Client Alert | Capital Markets

Reminders for US Public Companies for the 2017 Annual Reporting and Proxy Season

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Executive Summary

This memorandum outlines certain considerations for US public companies in preparation for the 2017 annual reporting and proxy season. Part I of this memorandum discusses new developments and practical action items for the 2017 reporting season; Part II provides a brief overview of recent corporate governance and regulatory developments and trends; and Part III includes a discussion of expected regulatory developments and pending rulemaking initiatives.

Part I. New Considerations and Action Items for the 2017 Reporting Season

1. ISS and Glass Lewis Proxy Voting Guidelines[1]

Rating Methodologies

Institutional Shareholder Services Inc. (ISS) has revised and rebranded its corporate governance rating system, which will now be referred to as QualityScore (successor to QuickScore). QualityScore includes 15 additional factors ISS will consider in determining a company's rating. This change in methodology may impact a company's score even if its corporate governance policies have not changed. Companies can go here[2] to receive a log-in ID, which will enable them to review, verify, update and provide feedback on the data used to determine their scores.

Glass Lewis has announced "open enrollment" in its "Issuer Data Report" program, which enables companies to access a data-only version of their Glass Lewis report, giving companies an opportunity to weigh in before Glass Lewis completes its recommendations for the upcoming proxy season. Companies can sign up for the program here.[3]

We recommend that companies sign up at each of the links above.

[1] ISS' 2017 Voting Guidelines can be found at https://www.issgovernance.com/file/policy/2017-americas-iss-policy-updates.pdf. Glass Lewis' 2017 Policy Guidelines can be found at http://www.glasslewis.com/wp-content/uploads/2016/11/2017_Guideline_US.pdf.

[2] https://www.issgovernance.com/solutions/iss-analytics/qualityscore-data-verification/.

[3] https://meetyl.com/issuer_data_report.

Director Overboarding Policy

Both ISS and Glass Lewis will recommend voting against directors who (a) sit on more than five public company boards or (b) are CEOs (or executive officers, in the case of Glass Lewis) of public companies who sit on the boards of more than two public companies besides their own.[4]

Board Evaluation and Refreshment

Both ISS and Glass Lewis have increased their focus on board evaluation and refreshment. ISS continues to examine the proportion of non-executive directors with lengthy tenure and the number of women on the board, and has added three new factors to its QualityScore evaluation of board refreshment: (i) board mechanisms to encourage director refreshment; (ii) disclosures of the existence of a formal CEO and key executive officer succession plan; and (iii) board responses to low support for a management proposal. Glass Lewis believes "the board should evaluate the need for changes to board composition based on an analysis of skills and experience necessary for the company, as well as the results of the director evaluations, as opposed to relying solely on age or tenure limits."

Restrictions on Binding Shareholder Proposals

ISS will issue adverse vote recommendations for governance committee members if the company's charter imposes undue restrictions on shareholders' ability to amend the bylaws, such as a prohibition on the submission of binding shareholder proposals, or share ownership or time holding requirements that are in excess of Rule 14a-8 requirements.

Stock Distributions: Splits and Dividends

ISS will generally favor management proposals to increase common share authorization for stock splits or stock dividends, provided that the effective increase in authorized shares is equal to or less than the allowable increase calculated in accordance with ISS' Common Stock Authorization policy.

Equity-based and Other Incentive Plans

ISS issued several new and revised policy changes related to equity-based and other incentive plans that contain considerable technical content and warrant careful examination and precise disclosure to ensure that the plans are appropriately evaluated within the correct policy framework.

In addition to minor changes to various factor weightings, ISS' updated policy includes changes with respect to its approach to:

- Equity Plan Scorecard (EPSC)[5] – ISS:
    - added dividends payable on unvested awards as a negative plan feature in connection with its evaluation of a company's EPSC; and
    - modified the minimum vesting factor such that an equity plan must specify a minimum vesting period of one year for all award types under the plan in order to receive full points and no points will be earned if the plan allows for individual award agreements that reduce or eliminate the one-year vesting requirement.
- Proposals for Shareholder Ratification of Director Compensation – ISS codified the evaluation framework it will apply to management proposals seeking advisory shareholder ratification of non-employee director compensation.
- Non-Employee Director Equity Plans – ISS clarified and broadened the various factors considered when assessing the reasonableness of non-employee director equity plans and included new factors (including relative pay magnitude and meaningful pay limits).

[4] ISS and Glass Lewis generally will not recommend that shareholders vote against overcommitted directors at the companies where such directors serve as executive officers.

[5] Proposals evaluated by ISS under the EPSC policy generally include those to approve or amend (1) stock option plans for employees and/or employees and directors, (2) restricted stock plans for employees and/or employees and directors and (3) omnibus stock incentive plans for employees and/or employees and directors.

- Amendments to Cash and Equity Plans – ISS renamed and reorganized its policy to more clearly differentiate the evaluation framework applicable to the various types of amendment proposals.

Governance Following an IPO or Spin-Off

Both ISS and Glass Lewis will review a newly-public company's governing documents and will consider recommending a vote against directors, committee members or the entire board if they believe the adopted bylaw or charter provisions are materially adverse to shareholder rights. There is no specific bright line test and ISS will instead consider the following range of factors:

- the level of impairment of shareholders' rights;
- the disclosed rationale;
- the ability to change the governance structure (e.g., limitations on shareholders' right to amend the bylaws or charter, or supermajority vote requirements to amend);
- whether the company has a classified board; and
- any reasonable sunset provisions and other relevant factors.

ISS will also recommend a vote against directors at a company that has implemented a multi-class capital structure with unequal voting rights unless a sunset provision is in place. ISS does not specify the timing of the sunset requirement, but a vote by shareholders within three years will not be sufficient.

Similarly, Glass Lewis will consider the following range of factors:

- the adoption of anti-takeover provisions, such as a poison pill or classified board;
- supermajority vote requirements to amend governing documents;
- the presence of exclusive forum or fee-shifting provisions;
- whether shareholders can call special meetings or act by written consent;
- the voting standard provided for the election of directors;
- the ability of shareholders to remove directors without cause; and
- the presence of evergreen provisions in the company's equity compensation arrangements.

Many newly-public companies will have sufficient inside shareholders following their IPO to withstand a negative recommendation from ISS or Glass Lewis. Accordingly, in the initial period following an IPO, such companies may not need to focus on these points; however, we expect that many companies will need to submit to shareholders charter amendments to address these items once the concentration of ownership by inside shareholders declines in the years following an IPO. For example, we would expect to see evergreen provisions in equity incentive plans increasingly removed in the years that follow an IPO.

2. Annual Director & Officer Questionnaire Updates and Related Matters

Nasdaq's "Golden Leash" Rule

On July 31, 2016, Nasdaq's new Rule 5250(b)(3) became effective. The new rule requires Nasdaq-listed US companies to publicly disclose any arrangements or agreements relating to compensation provided by a third party to the company's directors or director nominees in connection with their candidacy or board service.

In light of the new rule, and with respect to corporate governance best practices generally, companies should consider the following:

- Update of D&O Questionnaires: Companies should review their D&O questionnaires to ensure they adequately capture any golden leash arrangements disclosable under the new rules. Further, while the NYSE has not indicated a current intention to adopt a similar rule, it is expected that some NYSE-listed companies may choose to begin voluntarily collecting pertinent information and including additional disclosures regarding compensation provided by third parties to the company's directors or nominees, to the extent such arrangements are not already disclosed under existing rules.

- Location of Disclosures: To the extent new disclosure is required, we expect most companies will augment existing disclosures in their proxy statements, rather than include such additional disclosure on their websites.[6]
- Review of Bylaws: Companies may need to assess the adequacy of their advance notice bylaw provisions. At the extreme, such provisions can seek to disqualify any nominee who received any third-party compensation in connection with such nominee's candidacy or service (other than indemnification or reimbursement of expenses), although ISS, Glass Lewis and the Council of Institutional Investors (CII) all view an outright prohibition on board service due to a third-party compensation arrangement to be an infringement of shareholders' fundamental right to vote for an otherwise qualified director. In light of continued shareholder activism, companies should review their bylaws to ensure that advance notice provisions elicit the required information and reflect an appropriate approach to third-party compensation for directors.

Given the continued momentum of the proxy access movement (see Part II below), questions regarding director qualifications and eligibility will likely continue to be an area of focus for regulators and institutional investor groups. Nasdaq is considering whether to propose additional requirements relating to directors and nominees that receive third-party payments, including whether such directors should be prohibited from being considered independent or from serving on the board altogether.

Auditing Standard 18

In 2015, the Public Company Accounting Oversight Board (PCAOB) adopted Auditing Standard 18 (AS 18), which requires auditors to evaluate a company's identification of, and accounting for, "related party transactions." While company disclosure requirements under Item 404 of Regulation S-K have not changed, auditors have in some cases been requesting that questions be included in a company's D&O questionnaire to ensure it adequately captures related party information necessary for their review under AS 18. While AS 18 is designed to facilitate the evaluation of transactions with the company, it directs the auditor to obtain from management the names of all related parties, even when no transaction has occurred or is contemplated. D&O questionnaires are one way to obtain the required information without significant duplicative efforts.

3. Disclosure Considerations

Presentation of Non-GAAP Financial Information

While it has become commonplace for companies to use non-GAAP financial measures in their annual reports and proxy statements, particularly to demonstrate the connection between pay and performance, new and revised guidance from the Division of Corporation Finance (Corp Fin)[7] clarifies 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.

The recent guidance makes it clear that non-GAAP financial information cannot be presented more prominently than GAAP information or in a way that makes the relevant disclosure misleading. Corp Fin's recent guidance outlined specific instances where non-GAAP measures may be deemed misleading, such as:

[6] Companies must make any required disclosure either on their website (or through a hyperlink to another, "continuously-accessible" website) or in their proxy or information statements, no later than the date on which such document is furnished or filed in connection with the company's next shareholder meeting at which directors are elected (for companies that do not file proxy or information statements, no later than when the company files its next annual report on Form 10-K). Thereafter, a listed company must make the required disclosure at least annually, until the earlier of the resignation of the director or one year following the termination of the compensation agreement or arrangement. New agreements or arrangements do not need to be disclosed at the time they are entered into, so long as disclosure is made for the next shareholder meeting at which directors are elected.

[7] 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.

- Certain adjustments, such as presenting a performance measure that excludes normal, recurring cash operating expenses necessary to operate a registrant's business.

- A non-GAAP measure presented inconsistently between periods, such as a non-GAAP measure that adjusts a particular charge or gain in the current period but for which other, similar charges or gains were not adjusted in prior periods.

- A non-GAAP measure that excludes charges, but does not exclude gains, such as a non-GAAP measure that is adjusted only for non-recurring charges when there were non-recurring gains that occurred during the same period.

- Non-GAAP measures that accelerate revenue are prohibited in all circumstances. Non-GAAP revenue measures that substitute individually tailored recognition and measurement methods for those of GAAP are considered misleading under Rule 100(b) and are prohibited in documents filed with or furnished to the SEC and elsewhere, such as on company websites. Non-GAAP measures that substitute individually tailored recognition and measurement methods for other financial statement line items may also violate Rule 100(b).

Other key takeaways from Corp Fin's guidance include:

- Only non-GAAP performance measures, not liquidity measures, should be presented on a per-share basis, and neither EBIT nor EBITDA may be presented on a per-share basis.

- When non-GAAP measures are used, the comparable GAAP measure must be displayed with equal or greater prominence.

- Item 10(e) prohibits the labeling of items used to adjust a non-GAAP measure as "non-recurring," "infrequent" or "unusual" if the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years.

Since this guidance was released, the SEC has issued over 150 comment letters on non-GAAP measures directed at companies with improper disclosure. Companies should expect the SEC to focus on non-GAAP financial measures when reviewing proxy statements[8] and annual reports for the 2017 reporting season and should evaluate their use and presentation of non-GAAP financial measures in light of the new guidance. Companies should also include robust explanations about the reasons why management believes that presentation of any non-GAAP financial measures provides useful information to investors.

Possible Updates to Risk Factor Disclosures

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

- Brexit: While the UK's withdrawal from the EU will not take effect for several years, approximately 400 US public companies included Brexit-related risk factors in their quarterly reports following the June 2016 referendum. Brexit has been mentioned in risk factors on currency exchange rate risks, international operations risks and global economic conditions, as well as discussed as a stand-alone risk factor. Forward-looking statement legends may need to reference Brexit as one of the factors that could materially impact projections.

[8] As a reminder, proxy disclosure of target levels for incentive compensation arrangements that are non-GAAP financial measures is not subject to Regulation G, although a company must disclose how the numbers are calculated from its audited financial statements. However, when non-GAAP financial measures are included in a proxy statement for any other purpose, a company must comply with Regulation G and Item 10(e). For pay-related circumstances only, the Staff has stated that it will not object if a registrant includes the required GAAP reconciliation and other information in an annex to the proxy statement, provided that the registrant includes a prominent cross-reference to this annex (or, if these non-GAAP numbers also appear in the Form 10-K which incorporates the proxy statement by reference, a prominent cross-reference to the relevant pages in the Form 10-K containing the required GAAP reconciliation and other information). See Instruction 5 to Item 402(b) of Regulation S-K and Regulation S-K C&DIs, Questions 118.08 and 118.09.

- Sustainability/Climate Change: There has been increasing attention to issues regarding sustainability and climate change disclosure. In the SEC's recent concept release[9] on Regulation S-K (see below), the SEC is considering whether to require specific line-item environmental and social policy disclosure in a company's periodic reports, which would represent a shift in the SEC's approach to environmental, social and governance matters disclosure. While some companies object to such a change, an increasing number are voluntarily providing sustainability reporting outside of SEC filings.

- Cybersecurity: There has been growing recognition that cybersecurity poses both economic and security threats to companies (see below). SEC guidance[10] 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.

Audit Committee Developments

- Disclosure: In 2015, the SEC issued a concept release[11] soliciting comments on possible revisions to existing disclosure requirements with respect to an audit committee's responsibilities for the oversight of independent auditors. Although no further action has been taken by the SEC, 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 possible expansion of current proxy statement disclosures. According to an analysis by Ernst & Young LLP[12] of the 2016 proxy statements of 78 Fortune 100 companies, voluntary audit-related disclosures continued to trend upward in a number of areas: 50% of companies disclosed factors considered by the audit committee when assessing the qualifications and work quality of the external auditor (up from 42% in 2015 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 63% in 2015 and 3% in 2012); 82% explicitly stated that the audit committee is responsible for the appointment, compensation and oversight of the external auditor (up from 42% in 2012); and 31% provided information about the reasons for changes in fees paid to the external auditor (up from 21% in 2015 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).

- PCAOB Auditing Standard Renumbering: Effective December 31, 2016, Auditing Standard No. 16 (AS 16), which addresses auditor communications with the audit committee, was superseded by Auditing Standard No. 1301. To the extent audit committee reports include explicit references to AS 16, they should be updated accordingly; alternatively, companies could eliminate the specific reference and generally refer to the applicable PCAOB standards in the audit committee report.

New Item 16 of Form 10-K: Form 10-K Summary

The SEC adopted an interim final rule, effective June 9, 2016, to specifically allow (but not require) a company to include a summary of the information included in the form in its Form 10-K, provided that each summary item is fair and accurate and includes a hyperlink to the related section in the Form 10-K. While companies are free to determine which items to summarize, the summary can only include information included in the Form 10-K at the time it is filed. As a result, Part III information forward incorporated by reference from the proxy or information statement cannot be summarized and, in that case, the summary must indicate that it omits the Part III information. While it remains to be seen how many additional companies will choose to provide summaries based on the rule, companies that currently include summaries in their Form 10-Ks should ensure that they conform to the new rule's requirements.

[9] The concept release can be found at https://www.sec.gov/rules/concept/2016/33-10064.pdf.

[10] The SEC's Disclosure Topic 2 is available at https://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm.

[11] The concept release can be found at https://www.sec.gov/rules/concept/2015/33-9862.pdf.

[12] The E&Y report can be found at http://www.ey.com/gl/en/issues/governance-and-reporting/ey-audit-committee-reporting-to-shareholders-in-2016#Summary.

Inline XBRL

Public reporting companies can now voluntarily file their structured financial statement data in a format known as Inline XBRL, a change that will allow filers to integrate XBRL data directly into their HTML filings, rather than providing it as separate exhibits.[13] Companies can use Inline XBRL through March 2020, after which time the SEC hopes that user feedback can be used to develop tools to facilitate the use of Inline XBRL and to inform any future rulemaking in this area.

Corp Fin No Longer Requires Hard Copies of Annual Shareholder Reports

In a recently released compliance and disclosure interpretation (C&DI),14 Corp Fin made it 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 mailing such reports to shareholders.

"Tandy Letter" Representations No Longer Required

On October 5, 2016, Corp Fin announced[15] that, effective immediately, it would no longer require companies to include "Tandy letter" representations (in which a company represents that it will not raise the SEC's comment process as a defense in securities litigation) in their responses to Staff comments or acceleration requests, noting that while companies remain responsible for the accuracy and adequacy of the disclosure in their filings, the affirmative representations are not necessary.

4. Annual Meeting Considerations

Say-When-On-Pay Votes Are Due in 2017 for Most Public Companies

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

Section 162(m) of the Internal Revenue Code

In preparation for the upcoming proxy season, companies should assess whether their executive compensation plans are due for reapproval for purposes of preserving the exclusion from Section 162(m) of the Internal Revenue Code.

Proxy Card Developments

- Unbundling: In response to concerns that shareholder proposals were not being presented with the same specificity as management proposals on some companies' proxy cards, in March 2016, Corp Fin issued new guidance16 on the proxy card requirements of Rule 14a-4(a)(3). The guidance emphasizes that proxy cards should "clearly identify and describe the specific action on which shareholders will be asked to vote" for both management and shareholder proposals, and includes examples of what not to do, such as labeling a proposal generally as "Shareholder Proposal" or "Shareholder Proposal on the Environment."

[13] The SEC's order can be found at https://www.sec.gov/rules/exorders/2016/34-78041.pdf.

[14] See C&DI for Proxy Rules and Schedule 14A (regarding Submission of Annual Reports to SEC under Rules 14a-3(c) and 14c-3(b)).

[15] The SEC's announcement can be found at https://www.sec.gov/corpfin/announcement/cf-announcement---no-more-tandy-language.html.

[16] See Exchange Act Rule 14a-4(a)(3) C&DIs, Question 301.01.

- Universal Proxy Ballots: Institutional investors have been advocating for amendments to existing proxy rules to eliminate the practice of distributing separate proxy ballots for management-sponsored candidates and dissident-backed nominees, which can make it difficult for shareholders who cannot attend the meeting to split their tickets among management-backed and dissident candidates. In October 2016, the SEC proposed amendments[17] to the proxy rules to require parties in a contested election to use universal proxy ballots that would include the names of all director nominees. If the optional use of a universal ballot becomes available under the proxy rules, the decision for using a universal ballot would be fact-specific, involving considerations regarding the shareholder profile and the proxy advisory firms' positions, among other factors.

Virtual Shareholder Meetings

While virtual annual shareholder meetings are gradually gaining momentum 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 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 virtual meetings become more prevalent, certain best practices are beginning to emerge, including: posting to the corporate website all of the (unedited and unfiltered) 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 rather than an audio of the meeting; and utilizing pre-meeting submission of shareholder questions to allow for more carefully considered questions and management responses. Other features that could improve the perception of transparency include the ability for all participants to see a running list of incoming questions and offering telephone access for shareholder questions during the meeting. Investor outreach efforts could also help further allay shareholder concerns.

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

1. Proxy Access

Increased Incidence of Proxy Access Proposals and Emergence of Proxy Access Enhancement Proposals

Shareholder proposals seeking proxy access ballooned in 2015 and 2016. Over 200 shareholder proxy access proposals were submitted in 2016, with 80 coming to a vote and 42 passing as of September 2016.[18] According to ISS, as of August 31, 2016, 264 US companies in the Russell 3000 (nearly 200 of which are S&P 500 companies) have adopted some form of proxy access. By the end of the 2017 proxy season, the majority of S&P 500 companies are expected to provide proxy access.[19] Furthermore, this year, when determining a company's QualityScore, ISS will give credit to a company for having a proxy access bylaw. However, the existence of any "problematic provisions," such as counting mutual funds under common management as separate shareholders under the aggregation limit, post-meeting holding requirements and broad board authority to interpret the proxy access provision, could result in no credit being given.

The vast majority of 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 abbreviated "3/3/20/20"). A number of additional company-friendly features have become standard over the last two years, such as a requirement that nominators continue to hold stock following the meeting

[17] The SEC's proposed amendments can be found at https://www.sec.gov/rules/proposed/2016/34-79164.pdf.

[18] Georgeson's 2016 Annual Corporate Governance Review, available at https://higherlogicdownload.s3.amazonaws.com/GOVERNANCEPROFESSIONALS/a8892c7c-6297-4149-b9fc-378577d0b150/UploadedImages/Alert%20PDF's/Georgeson%20Corp%20Gov%20Review.pdf.

[19] ISS Survey "The Finer Points of Proxy Access Bylaws Come Under the Microscope," available at https://www.issgovernance.com/governance-exchange/governance-insights/#1452866844042-c6b24eea-1b36.

and certain nomination and re-nomination restrictions. Recently, however, so-called “proxy access enhancement” proposals have begun to emerge. This type of proposal seeks to have companies that have already adopted proxy access amend a core set of company-friendly limitations that have become common in the last two years. These changes consist of the following:

- removing company-imposed aggregation limits for purposes of meeting the requisite share ownership thresholds (usually limiting the group to 20 shareholders or fewer);
- removing restrictions on the re-nomination of director candidates who receive less than a specified percentage of the vote in subsequent elections;
- eliminating post-meeting stock ownership requirements obligating a nominating shareholder to represent its intent to continue to own the shares for a specified period (usually one year) following the annual meeting;
- permitting loaned stock to be counted towards meeting the ownership threshold (without the requirement that for such securities to count as owned, there must be a right to recall the shares with specified notice); and
- expanding the percentage of the board that can be nominated to the greater of 25% or two directors.

As a result of Staff Legal Bulletin No. 14H, which created a heightened standard for excluding conflicting management and shareholder proposals, no-action requests during the 2016 proxy season largely shifted to a “substantially implemented” argument under Rule 14a-8(i)(10), with the SEC being largely unsympathetic to such arguments. While each of OshKosh Corporation and NVR, Inc. recently was able to exclude a proxy access enhancement proposal on the grounds of substantial implementation after making *some* of the requested changes, absent procedural defects, the SEC appears to have reiterated its position in a series of recent no-action letters and refused to side with H&R Block, Microsoft, Apple, Walgreens, United Natural Foods and Walt Disney, each of which have already adopted standard proxy access bylaws and argued that the proposals were excludable on the basis of substantial implementation. Despite limited recourse under the SEC’s no-action regime, it is not clear whether these types of proposals will ultimately attract significant shareholder support. So far, proxy access enhancement failed to pass at the 2016 annual shareholder meetings of H&R Block (30% voted in favor), Microsoft (27% voted in favor) and United Natural Foods (36% voted in favor).[20]

Company Options in Responding to Proxy Access Proposals

Given the above trends, companies have essentially three options when responding to a shareholder proxy access proposal:

- *Negotiate the Withdrawal of the Proposal and Include a Management Proposal:* The company could include its own proposal with adjustments to the shareholder proposal. This would likely result in the proposal being adopted, but would require negotiation with the shareholder proponent over the content of the proposal, which may make it harder to introduce some of the desired elements to improve upon the proposal.
- *Include the Proposal and Oppose It:* While support for proxy access declined slightly in 2016, it would be important to speak to a proxy solicitor to discuss the steps necessary to try to win such a vote. It is important to note that, even if it passes, these proposals are typically non-binding and would require implementation at a later date via an amendment to the company’s bylaws. At that time, the potential effects of “proxy access enhancement” may be better understood, and the company could seek to introduce favorable changes to the proposal while still conforming to its essence.

[20] Statistics derived from each company’s Form 8-K announcing the voting results from their respective annual shareholder meeting.

- *Unilaterally Adopt "Market" Proxy Access, then Include and Oppose the Proposal:* During 2016, proxy access proposals were most likely to fail when the company had adopted some form of proxy access in advance of the meeting (38% average support versus 58% where the company had not previously adopted proxy access).[21]

In evaluating its options, the board should consider industry and peer company standards, the likelihood that the proposal will receive shareholder approval, the potential impact on the company,[22] risks of litigation and risks of adverse ISS or Glass Lewis recommendations.

2. Other Trending Shareholder Proposals[23]

Corporate Governance Proposals

- *Independent Board Chairs*: Between 2015 and 2016, the number of shareholder proposals requesting the separation of the roles of CEO and chair of the board decreased from 58 to 43. None of these 43 proposals passed.

- *Action by Written Consent of Shareholders*: There was a significant decrease in the number of proposals relating to action by written consent, down from 35 in 2015 to 17 in 2016. Of these 17 proposals, only one passed.

- *Special Shareholder Meetings*: Similar to 2015, in 2016, 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. On average there was only 43% support for these proposals, with only three out of 16 passing.

- *Supermajority Voting*: In 2016, there were 13 proposals to eliminate or reduce supermajority requirements, eight of which passed. Average support for these proposals was 57%.

- *Board Diversity*[24]*:* There were five board diversity proposals in the 2016 proxy season, with only one proposal passing. The average support for such proposals was 20%.

- *Political Contributions*: In 2016, 69 proposals relating to political contributions and lobbying were voted on. These proposals only received an average of 22% support for lobbying proposals and an average of 24% support for political spending proposals.

Environmental and Social Proposals

- *Climate Change*: In 2016, the most common environmental proposals related to climate change, including proposals with respect to renewable energy and greenhouse gas emissions, with only one out of 91 proposals passing at an oil and gas exploration company.

- *Sustainability*: In 2016, there was an increase in proposals relating to board reporting on supply chain sustainability. There were 11 sustainability proposals, one of which passed.

[21] Georgeson's 2016 Annual Corporate Governance Review, available at https://higherlogicdownload.s3.amazonaws.com/GOVERNANCEPROFESSIONALS/a8892c7c-6297-4149-b9fc-378577d0b150/UploadedImages/Alert%20PDF's/Georgeson%20Corp%20Gov%20Review.pdf.

[22] In what appears to be the first attempted use of a company's proxy access bylaw, on November 10, 2016, GAMCO Asset Management filed a Schedule 13D/A and a Schedule 14N announcing it had used the proxy access bylaw at National Fuel Gas Company (NFG) to nominate a director candidate for election at NFG's 2017 Annual Meeting. NFG had amended its bylaws to adopt proxy access in March 2016. NFG ultimately filed a Form 8-K announcing that it had rejected GAMCO's nomination due to non-compliance with the requirements of NFG's proxy access bylaw, including a representation from the shareholder making the nomination that it had acquired the shares for its proxy access request in the ordinary course of business and not with the intent to change or influence control of the company, and that it does not presently have such intent. Based on GAMCO's past conduct and current actions, NFG's board determined that it did have the intent to influence control of the company and, as a result, GAMCO's notice did not comply with NFG's proxy access bylaw. GAMCO's nominee subsequently withdrew his candidacy.

[23] Unless otherwise indicated, statistics were taken from Georgeson's 2016 Annual Corporate Governance Review, which is available at https://higherlogicdownload.s3.amazonaws.com/GOVERNANCEPROFESSIONALS/a8892c7c-6297-4149-b9fc-378577d0b150/UploadedImages/Alert%20PDF's/Georgeson%20Corp%20Gov%20Review.pdf.

[24] Alliance Advisors 2016 Proxy Review, available at http://allianceadvisorsllc.com/wp-content/uploads/2016/07/Alliance-Advisors-Newsletter-July-2016-2016-Proxy-Season-Review.pdf.

Compensation Proposals

- *Golden Parachutes*: In 2016, there was a significant decrease in the number of proposals to limit golden parachutes. There were only three such proposals in 2016, and none passed.
- *Stock Retention*: There were 11 stock retention proposals in 2016, none of which passed.
- *Adopt a Payout Policy Giving Preference to Share Buybacks Over Dividends*: Proposals requesting that companies adopt a policy that would preference the buyback of shareholder stocks as a means of returning capital to shareholders, as opposed to the distribution of dividends, began to appear in 2016. There were 15 such proposals; however, none of the proposals garnered more than 3% support.

3. Cybersecurity: Risk Management and Related Disclosures

Board Engagement and Cyber-Breach Response Plans

Given the increasing frequency of cyber-attacks, 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 also the threat of litigation and potential liability for failing to implement adequate measures to protect the company from cyber-threats. Recently there have been a series of derivative lawsuits brought against companies and their officers and directors relating to data breaches resulting from cyber-attacks. According to a September 2016 BDO survey[25] of 160 directors of public company boards, boards are becoming more engaged on cybersecurity issues, investments to defend against cyber-attacks are increasing and more companies are putting cyber-breach response plans in place.

To aid companies in determining "best practices" in cybersecurity management, the SEC, DOJ, Financial Industry Regulatory Authority and the National Institute of Standards and Technology of the US Department of Commerce have all issued recent guidance which generally 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.

Disclosure Considerations

The SEC made it clear in its 2011 Disclosure Guidance Topic No. 2[26] that cybersecurity disclosures may be required in risk factors, management's discussion and analysis, business and legal proceedings sections and in the notes to the financial statements. In December 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.

Companies are required to disclose the role of the board in risk oversight in their proxy statements and consideration should be given to whether cybersecurity risk management should be separately addressed. Companies should also consider whether cybersecurity risks warrant their own risk factor.

4. Compensation-Related Issues

Recent Director Compensation Litigation

In recent years there have been a series of shareholder derivative suits brought to challenge board compensation based on claims of breach of fiduciary duty, corporate waste or unjust enrichment, all founded on the accusation that the compensation the board has set for itself is excessive compared to similar companies' compensation plans. In the past, the Delaware Court of Chancery (the Court) held that board

[25] The survey was conducted by the Corporate Governance Practice of BDO USA and is available at https://www.bdo.com/insights/assurance/client-advisories/2016-board-survey.

[26] Available at https://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm.

compensation fell under the “business judgement rule,” making it difficult for shareholder plaintiffs to proceed past the motion to dismiss phase. However, in recent cases,[27] the Court has found that if the compensation plan is not sufficiently defined and there are no meaningful limits on the amount of compensation the board can grant to board members, there can be no presumption that the board acted in the best interests of the company, and therefore the burden shifts to the board to prove the compensation is proper under an “entire fairness” standard of review. The business judgment standard can be reinstated if the shareholders ratify the board compensation decision under state corporate law procedures.[28] Many companies have equity plans with large annual limits intended to provide sufficient shares for awards to top executives. Companies and boards should review their plans and consider whether their shareholders should approve a separate plan for directors with annual limits or an annual formula appropriate for director compensation, or whether their shareholders should approve an amendment to their existing plan to add separate annual limits or an annual formula for directors appropriate for director compensation. Companies may also want to ensure that director pay is in line with their peer group and evaluate director pay each year and make adjustments accordingly.

ISS Policies on Management Proposals Seeking Shareholder Ratification of Director Compensation and on Grandfathered Agreements

In response to lawsuits on non-employee director compensation, some companies have put forth advisory proposals seeking ratification of non-employee director compensation. ISS will evaluate such proposals based on: if the equity plan under which non-employee director grants are made is on the ballot, whether or not it warrants support; the relative magnitude of director compensation as compared to companies of a similar profile; the presence of problematic pay practices relating to director compensation; director stock ownership guidelines and holding requirements; equity award vesting schedules; the mix of cash and equity-based compensation; meaningful limits on director compensation; the availability of retirement benefits or perquisites; and the quality of disclosure surrounding director compensation.

Separately, in January 2016, ISS amended its policy related to executive compensation and employment agreements. In related guidance, ISS indicated that it is not considered best practice to automatically renew or extend existing employment agreements, which may contain potentially problematic provisions, but noted that if an “evergreen” employment agreement is not materially amended in a manner contrary to shareholder interests, it should be “evaluated on a holistic basis, considering a company’s other compensation practices along with features in the existing agreement.” Therefore, companies and committees should be conscious of the fact that ISS is taking a firmer approach to problematic pay practices in “grandfathered” agreements.

ERISA Fiduciary Concern Relating to 401(k) Plan Summary Plan Description Documents

Any publicly traded company that offers an employer stock fund as a 401(k) plan investment option is required to provide participants with both a summary plan description (SPD) and a prospectus, which companies frequently combine into one document. Because federal securities laws require the incorporation by reference of certain documents into any prospectus, certain SEC filings are incorporated into this combined SPD/prospectus. Recent cases have been split as to whether this incorporation by reference may subject those filings to potential ERISA liability. The Sixth Circuit has recognized a claim for breach of fiduciary duty under ERISA where plaintiffs claimed that the defendants breached their fiduciary duty by failing to provide them with accurate information resulting from the incorporation of misleading SEC filings into the plan’s SPD. Conversely, the Court of Appeals for the Second Circuit upheld the lower court’s dismissal of a similar claim, finding that the incorporation of the SEC filings in the SPD did not give rise to a claim for fiduciary breach in the absence of allegations that the plan administrators intentionally or knowingly made misleading statements by virtue of such incorporation. Companies should be aware of the possibility that documents incorporated by reference into a combined SPD/prospectus could be subject to ERISA liability and should consider whether it is appropriate to have a separate SPD and prospectus or to keep the SPD and prospectus combined in one document.

[27] See *Seinfeld v. Slager et al.*, C.A. No. 6462-VCG (Del. Ch. June 29, 2012) and *Calma v. Templeton et al*., C.A. No. 9579-CB (Del. Ch. April 30, 2015).

[28] See *Espinoza v. Zuckerberg et al*., C.A. No. 9745-CB (Del. Ch. Oct. 28, 2015).

Part III. Future Rulemaking, Looking Ahead

1. 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. The below discussion reflects the current state of pending Dodd-Frank-related disclosure requirements and related rulemaking initiatives.

Pay Ratio Disclosure[29]

Pursuant to the SEC's final pay ratio disclosure rule, adopted in 2015, companies must disclose how the median pay of their workforce compares to the compensation of their chief executive officers.[30] The SEC recently provided guidance on determining the median employee, calculating the relevant time period, and accounting for furloughed employees and independent contractors.[31]

Initial pay ratio disclosure will be required with respect to compensation for a company's first full fiscal year that begins on or after January 1, 2017. Therefore, companies generally will first be required to include pay ratio disclosure in their 2018 proxy statements. However, starting the process early can help ensure that companies have sufficient time to evaluate the various options the rule provides, address any issues that arise in applying those options and consider how to draft disclosure that provides useful information and puts the company's pay ratio in the proper context. Management may consider doing an internal "dry run" of calculating the company's estimated pay ratio for 2016 to help identify elements of the calculation that remain unknown, allow sufficient time to resolve any issues and give the company a better sense of how its estimated ratio compares to those of its peer companies. Companies may wish to consider hiring an outside advisor and reviewing the disclosures of early adopters of the requirements. Companies may also consider updating their timetable for the proxy statement and annual meeting to account for the time required for compliance with the rule.

Pay versus Performance Disclosures[32]

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.[33] Although the comment period has closed, the rules have not been finalized and no disclosure changes will be in effect for the 2017 reporting season. Given the rules' express focus on total shareholder return (TSR), companies that do not currently use relative TSR as a metric in executive pay might consider 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.

[29] The rule can be found at https://www.sec.gov/rules/final/2015/33-9877.pdf.

[30] The pay ratio rule requires 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. Emerging growth companies (EGCs) and smaller reporting companies (SRCs) are exempt.

[31] See Regulation S-K C&DIs, Questions 128C.01 to 128C.05.

[32] The proposed rules can be found at https://www.sec.gov/rules/proposed/2015/34-74835.pdf.

[33] Performance must be measured both by company TSR and peer group TSR. The rules would require the inclusion (in any annual report, proxy statement or registration statement that would otherwise require executive compensation disclosure under Item 402 of Regulation S-K) of a new pay versus performance table showing, for each of the company's last five fiscal years (three years in the case of SRCs), the annual compensation of the principal executive officer (PEO) and the average compensation, on an annual basis, for the named executive officers (other than the PEO). As proposed, the rules would apply to all SEC reporting companies, with the exception of registered investment companies and EGCs. The rules' phase-in would require initial disclosure covering the most recent three years; with another year of disclosure added in each of the two subsequent years.

Compensation Clawbacks[34]

In 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 executives in the event of a financial restatement to correct a material error.[35] The proposal also specifies disclosure requirements relating to clawback policies and actual clawbacks. Although the comment period has closed, the SEC has not issued a final clawback rule and it is not clear when it will do so.

Even without a regulatory mandate, there has been a strong trend favoring the adoption of clawback policies. In 2015, approximately three-quarters of S&P 500 companies (including 90% of the top 250 such companies) disclosed a clawback policy covering one or more named executive officers, with most of these policies addressing both cash and equity incentive compensation. Although clawbacks have gained significant attention from a governance perspective, companies may want to consider waiting to amend their clawback policies until the rules are finalized, given the potential for important substantive differences between the proposed and final rules. In the meantime, companies that currently have clawback policies should consider enhancing disclosures related to such policies in their 2017 proxy statements.

Employee and Director Hedging Disclosure[36]

In 2015, the SEC proposed rules that would require each issuer to disclose, in any proxy or consent solicitation materials, whether any employees or directors are permitted to purchase financial instruments designed to hedge their equity securities of the company. While the comment period has expired, the rule has not been finalized and will not impact 2017 proxy disclosures. 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. As of early 2015, approximately 54% of Russell 3000 companies and 84% of large capital S&P 500 companies prohibited employees from hedging company shares. Because there is no universally accepted best practice approach to hedging/pledging policies, some companies may elect to prohibit hedging and pledging altogether, while others may elect to 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.

2. Specialized Disclosure

New Disclosure Requirements for Resource Extraction Issuers[37]

In June 2016, the SEC adopted final rules implementing disclosure requirements for resource extraction issuers, as required under Section 13(q) of the Exchange Act. The rules require the disclosure of payments made to governments by any company that is required to file an annual report with the SEC and is engaged in the commercial development of oil, natural gas, or minerals. This includes payments made by a company's subsidiaries or other entities under its control. Under these rules, companies must disclose any relevant payments on Form SD no later than 150 days after the end of their fiscal year. Although compliance is required for fiscal years ending on or after September 30, 2018 (so calendar-year companies will first need to comply by May 30, 2019), companies affected by the rules should begin to prepare for compliance, including by reviewing systems and controls for financial reporting to determine what additional procedures may be needed to ensure payments required to be disclosed are captured, including those by subsidiaries or joint-

[34] The proposed rule can be found at https://www.sec.gov/rules/proposed/2015/33-9861.pdf.

[35] Clawbacks of any 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 clawback listing 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.

[36] The proposed rule can be found at https://www.sec.gov/rules/proposed/2015/33-9723.pdf.

[37] The rules can be found at https://www.sec.gov/rules/final/2016/34-78167.pdf.

ventures. Training programs and guidance may also need to be developed so that employees are adequately informed of what needs to be reported.

Conflict Minerals Disclosure Rules[38]

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 originate from the Democratic Republic of the Congo or adjoining countries which are "necessary to the functionality or production" of a product manufactured or contracted to be manufactured by the company.[39] The rules have been challenged and remain the subject of ongoing litigation at this time.[40] In recent conferences, the SEC staff indicated that there is still no independent private sector audit (IPSA) requirement for any Form SD being filed in spring 2017 with respect to the usage of conflict minerals in 2016 unless a company voluntarily describes any product as "DRC conflict free."

Mining Disclosure Rules[41]

On June 16, 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. 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% total asset threshold would be directed to consider whether there are other factors which would render its mining operations material. It could take a year or more before the SEC considers 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.

3. SEC Initiatives

Simplified Disclosure Initiative: Potential Revisions to Regulation S-K

The SEC commenced a number of initiatives during 2016 as part of a program to review and enhance disclosure effectiveness, including:

- A concept release[42] soliciting comments on the disclosures required by Regulation S-K, which looks at what information should be disclosed and how it can be presented, considers whether new topics of disclosure should be added, and questions whether a principles-based rather than prescriptive disclosure regime would be most useful to investors;

- A report[43] submitted to Congress, detailing the SEC's recommendations for modernizing and simplifying Regulation S-K, including 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) (Management's Discussion and Analysis) 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;

[38] The rules can be found at https://www.sec.gov/rules/final/2012/34-67716.pdf.

[39] 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 (as defined in the rule), it must disclose this determination on Form SD. Otherwise, it must file a Conflict Minerals Report as an exhibit to its Form SD.

[40] In response to an April 2014 US Court of Appeals for the District of Columbia ruling that the conflict mineral rules violated the First Amendment to the extent that they required certain disclosures, SEC guidance 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." An IPSA is only required if a company voluntarily elects to describe any of its products as "DRC conflict free."

[41] The proposed rules can be found at https://www.sec.gov/rules/proposed/2016/33-10098.pdf.

[42] The concept release can be found at https://www.sec.gov/rules/concept/2016/33-10064.pdf.

[43] The report can be found at https://www.sec.gov/reportspubs/sec-fast-act-report-2016.pdf.

- Proposed amendments[44] to Regulation S-K intended to eliminate duplicative or outdated disclosure requirements; and
- Request for comments[45] on current and potential future disclosure requirements in Subpart 400 of Regulation S-K relating to disclosures concerning management and certain security holders, including with respect to compensation, security ownership and related person transactions.

Hyperlinks for Exhibits in Filed Documents[46]

The SEC has proposed mandating the inclusion of hyperlinks for all exhibits in the exhibit index of any registration statement or report subject to Item 601 of Regulation S-K. As proposed, the rule would not apply to exhibits filed on paper prior to the implementation of EDGAR, but it is not clear whether the final rule will require issuers to re-file those exhibits electronically. The requirement would apply to nearly all forms that are required to include exhibits under Item 601.

Proposed Changes to Definition of Smaller Reporting Company (SRC)[47]

Proposed changes to the definition of "smaller reporting company" would increase the number of companies that would qualify as SRCs and be eligible for reduced disclosure requirements under Regulations S-X and S-K. The new definition would include companies with less than $250 million of public float (increased from $75 million) and companies without a public float and annual revenues less than $100 million (increased from $50 million).

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[44] The proposed amendments can be found at https://www.sec.gov/rules/proposed/2016/33-10110.pdf.

[45] The request for comments can be found at https://www.sec.gov/rules/other/2016/33-10198.pdf.

[46] The proposed rule can be found at https://www.sec.gov/rules/proposed/2016/33-10201.pdf.

[47] The proposed rule can be found at https://www.sec.gov/rules/proposed/2016/33-10107.pdf.