

- *Transition Disclosures*—While calendar year companies will not need to apply the new revenue recognition standard until their first quarterly report of 2018, Staff Accounting Bulletin No. 74 ("SAB 74") requires that companies include robust transition disclosures in their annual reports to enable investors to understand the anticipated effects of the new standard. The SEC has emphasized the importance of these transition disclosures[11], indicating that it will focus on (i) disclosure of the impact that adoption of the new standard is expected to have on the company's financial statements, or a statement that such impact is not known or reasonably estimable, and a qualitative description of the effect of the new policies and a comparison to the company's current accounting; (ii) disclosure of the status of the company's implementation process for the new standard and significant implementation matters yet to be addressed; and (iii) involvement of the audit committee in the process to ensure that its SAB 74 disclosures are timely identified and subject to effective internal control over financial reporting.

- *Considerations for Registration Statements on Form S-3*—The choice of accounting method may have implications for registration statements on Form S-3 that will be filed between the filing date of a company's first quarter 2018 Form 10-Q and the filing date of its subsequent 2018 Form 10-K. If a company using the full retrospective method files a Form S-3 during the period between filing its first Form 10-Q applying the new standard and its first Form 10-K applying the new standard, the prospectus would have to revise the audited financial statements contained in the company's most recently filed Form 10-K, which would mean revising its 2017, 2016 and 2015 financial statements.[12] If a calendar-year company using the full retrospective method does not file a Form S-3 during this period, it generally would not need to revise its 2017 and 2016 financial statements until it files its 2018 Form 10-K and would not need to revise its 2015 financial statements at all since they would not appear in its 2018 Form 10-K.

- *SEC Comments for Early Adopters*—Corp Fin's comment letters on revenue recognition standard disclosures thus far indicate the following trends: (i) early adopters have been asked to clarify considerations made for operationalizing different aspects of the standards; (ii) the SEC has been requesting more robust SAB 74 disclosures for periods ending December 31, 2016; and (iii) several companies have disclosed incorrect effective dates for the standard. The emphasis of the comments was on the adequacy of disclosure and seeking to understand how the company made judgments in applying the new principles-based standard.

  The SEC stressed that it will monitor revenue-related disclosures carefully, and if companies have questions about the standard, Corp Fin is willing to work with them collaboratively to help resolve those issues.

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10 Available here.

11 See, for example, speeches by Wesley Bricker, Chief Accountant of the SEC, available here and here; and Sagar Teotia, Deputy Chief Accountant of the SEC, available here.

12 Item 11(b)(ii) of Form S-3 requires that a prospectus include restated financial statements if there has been a change in accounting that requires a material retroactive restatement of financial statements. The issue raised by Item 11(b)(ii) only applies to a Form S-3 filed between a company's first Form 10-Q applying the new standard and the Form 10-K for that fiscal year. If a company already has an effective shelf registration statement on Form S-3 in place, it may conduct a "takedown" offering without revising prior financial statements, as long as management determines that the application of the new standard does not constitute a "fundamental change" under Item 512(a) of Regulation S-K.

PCAOB Auditing Standard 3101[13]

In October 2017, the SEC unanimously approved[14] the Public Company Accounting Oversight Board's ("PCAOB") proposal to adopt a new auditing standard, AS 3101, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, and related amendments to other auditing standards (collectively, the "New Standard"). The New Standard will significantly revise the auditor's report by: (i) requiring disclosure of the communication of critical audit matters ("CAMs")[15] and (ii) implementing additional content requirements and formatting changes to improve the utility, organization and readability of auditor reports.

The changes other than communication of CAMs are effective for all audits relating to fiscal years ending on or after December 15, 2017. CAM requirements will be phased-in for large accelerated filers for audits relating to fiscal years ending on or after June 30, 2019, and for all other companies for audits relating to fiscal years ending on or after December 15, 2020. Auditors may voluntarily comply early. CAM requirements will generally apply to all audit reports filed with the SEC, but will not apply to audit reports of emerging growth companies ("EGCs"), certain brokers and dealers, investment companies other than business development companies and benefit plans.

The New Standard will require an auditor's report to disclose any CAMs arising from the current period's audit, or to state that the auditor determined that there were no CAMs for that period. For any CAMs, the auditor must disclose in its report the principal considerations that led the auditor to determine that the matter is a CAM and how the CAM was addressed in the audit, and must refer to the relevant financial statement accounts or disclosures.

The PCAOB staff has released guidance, including an annotated example of the new auditor's report highlighting the key changes, followed by explanations[16], to aid auditors in complying with the new standard.

In preparation for compliance, given the complexity and sensitivity of the issues involved, companies should consider taking the following steps:

- *Begin working with auditors now*—Start a dialogue with auditors with respect to how they expect to approach the CAM requirements in the context of their particular company, what matters may merit this designation and what disclosures the auditors would anticipate making in their auditor's reports.
- *Establish CAM notification procedures*—Establish a process for receiving timely notification from the auditors of any intention to disclose a CAM and the information that the auditor intends to include in its report about the matter. Once the New Standard is implemented, ensure sufficient time is allocated for the audit committee, other executives and legal counsel to discuss and review the auditor's report.
- *Monitor Disclosures*—Disclosure of a CAM by the auditor in its report could result in disclosure of original information, which may compel the company to provide its own disclosure. Management should pay close attention to any differences between the CAM disclosures in the auditor's report and management's disclosures in its filed documents concerning the same matters. In addition, given that the new auditor's report discussion will reflect the auditor's perspective, which is inherently different from management's perspective, management may wish to revise or supplement its own disclosures on a matter in order to ensure that an accurate and complete picture is disclosed.

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13 For more information, see our prior alert, available here.

14 The SEC's order can be found here.

15 A CAM is defined as any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (i) relates to accounts or disclosures that are material to the financial statements; and (ii) involved especially challenging, subjective, or complex auditor judgment. The New Standard includes guidance for auditors in determining whether a matter rises to the level of a CAM due to its involving especially challenging, subjective, or complex auditor judgment.

16 Available here. The guidance also notes that questions pertaining to AS 3101 and related amendments may be directed to the staff in the PCAOB's Office of the Chief Auditor via the standards' help line at (202) 591-4395 or may be submitted through a web form.

- *Consider Enhanced Proxy Disclosure*—Companies with long-tenured auditors may consider enhanced disclosure in their proxy statements addressing the benefits of having a long-term relationship with their auditor, such as institutional knowledge and higher quality audits, as well as how the audit committee monitors auditor independence.

Audit Committee Disclosures

In 2015, the SEC issued a concept release[17] soliciting comments on possible revisions to existing disclosure requirements with respect to an audit committee's responsibilities for the oversight of independent auditors. There has been an increase in voluntary audit-related disclosures, which has helped establish the scope of audit committees' oversight role, and an overall trend towards more robust discussion of the role of the audit committee. According to an analysis by Ernst & Young LLP[18] of the 2017 proxy statements of 75 Fortune 100 companies that filed proxy statements each year from 2012 to 2017, voluntary audit-related disclosures continued to trend upward in a number of areas: 56% of companies disclosed factors considered by the audit committee when assessing the qualifications and work quality of the external auditor (up from 48% in 2016 and 17% in 2012); 73% stated that the audit committee believed that the choice of external auditor was in the best interests of the company and/or the shareholders (up from 72% in 2016 and 3% in 2012); 87% explicitly stated that the audit committee is responsible for the appointment, compensation and oversight of the external auditor (up from 81% in 2016 and 45% in 2012); and 43% provided information about the reasons for changes in fees paid to the external auditor (up from 31% in 2016 and 9% in 2012) (under current SEC rules, companies are required to disclose fees paid to the external auditor, but are not required to discuss the reasons for any changes in fees).

Although no further action has been taken by the SEC in connection with the 2015 concept release, given the continued investor interest in audit committee disclosures, companies should consider improvements to audit committee communications and expansion of current proxy statement disclosures.

US Tax Reform Considerations

On December 22, 2017 (the "enactment date"), tax reform (the "Tax Act")[19] was signed into law. The Tax Act will have significant implications for companies, including on their accounting and associated disclosure, as discussed below. Certain compensation provisions of the Tax Act are also noted below.

Accounting Disclosure Guidance[20]

The SEC's Office of the Chief Accountant and Corp Fin have each issued guidance to aid companies in their disclosures addressing the accounting impact of the Tax Act.

- *Staff Accounting Bulletin 118 ("SAB 118")*[21]—SAB 118 expresses the Staff's views on how the standard on accounting for income taxes (Financial Accounting Standards Codification Topic 740, Income Taxes ("ASC 740")) should be applied in the context of the Tax Act. ASC 740 requires companies to reflect the accounting impact of legislative changes in the quarter they are signed into law, even if they go into effect at a future date. SAB 118 acknowledges, however, that accounting for certain income tax effects of the Tax Act may be incomplete by the time financial statements are issued for the reporting period that includes the enactment date, and provides guidance on how companies should address certain situations, including (i) when the tax effects of the Tax Act are incomplete, partially incomplete or unable to be reasonably estimated, (ii) how companies should determine the measurement period, and (iii) what types of supplemental disclosures should be included in the financial statements where the accounting under ASC 740 is incomplete.

17 The concept release can be found here.

18 The Ernst & Young report can be found here. A review of S&P 500 companies' proxy statements conducted by The Center for Audit Quality (CAQ) and Audit Analytics revealed similar trends. That survey is available here.

19 The official title of the Tax Act is "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." Prior to an amendment, the Tax Act was originally titled the "Tax Cuts and Jobs Act." The full bill is available here.

20 For a more in-depth discussion of the accounting disclosure guidance provided by the SEC, and related disclosure considerations, please see our prior alert, available here.

21 SAB 118 is available here.

- *Item 2.06 of Form 8-K Compliance and Disclosure Interpretation ("C&DI") 110.02*[22]—The Tax Act's reduced corporate income tax rate may result in a reduction in the value of deferred tax assets. For companies relying on SAB 118, this new C&DI clarifies that the re-measurement of a deferred tax asset to incorporate the effects of the Act is not an impairment under ASC 740 and, therefore, does not trigger an obligation to file under Item 2.06 of Form 8-K[23] with respect to disclosure of material impairment of an asset. However, the Tax Act could have implications for a registrant's financial statements, including whether it is more likely than not that a deferred tax asset will be realized. A company that uses the "measurement-period" approach of SAB 118 that concludes that an impairment has occurred due to changes resulting from the enactment of the Tax Act may rely on the Instruction to Item 2.06 and disclose the impairment, or a provisional amount with respect to that possible impairment, in its next periodic report.[24]

Additional Disclosure Considerations

- *Voluntary Disclosures/Regulation FD*—If a company does not provide a public update on the Tax Act's impact on its 2017 financial results and anticipated results for 2018, answering investor or analyst questions selectively should be considered carefully because of the risk of a violation of Regulation FD.
- *Earnings Release*—SAB 118 does not address the financial statements included in a company's earnings release, but companies should consider the extent to which it is appropriate to include the disclosures called for in SAB 118 in their earnings release, including by: (i) specifically identifying amounts that are provisional and including an explanation of the extent to which the impact of the Tax Act is or is not reflected in their earnings release financial statements, and (ii) addressing both positive and negative tax accounting effects of the Tax Act to the extent that they have completed their ASC 740 assessment of such effects.
- *Item 2.02 of Form 8-K*—Any disclosures regarding material tax accounting effects of the Tax Act that relate to, but are made after the end of, the fiscal period that includes the enactment date could trigger a required Item 2.02 Form 8-K.[25]
- *Other Disclosure in Periodic Reports*—Companies should update their discussion of known trends and uncertainties in MD&A, as well as any changes in their business or strategy that may result from the impacts of the Tax Act, and should also consider possible disclosure updates regarding the impact that future tax rates and any impairments could have on contractual provisions, such as debt maintenance covenants and executive compensation targets.
- *Non-GAAP Financial Measures*—Companies that have completed or provisionally provided for their assessment of the Tax Act's tax accounting effects and reflected those effects in their financial statements, but then back out that impact to address period-over-period comparability, should be mindful of the non-GAAP presentation and reconciliation requirements.

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[22] C&DI 110.02 is available here.

[23] Form 8-K requires disclosure when a material charge for asset impairment is required under GAAP and an estimate of the charge (unless the company is not able in good faith to estimate the charge, in which case disclosure of the estimate can be delayed until known). No Form 8-K filing is required if the company reaches the conclusion in connection with the preparation of financial statements required to be included in the next Form 10-K or Form 10-Q, and the SEC staff has made clear that a conclusion that "coincides" with the preparation of the financial statements is made "in connection with" their preparation.

[24] The relevant instruction provides that "[n]o filing is required under [] Item 2.06 if the conclusion [regarding the material charge for the impairment] is made in connection with the preparation, review or audit of financial statements required to be included in the next periodic report due to be filed under the Exchange Act, the periodic report is filed on a timely basis and such conclusion is disclosed in the report."

[25] Item 2.02 of Form 8-K is triggered by any public disclosure of material non-public information regarding a company's results of operations or financial condition for a completed quarterly or annual fiscal period.

Certain Compensation Provisions

- *Section 162(m) of the Internal Revenue*—The Tax Act eliminates Section 162(m)'s exemption for performance-based compensation.[26] Companies submitting compensation plans or agreements for a shareholder vote may need to revise their standard tax discussion to reflect the absence of the deduction. Elimination of the deduction could also be relevant to compensation disclosure and analysis, as the impact of accounting and tax treatments of the particular form of compensation is specifically noted as an example of potentially material information that should be disclosed.[27]

- *Deferral of Tax on Private Company Stock Options and RSUs*—The Tax Act allows employees of certain private companies to elect to defer the taxation of stock options and restricted stock units ("RSUs") for up to five years after exercise of the options or settlement of the RSUs.

Possible Updates to Risk Factor Disclosures

When reviewing risk factors for this reporting season, companies should consider:

- *Cybersecurity*—In light of recent cybersecurity breaches at several high-profile companies, as well as at the SEC itself, there is increasing recognition that cybersecurity poses both economic and security threats that can impact any company. SEC guidance[28] notes that material cybersecurity risks must be disclosed to avoid potential incomplete or misleading disclosures and companies should carefully analyze whether they need new, revised or expanded cybersecurity disclosure.

- *Political Changes*—Changes and potential changes in law, regulation and policy under the current presidential administration may necessitate modifications to risk factor disclosure for certain companies. Approximately 550 companies disclosed risk factors related to the current administration in their Forms 10-K and 20-F filed between September 1, 2016, and April 30, 2017. Some examples include: changes to immigration policies may present risks to companies that rely on foreign employees or contractors; the potential withdrawal or modification of international trade agreements may create additional risks for certain companies; companies in the health care or insurance industries may face risks relating to efforts to repeal or modify the Affordable Care Act; and changes in tax or environmental policies could also require risk factor disclosure.

- *Tax Reform*—The passage of the Tax Act may make it difficult for companies, especially large multinational companies, to accurately determine the impact of the tax changes on their financial statements in time to file their annual and quarterly reports with the SEC. Accounting rules require companies to reflect the impact of legislative changes in the quarter they are signed into law, even if they go into effect at a future date (see above). While the SEC has issued guidance which provides significant relief and helpful direction on some of the accounting and disclosure issues raised by the Tax Act, given the complexity of such determinations, companies may wish to disclose as a risk factor both the potential impact of the legislation, as well as the risk that such impact cannot be accurately determined within the required disclosure timeframe.

- *Climate Change and Sustainability*—These issues have been receiving increased attention, and risk factor disclosure could be necessary to address the impact of existing or pending legislation on a company's business, as well as the effects of increasing public consciousness and activism related to climate change and sustainability issues. Potential changes in climate regulation, especially in light of the US withdrawal from the Paris climate accord, could also pose specific risks to certain companies.

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[26] Compensation is not subject to the new rules if it would have otherwise been deductible under the current Section 162(m) rules when paid and it is payable pursuant to a written binding contract that was in effect on November 2, 2017 and that is not materially modified thereafter. The Joint Explanatory Statement released with the bill provides the following guidance: (i) a plan in effect on November 2, 2017 is not by itself sufficient to qualify for the written binding contract exception; (ii) a written plan may qualify for the grandfather if it meets certain requirements, including that the amounts payable under the plan are not subject to discretion, and that the employer does not have the right to terminate or materially amend the plan (except on a prospective basis for future service periods); and (iii) a written binding contract that is renewed after November 2, 2017 ceases to qualify for the exception.

[27] See Item 402(b)(2)(xii) of Regulation S-K.

[28] The SEC's Disclosure Topic 2 is available here.

- *Shareholder Activism*—As companies become increasingly aware of the prevalence of activism and the potential downside of being a target, shareholder activism is being included as a risk factor in some companies' periodic reports. In the first half of 2017, 65 companies included such a risk factor, over a fivefold increase from 2014. This disclosure can take the form of a standalone risk factor describing how the company's business could be impacted by the actions of activist shareholders (such as by causing the company to incur substantial costs, including litigation, diverting management attention and resources, or creating uncertainty that impacts retention of employees or customers) or adding shareholder activism to a list of factors that could hinder investment or other business activities and impact a company's stock price.

- *Brexit*—While the full effect of the United Kingdom's withdrawal from the EU may not be seen for several years, approximately 600 companies have disclosed Brexit-related risk factors in their Forms 10-K and 20-F filed between September 1, 2016, and April 30, 2017. Brexit has been referenced in risk factors on currency exchange rate risks, cross-border trade and labor, international operations risks and global economic conditions, and risks related to political and regulatory uncertainty. As Brexit negotiations progress, impacted companies should continue evaluating whether Brexit poses a material risk to their business, what level of Brexit-related disclosure is appropriate and whether any prior Brexit risk factor disclosures require updates.

Presentation of Non-GAAP Financial Information

2016 guidance from Corp Fin[29] clarified the SEC's position on complying with a number of key aspects of Regulation G and Item 10(e) of Regulation S-K relating to the use of non-GAAP financial information. Since this guidance was released, the SEC has issued numerous comment letters on non-GAAP measures directed at companies with improper disclosure (656 in the first half of 2017, compared to 429 in the first half of 2016). Some of the most common comments focus on the undue prominence of non-GAAP information, including lack of comparable GAAP metrics, or presentation of the non-GAAP metric ahead of the comparable GAAP number. Although the pace of comments on these issues has been declining, companies should continue to closely monitor their non-GAAP financial disclosures to ensure they are compliant with the requirements.

Specialized Disclosure Rules

- *Repeal of Resource Extraction Rule*—In February 2017, Rule 13q-1 of the Exchange Act, which would have required companies to publicly disclose payments to the US or foreign governments related to the commercial development of oil, natural gas or mineral resources, was repealed. The SEC is still required to promulgate rules mandating disclosure of payments to foreign governments; however, the Congressional Review Act expressly prohibits any rulemaking that is "substantially the same" as the disapproved rule without additional statutory authorization, which is unlikely to be forthcoming.

- *Conflict Minerals Disclosure Rules*—Any company that files reports with the SEC under the Exchange Act is required to disclose annually on Form SD whether it uses "conflict minerals" that originate from the designated countries which are "necessary to the functionality or production" of a product the company manufactures or contracts to be manufactured.[30] In April 2017 guidance, the Staff announced it would not recommend enforcement action if a company only includes disclosure in Form SD concerning the "reasonable country of origin inquiry" (under Items 1.01(a) and (b)) and does not disclose its due diligence on the source and chain of custody of conflict minerals or a Conflict Minerals Report and associated Independent Private Sector Audit (under Item 1.01(c)).[31] However, notwithstanding the Staff guidance, the requirements remain in place, and

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[29] See Non-GAAP Financial Measures Compliance and Disclosure Interpretations (C&DIs), Questions 100.01–100.04, 102.01–102.03, 102.05, 102.07, 102.10, 102.11 and 103.02.

[30] The rules can be found here.

[31] Item 1.01(c) requires that if the company knows, or reasonably believes, based on its RCOI, that any of its necessary conflict minerals originated in the Democratic Republic of Congo or an adjoining country and are not from recycled or scrap sources, the company must (i) exercise due diligence, including obtaining an IPSA, on the source and chain of custody of its conflict minerals, and describe the due diligence conducted in the Conflict Minerals Report attached as an exhibit to its Form SD, and (ii) describe its products that contain necessary conflict minerals, the facilities used to process the necessary conflict minerals, the country of origin of the necessary conflict minerals, and the efforts to determine the mine or location of origin with the greatest possible specificity.

without more definitive and clear relief or additional guidance, reporting companies may choose to keep their reporting approach unchanged.[32]

In November 2017, the House Financial Services Committee passed a bill[33] that would amend the Exchange Act to repeal Section 13(p), under which the SEC's conflict minerals disclosure rules and related requirements were adopted. However, this should not impact companies' current compliance plans, as even if the bill is passed, there is no guarantee it will be enacted into law.

- *Mining Disclosure Rules*—In June 2016, the SEC proposed rules that would revise the property disclosure requirements for mining registrants and the related guidance currently set out in Item 102 of Regulation S-K and Industry Guide 7.[34] The SEC has not yet considered final rules, and the proposing release does not address how much time issuers would have to comply with the new regime if it is adopted.

  In November 2017, the House Financial Services Committee passed a bill[35] that would repeal Section 1503 of the Dodd-Frank Act, which requires detailed disclosures about mine safety and health in quarterly and annual reports filed with the SEC.[36] However, this should not impact companies' current compliance plans, as even if the bill is passed, there is no guarantee it will be enacted into law.

EGC Check Boxes on Cover Pages of Forms[37]

Effective April 12, 2017, the SEC made a number of technical amendments to existing rules and certain Securities Act and Exchange Act forms such that the cover pages of certain forms are now required to include two check boxes to allow companies to indicate: (i) whether, at the time of the filing, the company is an EGC; and (ii) if so, whether it has elected not to use the extended transition period for an EGC to comply with any new or revised financial accounting standards.

As a reminder, if a registrant's status as an EGC will terminate as of the end of its current fiscal year, its next year's proxy statement will require several enhancements, including compensation information for five named executive officers and a full compensation discussion and analysis section and holding of say-on-pay and say-on-frequency votes, among other things.[38]

Inline XBRL

The SEC has not yet issued final rules following its proposed rules that would require companies to provide their financial statements in the Inline XBRL format. Inline XBRL allows filings to be made that integrate XBRL data directly into HTML filings, rather than requiring a copy of the filing to be attached as a separate XBRL exhibit.[39] Currently, public reporting companies can voluntarily file their structured financial statement data in inline XBRL format.

32 For additional information on the Staff guidance, see our prior release, available here.

33 Available here.

34 The proposal would rescind Industry Guide 7 and include the SEC's disclosure requirements in a new subpart of Regulation S-K. The proposed rules would require a company to provide disclosure for mining operations that are material to its business or financial condition. If a registrant's mining assets constitute 10% or more of its total assets, there would be a rebuttable presumption that its mining operations are material. Registrants with mining assets below the 10% threshold would be directed to consider whether there are other factors which would render its mining operations material. The proposed rules can be found here.

35 Available here.

36 For additional information on the mine safety reporting requirements, see our prior alert, available here.

37 The amendments can be found here. The filings subject to these technical amendments include Forms S-1, S-3, S-4, S-8, S-11, F-1, F-3 and F-4 under the Securities Act and Forms 10, 8-K, 10-Q, 10-K, 20-F and 40-F under the Exchange Act.

38 EGC status terminates on the earliest of: (1) the last day of the first fiscal year in which the registrant's annual gross revenues exceed $1.07 billion; (2) the date on which the registrant is deemed to be a large accelerated filer; (3) the date on which the registrant has, during the previous three-year period, issued more than $1 billion in non-convertible debt; and (4) the last day of the fiscal year in which the fifth anniversary of the registrant's first sale of equity securities pursuant to an effective registration statement occurs.

39 The SEC's order can be found here.

Paper Copies of Annual Report No Longer Required; NYSE Proposes to Eliminate Requirement to Provide Hard Copies of Proxy Materials

In 2016, Corp Fin released a C&DI which made clear that a registrant can satisfy the physical delivery requirements of Exchange Act Rules 14a-3(c) and 14c-3(b) and Form 10-K, which require mailing of copies of the annual report to the SEC, by posting an electronic version of its annual report to its corporate website before the dates specified in the respective rules. The report must remain accessible for at least one year after posting. Companies remain responsible for delivering such reports to shareholders.

On December 6, 2017, the NYSE proposed[40] to amend Section 402.01 of the NYSE Listing Manual to provide that listed companies would not be required to provide hard copies of proxy materials to the NYSE, so long as they were included in an SEC filing available on EDGAR.

Other Considerations

NYSE Rule Changes

- *Dividend Notification Requirements*—In August 2017, the SEC approved[41] an amendment to the NYSE Listed Company Manual (the "Listed Company Manual") requiring listed companies submitting dividends during or outside of market hours to provide the NYSE with 10 minutes of advance notice before releasing the dividend information to the public. The advance notice requirement for announcements during market hours was effective immediately; however, the NYSE delayed implementation as it relates to announcements issued outside of market hours. The NYSE expects the new implementation date to be no later than February 1, 2018; listed companies will be given at least 30 days notice of the implementation date.
- *Material News Issuances*—The SEC approved a rule change[42] to the Listed Company Manual requiring that a listed company not issue material news after the NYSE closes trading until the earlier of (i) publication of the company's official closing price on the Exchange or (ii) five minutes after the NYSE's official closing time. Companies may still publicly disclose material information following a nonintentional disclosure to comply with Regulation FD.

T+2 Settlement

On September 5, 2017, the securities industry implemented a shortened T+2 settlement cycle for most securities transactions, pursuant to amendments to Rule 15c6-1 adopted by the SEC and corresponding changes to NYSE[43] and Nasdaq[44] rules.

SEC Guidance on Omission of Financial Information in Confidentially-Submitted Registration Statements

The SEC issued C&DIs[45] explaining that (i) an EGC issuer may omit from its draft registration statements interim financial information that it reasonably believes it will not be required to present separately at the time of the contemplated offering, and (ii) a non-EGC issuer may omit from its draft registration statements interim and annual financial information that it reasonably believes it will not be required to present separately at the time it files its registration statement publicly.

D&O Insurance for Spoofing

Two recent cases illustrate a circuit split in whether D&O insurance policyholders will be able to secure coverage under a computer fraud insurance policy in connection with losses related to "spoofing" (i.e., whereby an individual's server is tricked into recognizing a fraudulent email as one that actually originated from a known,

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40 The proposed rule is available here.

41 The SEC's order can be found here.

42 The SEC's approval of the rule change can be found here.

43 The NYSE's alert can be found here.

44 Nasdaq's alert can be found here.

45 C&DIs 101.04 and 101.05 are available here.

trusted source).[46] Following these decisions, circuits appear to be split as to whether this is covered by the computer fraud policy of D&O insurance.

Part II. Recent Trends and Developments in Corporate Governance and Regulatory Matters

Guidance on Shareholder Proposals—Staff Legal Bulletin 14I

In November 2017, the Staff of Corp Fin published Staff Legal Bulletin 14I ("SLB 14I"), which provides guidance on the excludability of certain shareholder proposals under the "ordinary business" and the "economic relevance" bases provided in Rule 14a-8 of the Securities Exchange Act of 1934 ("Rule 14a-8"). SLB 14I also outlines what types of documentation must be submitted to prove eligibility when submitting a proposal by proxy[47] and makes clear that Rule 14a-8(d)'s 500-word limit for shareholder proposals includes any words that are part of images and graphics included in the proposal.

"Ordinary Business" Exception

Under Rule 14a-8(i)(7), a company may exclude shareholder proposals that concern matters relating to the company's "ordinary business" operations from its proxy materials; however, exclusion of proposals that focus on significant policy issues that transcend ordinary business is not permitted. As these substantive determinations often raise difficult judgment calls for the Staff, SLB 14I shifts responsibility from the Staff to the board in the first instance to analyze, determine and explain whether a particular policy issue is sufficiently significant because the matter transcends ordinary business and would be appropriate for a shareholder vote. Where there is a well-established path to, or historical basis for, exclusion under the circumstances, or where the issue clearly falls on the side of "ordinary business," the Staff does not expect this analysis to be included[48], but where there is not a long line of precedent supporting an "ordinary business" argument, no-action requests made in reliance on Rule 14a-8(i)(7) should now include a discussion detailing the specific processes used by the board in its analysis of the *policy issue's impact on the company*; the additional discussion is not required to address the social impact of the policy issue itself.

While SLB 14I seems to signal Staff deference to the board's judgment, it also places significant burdens on the board, in particular the time and resources to prepare a comprehensive response within the timing constraints of Rule 14a-8(j). Statements by Corp Fin Staff indicate that, in terms of the content of the board report, the description of the board's "well-informed and well-reasoned" analysis is most important, and the level of board involvement (review by the full board versus complete delegation to a committee, or something in between) is an important factor in the weight the SEC will give to the board's determination.

The SEC recently rejected a no-action request submitted by Apple Inc. under SLB 14I, which sought to exclude a shareholder proposal regarding the establishment of a Human Rights Committee because it involves the company's ordinary business operations under Rule 14a-8(i)(7).[49] The Staff was "unable to conclude, based on the information presented in [Apple's] correspondence, including the discussion of the board's analysis on this matter, that this particular proposal is not sufficiently significant to the Company's business operations such that exclusion would be appropriate." The Staff response noted that Apple's letter states "'the Board and management firmly believe that human rights are an integral component of the Company's business operations'" and

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46 *Medidata Solutions, Inc. v. Federal Insurance Company*, CV-00907 (S.D.N.Y. July 21, 2017); *American Tooling Center vs. Travelers Casualty and Surety Company*, CV-12108-JCO.

47 Failure to provide such documentation may result in the exclusion of such a proposal on procedural grounds pursuant to Rule 14a-8(b) eligibility requirements, but only after the company notifies the proponent of the specific defect within 14 days of receiving the proposal so that the proponent has an opportunity to cure pursuant to Rule 14a-8(f)(1).

48 See statements by Corp Fin Director William Hinman and Corp Fin Associate Director Michele Anderson at the November 2017 PLI Securities Regulation Institute, and Corp Fin Senior Special Counsel Matt McNair on a webcast presented by thecorporatecounsel.net, available here.

49 The no-action request is available here.

emphasized that "the board's analysis does not explain why this particular proposal would not raise a significant issue for the Company."

"Economic Impact" Exception

Rule 14a-8(i)(5) allows a company to exclude from its proxy materials shareholder proposals that: (1) relate to operations which represent less than 5% of the company's total assets, net earnings, and gross sales; and (2) are not otherwise significantly related to the company's business. SLB 14I indicates that going forward the Staff will focus more on the proposal's *actual significance* to the company's business, based on the particular facts and circumstances concerning the company, when it otherwise relates to operations accounting for less than 5% of the company's total assets, even where the proposal raises significant social or ethical issues. The Staff will look to the company's board to provide its analysis as to whether a particular proposal is "otherwise significantly related to the company's business" as part of a company's no-action request and the company's discussion should detail the specific processes used to ensure that the board's conclusions are "well-informed and well-reasoned." However, the SEC specifically confirmed that the Staff will generally view substantive governance matters as significant to most companies.

Statements by Corp Fin Staff indicate that, with respect to 14a-8(i)(5) no-action requests, the Staff is not changing the historical framework within which it will evaluate such requests; however, now more weight will be given to a board's determination as to whether the issue has a true (non-speculative) nexus with the company's business. Further, board analysis is not required if the company can demonstrate the propriety of the exclusion without such analysis. In addition, the Staff confirmed that it will no longer link this exception to its analysis under the ordinary business exception, whereas previously the availability of relief under Rule 14a-8(i)(7) was largely determinative of the availability of relief under Rule 14a-8(i)(5).

Proxy Access

Increased Incidence of Proxy Access Proposals and Emergence of "Fix-It" Proposals

Shareholder proposals seeking proxy access remained prevalent in 2017, with 157 such proposals submitted as of June 30, 2017.[50] As of June 30, 2017, 60% of S&P 500 companies had proxy access bylaws, compared to 12 companies pre-2015.[51] A large majority of the proxy access bylaws adopted to date enable a shareholder or a group of up to 20 shareholders who have held 3% of the company's stock for three years to nominate up to 20% of the board (commonly described as "3/3/20/20"). Further, a number of additional company-friendly features have become standard over the last few years, such as certain nomination and re-nomination restrictions.

In 2017, however, so-called "fix-it" proposals have begun to emerge. These proposals seek to have companies that have already adopted proxy access amend a core set of features that have become common. Most "fix it" proposals in 2017 sought to increase the number of shareholders permitted to constitute a nominating group. While the number of such proposals increased in 2017, they were universally unsuccessful. It is expected that in 2018, these proposals will seek to remove aggregation limits altogether. In 2017, many companies faced with the request to increase aggregation limits successfully obtained no-action relief from the SEC on the basis of substantial implementation; those companies generally provided a comprehensive analysis of the distribution of stock ownership to show that there were many ways for a group of shareholders to reach the existing requisite ownership threshold and that a higher aggregation cap would not meaningfully improve shareholder access. For proposals seeking to remove the aggregation limits altogether (i.e., rather than increase such limits to a specified higher number), in at least two instances, the SEC declined to grant no-action relief[52]; however, in one of its most recent pronouncements on the subject, the SEC sided with the company and agreed that the proponent's

[50] EY Center for Board Matters, "2017 Proxy Season Review," available here.

[51] Id.

[52] *See* the SEC's responses to no-action requests by Microsoft Corporation, available here, and H&R Block, Inc., available here.

proposal that sought to, among other things, remove the aggregation limits, was excludable on the basis of "substantial implementation" under Rule 14a-8(i)(10).[53]

ISS will generally vote for proxy access proposals that have minimal or no limits on the number of shareholders permitted to form a nominating group. Glass Lewis will review proxy access "fix-it" proposals on a case-by-case basis and will generally recommend against such resolutions at companies that reasonably conform to broad market practices, but will recommend for such resolutions at companies with unnecessarily restrictive proxy access bylaws.

Companies faced with a proxy access proposal have a few options: attempt to negotiate withdrawal with the proponent (consideration should be given to the fact that this will likely require negotiation over the content of the proposal when drafting or revising the proxy access bylaw, which may make it harder to introduce some of the desired elements to improve upon the proposal); depending on the shareholder base of the company, include the proposal and simply oppose it (importantly, these proposals are typically non-binding and would require implementation at a later date via an amendment to the company's bylaws); or pre-emptively amend the bylaws to implement the market standard proxy access bylaw and either immediately seek no-action relief on the grounds of substantial implementation or (and in case no-action request is unsuccessful) simply include the proposal and oppose. In evaluating the alternatives, companies should consider the likelihood that the proposal will receive shareholder approval, the potential impact on the company, risks of litigation and risks of adverse ISS or Glass Lewis recommendations. Companies faced with "fix-it" proposals should consider the specifics of the proposal in determining whether there may be any basis for no-action relief from the SEC or to include the proposal and oppose it.

Environmental, Social and Governance (ESG) Proposals

ESG and Sustainability Proposals

Shareholders have been increasingly focused on environmental and social issues. As of June 30, 2017, ESG proposals constituted 56% of all shareholder proposals.[54] The types of ESG proposals received by the 250 largest US public companies in 2017 included those related to:[55]

- *Climate Change*—In 2017, there were 77 environmental proposals, 24 of which related to climate change (including proposals with respect to renewable energy and greenhouse gas emissions). Three of these proposals passed (likely as a result of institutional investor voting, see below). Each of these requested a report on the impact of climate change policies, including an analysis of the impact of commitments under the Paris climate accord to limit global temperature change to two degrees Celsius.
- *Sustainability*—In 2017, there was an increase in proposals relating to board reporting on supply chain sustainability, with 11 sustainability proposals submitted, compared to only one such proposal in 2016. One proposal, calling for the preparation of an annual sustainability report, passed.
- *Independent Board Chairs*—In 2017 there were 43 proposals requesting the separation of the roles of CEO and chair of the board, up from 32 in 2016. None of these proposals passed.

While most climate change proposals have been focused on the oil and gas industry, this may shift as investors focus on the economic impact that climate change could have on a company, which is not an industry-specific issue. It is worth noting that ISS voting recommendations had little impact on overall voting results on environmental proposals. In 2017, ISS recommended a vote "for" 55 of 76 select environmental proposals; however, only four such proposals received majority support.

[53] SEC's response to Northern Trust Corporation's no-action request, available here.

[54] These statistics come from ProxyMonitor.org, a publicly available database that tracks shareholder proposals in real time.

[55] *Id.*

Voting Policies of Institutional Investors Regarding ESG Proposals

The increased shareholder focus on ESG issues dovetails with a shift in the voting policies of large institutional investors. In 2017, 331 asset owners, investment managers, and service providers in the US (and 1,753 worldwide) signed the "Principles for Responsible Investment," a set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. Also in 2017, certain institutional investors updated their shareholder proposal voting policies regarding environmental and social proposals. For example, Vanguard updated its proxy voting guidelines to state that the fund will evaluate each environmental and social proposal on its merits, and may support those where there is a "logically demonstrable linkage" between the proposal and long-term shareholder value. BlackRock also updated its voting policy with respect to environmental and social proposals, stating that "ESG considerations are integral to our investment stewardship activities" and that investment teams should integrate material ESG considerations in their investment analysis.

ESG Disclosure Considerations

Recent shareholder proposals have been aimed at both requiring companies to begin providing environmental and social disclosure and also at improving the disclosure that companies already provide. In considering ESG-related disclosure issues, companies should engage with shareholders to understand their priorities, and should consider proxy disclosure enhancements regarding the actions already being taken or providing supplemental disclosures in a separate sustainability report.

Board Diversity and Accountability

Board diversity continues to remain at the forefront of corporate governance discussions and investors and shareholder activists are increasingly advocating for gender diversity on public company boards. In 2017, 35 proposals calling for the adoption of a policy on board diversity or a report on steps to increase board diversity were submitted, compared to 28 proposals in 2016. A substantial number of these were withdrawn, likely due to commitments made by companies to the proposals' proponents. Nine of the proposals were voted on and received, on average, 27.5% support. In 2017, two board diversity proposals received majority support, as compared to one in 2016.[56]

Institutional investors have stressed the importance of board diversity as well. In 2017, both BlackRock and State Street Global Advisors announced plans to push for greater gender diversity on boards and have indicated that, if progress is not made within a reasonable time frame, they may use their proxy voting power to influence change by voting against certain directors, such as members of nominating and governance committees. In addition, in September 2017, the New York City Comptroller sent a letter[57] to approximately 140 portfolio companies held by the New York City Pension Funds (the "NYCPF") requesting that the NYCPF be given the opportunity to "provide input" as the companies' boards implemented their proxy access bylaws and, in connection with this process and to aid shareholders in having meaningful discussions about particular nominees, asked that the company complete a matrix identifying the relevant skills, experience and attributes, as well as the gender, race and ethnicity, of each director of each company.

In light of these trends, succession planning for boards should examine the evolving needs of an organization and incorporate a review of the board's mix of skill sets, diversity of thought, and ability to act independently in the best interest of the organization. Boards should establish a robust director nomination process that provides a pipeline of director candidates, taking into account the diversity of such candidates as well as their relevant skills.

Separately, companies should consider taking a fresh look at their board diversity and refreshment disclosure, both in comparison to their peers and to governance leaders.

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56 Georgeson Annual Corporate Governance Review, available here.

57 The letter is available here.

Other Trending Shareholder Proposals[58]

In 2017, while there was an overall decrease in the number of shareholder proposals related to corporate governance issues, proposals continued to be focused on:

- *Golden Parachutes*—Between 2016 and 2017, the number of proposals to limit golden parachutes decreased from 11 to 6. None of these proposals passed.
- *Action by Written Consent of Shareholder*—There was a slight increase in the number of proposals relating to action by written consent, up from 13 in 2016 to 15 in 2017. None of these proposals passed.
- *Special Shareholder Meetings*—Shareholder proposals to either (i) lower the ownership percentage required for a shareholder to call a special meeting or (ii) adopt a new shareholder special meeting right, did not gain wide support. Of the 23 proposals in 2017, only one passed.
- *Simple Majority Voting*—In 2017, there were 13 proposals to institute simple majority voting requirements, five of which passed.
- *Political Contributions*—In 2017, 58 proposals relating to political contributions and lobbying were voted on. None of these proposals passed. Proposals relating to lobbying or political spending only received an average of 26% support.

Cybersecurity: Risk Management and Related Disclosures

Board Engagement; Cyber-Breach Response Plans; and Recent SEC Actions

As high-profile cyber attacks continue to persist, ensuring the adequacy of a company's cybersecurity measures is a critical part of a board's risk oversight responsibilities. In addition to the threat of significant business disruptions, substantial response costs, negative publicity and reputational harm, there is the threat of litigation and potential liability for failing to implement adequate measures to protect the company from cyber threats. Derivative lawsuits brought against companies and their officers and directors relating to data breaches resulting from cyber attacks continue to persist. Several notable developments in this context are:

- *August 2017 SEC Office of Compliance Inspections and Examinations Cybersecurity Risk Alert*—The alert listed the elements that were included in the policies and procedures of companies that SEC staff believes had implemented robust controls, including: (i) maintenance of an inventory of data, information, and vendors, (ii) detailed cybersecurity-related instructions, (iii) maintenance of prescriptive schedules and processes for testing data integrity and vulnerabilities, (iv) established and enforced controls to access data and systems, (v) mandatory employee training and (vi) engaged senior management.
- *November 2017 Corp Fin Director Speech*—In his speech, William Hinman indicated that the SEC intends to issue updated guidance focused on what internal processes and controls a company should have in place to evaluate a cybersecurity event; however, he did not indicate the timing of such guidance.
- *EDGAR Hack and Creation of SEC Cyber Unit*—In September 2017, the SEC disclosed the 2016 hack of the SEC's EDGAR system and announced the creation of a Cyber Unit within the Enforcement Division, which will monitor cyber-related misconduct, the implementation of an internal cybersecurity risk profile and the creation of a cybersecurity working group to coordinate information sharing, risk monitoring and incident response efforts throughout the agency.

To ensure preparedness, companies should establish a readiness plan in case of a cyber incident, consider purchasing cyber liability insurance, institute employee training programs and take steps to mitigate risks associated with outsourcing business functions to third parties.

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58 Proxy Monitor, available here.

Cybersecurity Disclosure Considerations – 2011 SEC Guidance and Comment Process

- *Pending Disclosure Initiatives*—In 2015, the US Congress introduced a bill to require the SEC to issue rules mandating public company disclosure of the cybersecurity expertise or experience of each director, or what other cybersecurity considerations were evaluated in the nomination of directors. While no formal rulemaking initiatives have been undertaken, the SEC has been active in recent years in commenting on public company periodic reports regarding cybersecurity issues, including requiring companies to disclose whether they have experienced cyber attacks, requesting a separate discussion of risks posed by cyber attacks and seeking disclosure of expenditures for cybersecurity protection measures.

Current Disclosure Requirements and Guidance

- *2011 SEC Guidance*—The SEC's 2011 Disclosure Guidance Topic No. 2[59] made clear that cybersecurity disclosures may be required in risk factors, MD&A, business and legal proceedings sections and in the notes to the financial statements.
- *Item 407 of Regulation S-K*—Companies are required to disclose the role of the board in risk oversight in their proxy statements; consideration should be given to whether cybersecurity risk management should be separately addressed.
- *Risk Factors*—Companies should consider whether cybersecurity risks warrant their own risk factor. According to Bloomberg BNA[60], between 2010 and June 30, 2017, 436 companies disclosed cybersecurity as a risk factor in the first six months of 2017, compared to 403 companies in 2016 and 305 companies in 2015.
- *Director Risk Oversight*—In January 2017, the National Association of Corporate Directors released an updated edition of its "Director's Handbook on Cyber-Risk Oversight".[61]

Virtual Shareholder Meetings[62]

While virtual annual shareholder meetings are gradually gaining momentum (163 companies held virtual-only shareholder meetings in 2017, up from 122 in 2016[63]) and third-party providers (such as Broadridge) offer platforms to support this meeting format, there is still significant investor resistance to, and legitimate critiques of, the virtual-only format. Despite this resistance, some companies are choosing to hold virtual meetings, and many more are incorporating virtual components to supplement their in-person meetings (i.e., hybrid format).

Opponents of virtual-only meetings argue that they allow management to manage "troublesome" shareholders and avoid uncomfortable questions, raising concerns that shareholder submission of written questions, which are potentially filtered by management, does not truly promote shareholder participation. As noted above, in 2019, Glass Lewis will begin recommending against members of the governance committee at companies that plan to hold virtual-only shareholder meetings unless they have provided assurances that shareholders will be afforded the same rights and opportunities to participate as they would at an in-person meeting.

As virtual meetings become more prevalent, certain common practices have emerged, including: posting to the corporate website all of the (unedited) questions received prior to or during the meeting, along with the company's responses, even for questions not addressed at the meeting; broadcasting a video of the meeting rather than only audio; and utilizing pre-meeting submission of shareholder questions to allow for more carefully considered questions and responses. The perception of transparency can also be increased by enabling all participants to see a running list of incoming questions and offering telephone access for questions during the meeting. Investor

59 Available here.

60 Available here.

61 Available here.

62 For additional considerations related to virtual shareholder meetings, see our prior release, available here.

63 "Virtual Only Shareholder Meetings: Streamlining Costs or Cutting Shareholders Out?", November 30, 2017, available here.

outreach efforts could also help allay shareholder concerns. Companies should evaluate which practices are best suited to their needs when considering whether and how to conduct a virtual meeting.

Virtual meetings are governed by state law. The SEC has not provided specific guidance related to virtual meetings, but has publicly stated its support for the use of technology as a means to promote shareholder engagement, access and transparency. Neither the NYSE nor Nasdaq specify particular formats for mandatory annual shareholder meetings.

Part III. Future Rulemaking, Looking Ahead

Dodd-Frank Compensation-Related Rulemaking

It is unclear whether pending Dodd-Frank rulemaking will eventually be implemented or whether portions of Dodd-Frank will be repealed by the “Financial CHOICE Act” or other legislation. It is not clear when, if at all, the Financial CHOICE Act will be considered by the Senate or what legislative changes it might undergo. This discussion reflects the current state of pending Dodd-Frank-related disclosure requirements and related rulemaking initiatives.

Pay versus Performance Disclosures

In 2015, the SEC proposed rules that would require companies to disclose the relationship between executive compensation actually paid and the financial performance of the company. The rules have not been finalized and no disclosure changes will be in effect for the 2018 reporting season.

Compensation Clawbacks[64]

In 2015, the SEC proposed rules that would require any company with securities listed on a national securities exchange to have a policy to “claw back” incentive-based compensation paid to current and former executives in the event of a financial restatement to correct a material error.[65] The proposal also specifies disclosure requirements relating to clawback policies and actual clawbacks. The SEC has not issued a final rule; however, there has been a trend favoring the adoption of broader clawback policies that go beyond the scope of Sarbanes-Oxley requirements (including with respect to the group of covered executives), which trigger clawbacks only when there is fraud or misconduct in connection with a financial restatement. Companies that do have a broader clawback policy in place should consider enhancing related disclosures in their 2018 proxy statements.

Employee and Director Hedging Disclosure[66]

In 2015, the SEC proposed rules that would require a company to disclose whether any employees or directors are permitted to hedge their equity securities of the company. The rule has not been finalized and will not impact 2018; however, anti-hedging positions of proxy advisory and corporate governance rating firms have prompted many companies to prohibit directors and executive officers (and sometimes employees generally) from engaging in hedging transactions with respect to their company’s stock. Because there is no universally accepted best practice approach to hedging policies, 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 to mitigate risk. Companies should also ensure that any disclosure they provide is consistent with their existing policy, rather than merely boilerplate language.

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64 The proposed rule can be found here.

65 Clawbacks of erroneously awarded incentive-based compensation would be required for the three fiscal years prior to a financial restatement and would be “no fault,” meaning they would be triggered regardless of whether an executive was involved in any misconduct or was responsible for the restatement. SRCs, EGCs and companies that list only debt or preferred securities would be subject to the standards to the extent that they have securities listed on a national securities exchange or association. Incentive-based compensation is defined 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.

66 The proposed rule can be found here.

SEC Initiatives

Simplified Disclosure[67]

As part of its ongoing initiative to review and enhance disclosure effectiveness, the SEC proposed amendments to simplify the disclosure requirements of Regulation S-K, including, for example, revising Item 102 to clarify that a description of property is required only to the extent that physical properties are material to the company's business, and revising Item 303(a) (MD&A) to require only a period-to-period comparison for the two most recent fiscal years presented in the financials, permitting a hyperlink to the prior year's annual report for the additional (third) year.

Enforcement Focus – Ending "Broken Windows"

At a securities conference in October 2017, Steven Peikin, co-director of the SEC's enforcement division, indicated that the SEC would end its "broken windows" strategy of pursuing many cases over even the smallest legal violations, and may also pull back from trying to make companies admit to wrongdoing as a condition of settling with the SEC. He also emphasized the benefits of cooperating with the SEC in an enforcement action.

SEC Contemplates Changes to Proxy Process

In a November 2017 speech,[68] SEC Chairman Jay Clayton expressed interest in reopening the 2010 "Proxy Plumbing" concept release, an SEC undertaking to review the proxy voting system, to look at whether companies' and shareholders' needs are being met as well as the costs and burdens the proxy system imposes on companies. He also discussed the benefits and costs of shareholder proposals and queried whether the SEC is adequately serving the interests of Main Street investors, particularly in regard to retail shareholders' participation in the proxy voting process.

SEC's Regulatory Agenda for 2018[69]

The SEC's regulatory agenda for 2018 focuses on, among other things: (i) EGC simplification, (ii) audit committee disclosure and (iii) mining disclosure modernization. Notably, universal proxy, corporate board diversity, clawbacks, pay for performance and hedging were all removed from the prior year's agenda and reclassified as "long-term" initiatives.

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67 For additional information, see our prior alert, available here.

68 The speech can be found here.

69 The SEC's rulemaking agenda can be found here