THE HOT LIST:
2017 PROXY SEASON TRENDS AND ACTION ITEMS

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2017 PROXY SEASON TRENDS AND ACTION ITEMS

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As we enter 2017, we want to bring to your attention a few items that we believe will play a prominent role in the upcoming 2017 proxy season.

In 2016, as we had predicted, proxy access was the foremost hot topic, especially for Fortune 500 companies, and this continues to be the dominant theme in 2017. Indeed, it is quite likely that concern about proxy access, like majority voting before it, is likely to trickle down to Russell 3000 companies over the course of the next few years. And, although it is too soon to tell, it is also possible that the new Administration will make some changes to the corporate governance landscape that will impact public companies. For now, we are advising our clients to continue preparing for the 2017 proxy season and beyond as if the status quo will remain in effect, and we expect to publish timely alerts if there are any significant changes.

This handbook is broken into three parts. **The first part** deals with issues public companies should consider as they prepare for the 2017 proxy season. We start by discussing changes in the voting policies of ISS and Glass Lewis along with the newly rebranded ISS governance rating system. We then review the current status quo of proxy access. Next, we examine a topic that we believe will generate a fair bit of discussion in the coming months – proxy presentation and readability. This topic is part of a greater discussion companies should be having about board involvement, refreshment and shareholder engagement. Finally, we discuss Staff Legal Bulleting No. 14H and say-when-on-pay.

The second part deals with a whole host of issues that the staff of the Securities and Exchange Commission has been focusing on, including non-GAAP measures, pay ratio disclosure, clawback rules, pay-for-performance disclosure, hedging disclosure, voluntary disclosures of audit committee matters, Form 10-K amendments, universal proxy card, and virtual-only annual meetings.

The third part deals with issues beyond proxy-related matters that are likely to impact public companies in general.

Please keep in mind that the Hot List is a summary only and is not intended to be specific legal or tax advice. We encourage you to call the authors of this alert or your DLA Piper contact if you have any questions or would like to discuss any of the issues described below in the context of your company.

PROXY SEASON ISSUES

I. ISS Proxy Voting Policy Updates

Based on its policy review and update process, ISS made several changes to its Benchmark Policy Guidelines which apply to annual meetings held on or after February 1, 2017.

A. Restrictions on Shareholder Right to Amend Bylaws

ISS views the shareholders' ability to amend bylaws as a "fundamental right." Under a new policy adopted under its Director Accountability pillar, ISS will generally recommend a vote against or withhold from members of the governance committee if a company's charter imposes "undue restrictions" on shareholders' ability to amend the bylaws, and to issue negative vote recommendations against such governance committee members on an ongoing basis until the "undue restrictions" are removed. Examples of restrictions include (a) the outright prohibition on the submission of binding shareholder proposals, or (b) share ownership requirements or time holding requirements in excess of SEC Rule 14a-8. This new provision appears to have a disproportionate impact on public companies incorporated in Maryland, where state law allows companies to endow the board of directors with the sole authority to amend bylaws.

B. Governance Provisions for Newly Public Companies

For newly public companies, ISS will generally recommend a vote against or withhold from directors individually, committee members, or the entire board (except new nominees, who should be considered case-by-case) if, in connection with the company's IPO, the company (a) adopted certain bylaw or charter provisions that materially adversely impact shareholder rights or (b) implemented a multi-class capital structure in which the classes will have unequal voting rights. Unless the adverse provision and/or problematic capital structure is reversed or removed, ISS will recommend a vote on a case-by-case basis on director nominees in subsequent years. The revised policies include a list of factors ISS will take into account in each instance.

C. Director Overboarding

Consistent with its policy change announced last year, ISS will generally vote against or withhold from directors who (a) are on more than five public company boards or (b) are CEOs of public companies who sit on the boards of more than two public companies besides their own.

D. Increase in Authorized Common Stock for a Stock Split or Share Dividend

ISS clarified an existing policy relating to forward stock splits and stock dividends. Going forward, ISS will generally recommend for a management proposal that seeks to increase the common share authorization for a stock split or stock dividend, so long as the effective increase in authorized shares is equal to or is less than the allowable increase calculated in accordance with ISS' Common Stock Authorization policy.

E. Equity-Based and Other Incentive Plans

ISS currently votes on a case-by-case on certain equity-based compensation plans, taking into account a plan's features and the equity grant practices of the company in question. ISS has used an equity plan scorecard (EPSC) approach with three pillars. For 2017, ISS added an additional factor under which it evaluates whether a company pays dividends on unvested awards during the performance/service vesting period or only after the underlying awards have been earned. Under this new factor, (a) full points will be earned if the equity plan expressly prohibits, for all award types, the payment of dividends before the vesting of the underlying award (however, accrual of dividends payable upon vesting is acceptable) and (b) no points will be earned if this prohibition is absent or incomplete. A company's general practice of not paying dividends until vesting is insufficient if not specifically enumerated in the plan document will result in no points being earned under this factor. ISS also changed the minimum vesting factor. Under the revised factor, (a) 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 for this factor and (b) no points will be earned if the plan allows for individual award agreements that reduce or eliminate the one-year vesting requirement. Finally, ISS made some minor changes to various factor weightings.

Additional information about the ISS approach to equity-based compensation plans is included in the Frequently Asked Questions dated December 16, 2016, available here.

F. Cash and Equity Plan Amendments

The existing cash and equity plan amendments factor was renamed and reorganized to separate the different evaluation frameworks applicable to different types of amendment proposals. As revised, the policy differentiates the evaluation framework applicable to amendment proposals presented for Section 162(m) purposes only from those involving multiple bundled amendments, amendments with or without new share requests, amendments potentially increasing cost, etc. The revised factor states that while ISS will vote on a case-by-case basis on amendments to cash and equity incentive plans, it will generally vote for proposals to amend executive cash, stock, or cash and stock incentive plans if the proposal (a) addresses administrative features only or (b) seeks approval for Section 162(m) purposes only and the plan is administered by a committee comprised solely of independent outsiders, per the ISS Categorization of Directors.

G. Director Compensation Programs

ISS is implementing a new policy regarding management proposals that seek ratification of non-employee director compensation. ISS indicated that the new policy was necessary to take into account a number of recent high-profile lawsuits regarding excessive non-employee director (NED) compensation that reflect increasing shareholder scrutiny. ISS articulated eight new factors it will take into account when deciding on such NED proposals. In addition, ISS also broadened and updated various factors it considers when assessing the reasonableness of NED equity plans.

2. Glass Lewis

In November 2016, Glass Lewis released an update to its proxy voting guidelines, available here. The following is a summary of the three principal changes made for the 2017 proxy season.

A. Director Overboarding

The 2017 Glass Lewis guidelines codify the policies outlined last year, and Glass Lewis will generally recommend a negative vote against a director who serves as an executive officer of any public company while serving on a total of more than two public company boards and any other director who serves on a total of more than five public company boards. Glass Lewis may take into account the following factors in determining whether a director serves on an excessive number of boards: (a) size and location of the other companies where the director serves on the board; (b) the director's board duties at the companies in question; (c) whether the director serves on the board of any large privately held companies; (d) the director's tenure on the boards in question; and (e) the director's attendance record at all companies.

B. Governance Provisions for Newly Public Companies

Glass Lewis generally believes that newly public companies should be allowed adequate time to fully comply with marketplace listing requirements and meet basic governance standards and historically has refrained from making recommendations based on governance standards during the one-year period following a company's initial public offering. Under the revised policy, Glass Lewis will review the terms of the company's governing documents in order to determine whether shareholder rights are being "severely restricted" from the outset. Glass Lewis indicated that certain restrictive terms of applicable governing documents may "subvert shareholder interests following the IPO."

In conducting this evaluation, the following provisions will be reviewed: (a) anti-takeover provisions such as a poison pill or classified board; (b) supermajority vote requirements to amend governing documents; (c) exclusive forum or fee-shifting provisions, (d) the ability of shareholder to call a special meeting or act by written consent; (e) the voting standard for the election of directors; (f) the ability of shareholders to remove directors without cause; and (g) the presence of evergreen provisions in the company's equity compensation arrangements. In cases where a board adopts an anti-takeover provision preceding an IPO, Glass Lewis may recommend a negative vote against the members of the board who served when the provision was adopted. A board may commit to submit the anti-takeover provision to a shareholder vote at the company's first shareholder meeting following the IPO or provide a sound rationale or sunset provision for adopting the anti-takeover provision in question.

In cases where Glass Lewis concludes that governing documents severely restrict the rights of the shareholders to effect change, it may recommend a vote against (a) the members of the governance committee or (b) the directors that served at the time of the governing documents' adoption, depending on the severity of the concern.

C. Board Evaluation and Refreshment

Glass Lewis generally favors a routine director evaluation, including independent external reviews, and periodic board refreshment. Glass Lewis clarified its approach by noting that while age limits can aid board succession planning, they are arbitrary in nature and can have the effect of restricting the ability of experienced and potentially valuable board members from continued service. Instead, shareholders should focus on monitoring a board's (a) overall composition, including its diversity of skill sets; (b) alignment with a company's strategy; (c) approach to corporate governance; and (d) stewardship of company performance, rather than imposing inflexible rules that don't necessarily correlate with returns or benefits for shareholders. Glass Lewis notes that if a board does adopts term or age limits, then it should follow through and not waive such limits. In fact, a waiver may lead to a vote against the nominating and/or governance committee members unless the rule was waived with sufficient explanation, such as consummation of a corporate transaction like a merger.

3. ISS QualityScore Governance Ratings

In early November, ISS released a newly rebranded corporate governance rating system called "QualityScore." QualityScore tracks 107 governance factors across four pillars: Board Structure, Compensation/Remuneration, Shareholder Rights and Takeover Defenses, and Audit and Risk Oversight. The following are the new or updated factors:

A. Board Structure Pillar

- **What is the proportion of women on the board?** This factor is in addition to another factor that relates to the number of women on the board.
- **What proportion of non-executive directors has been on the board for less than six years?** This factor awards increasing credit for increasing proportions of the board represented by directors with tenure less than six years as of the most recent annual meeting. No additional credit is given if the proportion of directors with less than six years tenure is greater than one-third of the board.
- **Does the board have any mechanisms to encourage director refreshment?** ISS notes that the "gold standard" regarding director refreshment is for a rigorous annual evaluation of all directors to ensure continued match of their skill set against the needs of the company. ISS indicates that mandatory retirement age and term limits are two popular mechanisms currently used by boards. This factor does not have any weight on the scoring model for US companies.
- **Does the company disclose the existence of a formal CEO and key executive officers succession plan?** QualityScore will take into account whether a company has disclosed the existence of a board-approved succession plan for the CEO, other senior management and key executives. The plan must be periodically evaluated by the board.
- **Has ISS' review found that the board of directors has taken unilateral action that materially reduces shareholder rights or the company has had other governance failures?** ISS has added a second component to this question related to "governance failures" at a company. Examples of governance failures include (a) material failures of governance, stewardship, risk oversight, or fiduciary responsibilities at the company; (b) failure to replace management as appropriate; or (c) egregious actions related to a director's service on other boards that raise substantial doubt about his or her ability to effectively oversee management and serve the best interests of shareholders at any company. ISS indicates that the most common categories of governance failures are (a) excessive pledging of shares and (b) failure to opt out of state laws requiring a classified board (Indiana and Iowa.) Newly public companies are also subject to this scrutiny if they have adverse charter and bylaw provisions and class structures.
- **Has the board adequately responded to low support for a management proposal?** (Q350). This factor relates to management-sponsored ballot items that may not be binding on the company, but reflect the will of the shareholders. ISS considers director elections, advisory vote on executive compensation, and frequency of say-on-pay as part of this factor.

B. Compensation/Remuneration Pillar

- **Does the company employ at least one metric that compares its performance to a benchmark or peer group (relative performance)?** QualityScore will take into account whether a company has adopted a pre-established metric, in any short-term or long-term incentive plan, that is set relative (measured on relative terms) to an external group, such as a peer group, an index, or competitors.

C. Shareholder Rights and Takeover Defenses

- Three new factors relate to the shareholders' litigation rights:
  - **Does the company have an exclusive venue/forum provision?** QualityScore will take into account whether a company has adopted an exclusive venue/forum provision. Absent some justifiable past harm, ISS views such a provision as a restriction on shareholders' rights. ISS did not provide any details on what it considers "past harm."
  - **Does the company have a fee shifting provision?** ISS indicates that such provisions may dissuade shareholders from pursuing meritorious legal action against a company and violate the ordinary American practice in which each party is responsible for its own litigation costs.
  - **Does the company have a representative claim limitation or other significant litigation rights limitations?** ISS explains that while such provisions are intended to prevent frivolous lawsuits brought by shareholders who own a small percentage of the outstanding shares, the provisions do not distinguish between frivolous and meritorious lawsuits.
- Four new factors relate to proxy access:
  - **What is the ownership threshold for proxy access?**
  - **What is the ownership duration threshold for proxy access?**
  - **What is the cap on shareholder nominees to fill board seats from proxy access?**
  - **What is the aggregation limit on shareholders to form a nominating group for proxy access?**
- **Can the board materially modify the company's capital structure without shareholder approval?** ISS indicates that most companies are required to put authorized capital increases or reduction to a shareholder vote. However, Maryland-incorporated REITS can increase or decrease authorized capital without shareholder vote.

D. Audit and Risk Oversight

- **What is the tenure of the external auditor?** Auditor tenure is the length of the auditor-client relationship. The exact reason why ISS included this new factor is not clear. This factor does not have any weight on the scoring model for US companies.

ISS also updated the commentary to the following factors:

- **How many (non-executive) directors serve on a significant number of outside boards?** ISS' benchmark policy defines excessive in the US as more than five public company board seats. For US companies, all directors are included except the CEO.
- **Are all directors elected annually?** QualityScore will now take into account whether a company, though currently elected annually, could classify its board without shareholder approval. This provision will have a disproportionate impact on companies incorporated in Maryland.
- **Does the company require a super-majority vote to approve amendments to the charter or bylaws?** QualityScore will now take into account whether shareholders have the ability to amend the bylaws of a company.
- **Do all directors with more than one year of service own stock (who can legally/practically do so)?** ISS clarified that it will take into account any limitations on certain directors who are employees or representatives of significant shareholders or investment firms and may be prohibited by internal policies from personally holding shares. Such directors are excluded from this calculation.

ACTION ITEMS

- Review the revised ISS and Glass Lewis policies and compare to your existing corporate governance structure.
- Companies incorporated in Maryland, which includes many of the publicly traded REITs, should pay attention to the ISS voting policies and their respective QualityScore, especially their scores in the Shareholder Rights and Takeover Defense pillar. Consider whether it is prudent to either adopt the changes sought by ISS or to engage in outreach to the largest institutional shareholders.
- ISS has adopted two changes to its voting guidelines related to director compensation proposals. A company that is considering presenting such proposals to its stockholders should review these guidelines carefully.

4. Proxy Access – Current Status and Outlook

Most proxy access bylaws address, in some form, the following issues: (a) ownership threshold, (b) length of ownership, (c) maximum number of stockholder nominated candidates, (d) calculation of qualifying ownership, including treatment of "loaned" shares, (e) stockholder group limit, (f) maximum number of access nominees, (g) notice deadlines, (h) future disqualification of stockholder nominees, (i) voting commitments, and (j) third-party compensation arrangements. As a result of the proposed SEC rule and the developments of the 2016 proxy season, the primary features of a proxy access bylaw have largely been settled with allowing a single or group of up to 20 shareholders who own at least 3 percent of the company's stock for at least three years to include in the company's proxy materials director nominees for up to 20 percent of the board (the so-called 3/3/20/20 formulation).

For the 2017 proxy season, we are seeing a newly emerging trend: proponents are asking companies that have previously adopted a proxy access bylaw to amend certain provisions (so-called Fix-It Proposals). Not surprisingly, companies have sought relief from the SEC staff on Fix-It Proposals, asserting that they can be excluded under Rule 14a-8(i)(10) since the company has "substantially implemented" the proposal. The results of such a request have not been generally favorable to companies. In fact, in seven of the nine instances we are aware of, the company has not succeeded in excluding the Fix-It Proposal. The takeaway from this experience is that the SEC staff appears to have two standards – one for initial adoption of a proxy access bylaw provision and a second for the amendment of a previously adopted proxy access bylaw provision. This line of demarcation between these two camps is not very clear. In addition, we are seeing another trend in the content of the proxy access bylaws being submitted for the 2017 proxy season including, among other matters: (a) allowing shareholders to nominate up to one-quarter (25 percent) of the board of directors and (b) redacting the limitation on the number of shareholders who can aggregate their shares to achieve the 3 percent holding requirement.

The number of US corporations that have adopted proxy access bylaws has dramatically increased, but, so far, we have not seen any parallel rise in the number of shareholder-appointed directors. This result has led some practitioners to ponder whether the proxy access phenomenon would be similar to instances involving majority voting. Interestingly enough, in November 2016, an fund associated with a well-known activist investor, filed a Schedule 14N and a Schedule 13D/A (this was the ninth amendment to the Schedule 13D) and submitted a proxy access director nomination to a public company, which had previously adopted a proxy access bylaw. This proxy access test drive was rather short-lived, since the public company rejected the director nomination on the basis that fund was not able to comply with certain provisions of the public company's existing bylaws. The fund withdrew its director nomination shortly thereafter. It remains to be seen how proxy access will impact the board nomination/election process in actual terms.

ACTION ITEMS

- Consider whether to adopt proxy access, even in the absence of a shareholder proposal, and otherwise prepare in the event a proposal is received.
- Monitor large shareholders and their prior actions.
- Engage large shareholders so that they are well informed of the company's strategic goals and business plans.
- Consider current trends and understand that, while a company may be able to implement its preferred version of a proxy access bylaw, if it deviates from the 3/3/20/20 model it may nevertheless be vulnerable to a future Fix-It Proposal.

5. Proxy Presentation and Readability

Companies of every size should use this upcoming proxy season as an opportunity to update and refresh their proxy statements to enhance the presentation of important disclosures and increase ease of readability. The key here is to turn the proxy statement into a communication tool rather than just a compliance tool. Providing reader-friendly features helps transform proxy statement disclosures from documents that simply respond to SEC rules into proactive messages for investors, while also making it easier for ISS and Glass Lewis to accurately score a company on the features that are relevant to those firms. Disclosure updates may be driven by say-on-pay votes, investor activism on a particular topic, or revisions by peer companies. Additionally, companies should think of a proxy statement as a tool to increase shareholder engagement, improve corporate branding, advocate management's position on past performance, and introduce management's strategic vision for the future.

Proxy redesign should improve functionality of the proxy, highlight significant information, and generally enhance the reader's experience. It should not distract the reader or otherwise incorporate design elements that do not advance the underlying message. When used effectively, proxy redesign can reduce the length of a proxy statement while providing cost savings and improving the reader's experience. Recommended areas of focus during the proxy refreshment process are: content and readability, online navigability, design, and access to complementary information.

ACTION ITEMS

- **Online proxy presentation.** Most institutional investors access and vote based on online access to a company's proxy statement. Companies are taking note of this and creating enhanced online version with features allowing for easy maneuverability, links to videos, and other interactive features.
- **Emphasize board involvement and refreshment.** There has been a lot of attention recently to clearly disclosing the level and quantity of board involvement in a company's operations. Explain how the board is involved in the company's strategy, strategic planning and long-term plans. Consider using a board skills matrix which explains how the mix and depth of a director's skill help the company.
- **Highlight and summarize information of interest.** Companies have been using three- to five-page summaries at the beginning of a proxy statement to highlight areas of interest, such as corporate governance or performance. This year, be sure to emphasize the company's strategic plan, board involvement in the setting of the strategic plan, board refreshment, and succession planning.
- **Easy-to-read FAQs.** Move some of the routine items into an FAQ section near the end of the proxy statement.
- **Use pictures of board and management.** Use headshots in conjunction with the standard bios to provide a more personal touch, while demonstrating board diversity. Revise the bio portion so that it is clear how the director's experience is relevant to the company's strategy.
- **Include useful infographics.** Graphics, such as charts and diagrams, can aid in investor review. But do not overdo it – too many infographics can lead to chart/table fatigue.
- **Create an eye-catching cover and back page.** Appealing cover graphics can make a company's proxy statement stand out, facilitate branding, and provide an inviting introduction to important disclosures.

6. SLB 14H – Update on Rule 14a-8(i)(9) conflicting proposals

In October 2015, the SEC Staff issued Staff Legal Bulletin No. 14H (SLB No. 14H), which provided new guidance on the ability of a company, under Rule 14a-8(i)(9), to exclude a shareholder proposal that "directly conflicts" with a management proposal. This rule seeks to avoid shareholder confusion when faced with a management proposal and a shareholder proposal that are in direct conflict with one another.

Under SLB No. 14H, the SEC Staff will permit a company to exclude a shareholder proposal as directly conflicting with a management proposal only "if a reasonable shareholder could not logically vote in favor of both proposals, i.e., a vote for one proposal is tantamount to a vote against the other proposal." The SEC Staff stated that the analysis "more appropriately focuses on whether a reasonable shareholder could vote favorably on both proposals, or whether they are, in essence, mutually exclusive proposals." The SEC Staff provided the following examples of situations where a conflict exists:

Direct Conflict Exists		Reason
Management proposal seeks shareholder approval of a merger	Shareholder proposal asks shareholders to vote against the merger	Shareholders cannot logically vote both for and against the same transaction
Management proposal seeks approval of a bylaw requiring the CEO to be the chair at all times	Shareholder proposal asks shareholders to approve a bylaw that would separate the CEO and chair roles	Shareholders cannot logically vote both for a combined CEO/chair and for a separate CEO/chair

The Staff also provided the following examples where, in its view, a direct conflict did not exist because "a reasonable shareholder, although possibly preferring one proposal over the other, could logically vote for both."

Direct Conflict Does Not Exist		Reason
Management proposal seeks to allow shareholders holding at least 5% of the company's stock for at least 5 years to nominate for inclusion in the company's proxy statement 10% of the directors	Shareholder proposal seeks to allow a shareholder or group of shareholders holding at least 3% of the company's outstanding stock for at least 3 years to nominate up to 20% of the directors	Both proposals generally seek a similar objective, which is to give shareholders the ability to include their nominees for director alongside management's nominees in the proxy statement, but the proposals do not present shareholders with a direct conflict in that a reasonable shareholder could logically vote in favor of both proposals
Management proposal seeks to approve an incentive plan that gives the compensation committee discretion to set the vesting provisions for equity awards	Shareholder proposal seeks to have the compensation committee implement a policy that equity awards would have no less than four-year annual vesting	A reasonable shareholder could logically vote for a compensation plan that gives the compensation committee the discretion to determine the vesting of awards, as well as a proposal seeking implementation of a specific vesting policy that would set minimum vesting standards applicable to future awards granted under the plan

Common types of proposals where the conflict issue comes into play include (i) proxy access bylaws (see discussion above); (ii) director eligibility criteria (companies may exclude proposals that seek to impose one or more requirements that would apply to, and potentially disqualify, management's current nominees, but allow proposals focused on setting qualifications for future nominees); and (iii) executive compensation (where the SEC Staff often allows companies to exclude proposals that attempt to limit the board's authority to set executive compensation levels where the company intends to propose a related plan or arrangement at the same meeting). In SLB No. 14H, the SEC Staff noted that, to minimize concerns about shareholder confusion, any company that includes on its ballot shareholder and management proposals focused on the same topic or objective can include disclosure in the proxy statement explaining the differences between the two proposals and how the company would expect to reconcile the voting results.

ACTION ITEMS

If your company receives a shareholder proposal that may be subject to Rule 14a-8(i)(9):

- *Analyze the proposal under the SEC's guidance and seek to exclude the shareholder proposal if it truly conflicts with a management proposal on the same topic.* In this effort, a company will need to demonstrate to the SEC Staff that a shareholder could not logically vote for both proposals.
- *Seek to preempt a shareholder proposal after receiving it.* If a company receives a shareholder proposal that is not already the subject of a management proposal, and that management finds troublesome, the company could consider implementing its own proposal on the same topic as a way to omit the shareholder proposal under Rule 14a-8(i)(10) (relating to substantially implemented proposals).

7. Say-When-On-Pay

Recall that in its 2011 say-on-pay rules, the SEC required a separate nonbinding advisory vote on the frequency of say-on-pay votes at least once every six years – sometimes called say-when-on-pay votes. 2017 will be the six-year mark at which most companies will again need to include in their 2017 proxy statements a say-when-on-pay vote. This vote is needed no matter how frequently a company conducts say-on-pay votes. In all likelihood, companies currently making annual say-on-pay proposals will stay the course, and some that did manage to achieve two- or three-year cycles back in 2011 will revert to annual votes.

ACTION ITEMS

- Review results of past say-on-pay proposals.
- Review position on say-on-pay frequency by large institutional shareholders

SEC STAFF FOCUS ISSUES

1. Non-GAAP Measures: The SEC's Crackdown

The regulatory regime governing the use of non-GAAP financial measures has not changed much since the SEC adopted Regulation G and Item 10(e) of Regulation S-K in 2003. Regulation G applies to all companies that have a class of security registered under Section 12 of the Exchange Act of 1934, as amended and relates to the use of "non-GAAP financial measures" in any public disclosure of material information, whether in writing or orally. Under this regulation, public companies that disclose or release non-GAAP financial measures are required to include, in that disclosure or release, a presentation of the most directly comparable GAAP financial measure and a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP financial measure.

Essentially, in addition to compliance with Regulation G, whenever one or more non-GAAP financial measures are included in a filing with the SEC, Item 10(e) of Regulation S-K requires the issuer to present, with equal or greater prominence, the most directly comparable financial measure or measures calculated and presented in accordance with GAAP and provide a reconciliation of the differences between the non-GAAP financial measure disclosed with the most directly comparable financial measure calculated and presented in accordance with GAAP. In addition, the issuer is required to disclose the reasons why its management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the registrant's financial condition and results of operations.

Beginning in 2015, the SEC staff began repeatedly voicing its concern that the increased use of non-GAAP measures may be confusing to investors and analysts. On May 17, 2016, the SEC staff revised its C&DIs related to non-GAAP measures, by publishing four new interpretations and revising eight existing interpretations. The revised CD&Is can be found here.

Since the issuance of the new CD&Is, more than 150 comment letters that the SEC has sent to companies have included comments on non-GAAP issues. These comments have focused on:

- **Equal or greater prominence.** When a non-GAAP item is included in an SEC filing or in an earnings release filed under Item 2.02 of Form 8-K, the comparable GAAP item must receive "equal or greater prominence." Comment letters to date have focused on the placement of the non-GAAP item relative to the comparable GAAP item in headlines, tables and bullets; in CEO quotes (usually in cases where the "equal or greater prominence" requirement is violated in other ways); and in discussions of company performance.

- **Related Non-GAAP items.** The staff may apply the "equal or greater prominence rule" to concepts like Adjusted EBITDA margin and other metrics derived from the primary non-GAAP measure and also require that they be separately reconciled to the comparable GAAP metric.
- **Misleading labels.** Comments on this topic have focused on inconsistent usage of non-GAAP terms, such as the use of EBITDA to describe metrics that include adjustments that are inconsistent with customary usage of the term, and use of the term "pro forma" to describe financial results that are not prepared in accordance with Regulation S-X. The staff also commented on situations where the company's actual adjustments are inconsistent with the definition of its non-GAAP measure (such as where identified "non-recurring" items actually occur regularly).
- **Earnings calls.** The staff has commented on situations where management discussed a non-GAAP measure on its earnings call, but did not discuss it in its earnings release or provide a reconciliation.
- **Explanations for the company's use of Non-GAAP measures.** Comments issued on this topic suggest that companies need to carefully review the explanations given for their use of non-GAAP measures and ensure that the reasons given are specific to the company and cover each non-GAAP measure that is used.
- **Performance measures v. liquidity measures.** The SEC prohibits the disclosure of per share liquidity measures. Accordingly, companies that disclose per share information need to ensure that their classification of a non-GAAP measure as a performance measure is appropriate.
- **Financial guidance.** The SEC's non-GAAP rules require that management guidance with respect to non-GAAP measures must be reconciled to the comparable GAAP measure "to the extent available without unreasonable efforts." Many companies, presumably based on this exception, do not provide reconciliations when disclosing future guidance. Comments here asked companies to provide such reconciliations or explain why the comparable GAAP measures were not available.

We believe the focus on proper use of non-GAAP measures is likely to lead to enforcement actions, which could also impact risk in civil litigation. In fact, in late January, the SEC announced settled charges against MDC Partners, Inc., a publicly traded marketing firm, for failure to comply with the rules related to non-GAAP financial measures. In addition, the company was charged with failure to disclose millions in perks awarded to its former CEO. This SEC Order can be found here.

ACTION ITEMS

- Review the new C&DIs and subsequently issued comment letters (particularly any that may have been issued to sector peers) to determine the SEC staff's current thinking on the use of non-GAAP measures.
- Consider how your disclosure controls and procedures apply to the disclosure of non-GAAP measures.
- Audit committees should pay close attention to the non-GAAP measures used by an issuer, including the required related disclosures and the processes the issuer follows, to consider both the appropriateness and reliability of the measure and whether the explanation for use should be updated or modified.
- Management should ensure that earnings call discussions of non-GAAP items are consistent with the written earnings release and that all non-GAAP measures intended to be discussed are properly disclosed and reconciled.
- Management should consider its use of non-GAAP measures in its financial guidance and reconcile those used unless there is a good reason why the comparable GAAP measures are not available.

2. Pay Ratio Disclosures

On August 5, 2015, the SEC adopted final rules concerning CEO-to-median-employee pay ratio disclosure (the Pay Ratio Rule). Mandated by the Dodd-Frank Act, the Pay Ratio Rule will require a company with a fiscal year beginning on or after January 1, 2017 to report the ratio in its 2018 proxy statement. The Pay Ratio Rule applies to all companies that are required to disclose executive compensation data under Regulation S-K's Item 402(c)(2)(x), an existing rule that governs executive compensation. The Pay Ratio Rule does not apply to emerging growth companies, smaller reporting companies, or foreign private issuers.

The rule will amend Regulation S-K by adding provision Item 402(u), which will require disclosure of:

- The median annual total compensation of all employees of the company, excluding the principal executive officer (CEO)
- The annual total compensation of the CEO
- The ratio of the annual total compensation of the median employee to that of the CEO.

The SEC refers to the three components above as the pay ratio disclosure. Besides disclosing pay ratio, companies are also required to describe their methodology and any material assumptions made in order to arrive at the calculation (for example, what, if any, adjustments or estimates were used). There will be significant complexity in performing the calculation to arrive at the correct ratio disclosure given the flexibility in the Pay Ratio Rule's reporting and calculation requirements. Employers must choose which reporting methodology best suits the company's business model, as the Pay Ratio Rule allows companies to use a range of permissible calculation types. These calculation types can include estimates, statistical sampling, and the utilization of consistently applied compensation measures that serve to identify accurately the median employee based on each company's unique facts and circumstances.

Implementing the Pay Ratio Rule will require companies to make some decisions including (a) determining exactly who is an "employee"; (b) disclosing the annual total compensation of the "median" employee of the registrant and thus determining its median employee; and (c) computing the total annual compensation of the CEO for the registrant's last completed fiscal year in accordance with Item 402(c)(2)(x) of Regulation S-K.

On October 18, 2016, the SEC issued five new compliance and disclosure interpretations (C&DIs) related to pay ratio disclosure. The new CD&Is (Questions 128C.01 through 128C.05) can be found here.

ACTION ITEMS

Given the flexibility inherent in the Pay Ratio Rule, as well as the various calculation methodologies a company can choose, we expect that registrants will encounter compliance issues and other difficulties in interpreting it. For this reason, even though the disclosure is not required to be included in 2017 proxy statements, it is prudent for registrants to complete a dry run calculation of their pay ratio disclosures for the 2016 year, which includes undertaking the following actions:

- Identify and test possible methodologies for calculating the pay ratio and prepare a preliminary estimate of the pay ratio.
- Determine whether data privacy rules will prevent sharing the employee information necessary to calculate and disclose the pay ratio so that there is sufficient time to get an exemption or other relief or obtain employee consent, as appropriate.
- Update systems and develop processes to collect the required information.
- Draft a mock disclosure based on the dry run calculations.

3. Clawback Rules

On July 1, 2015, the SEC issued proposed rules to implement certain Dodd-Frank Act mandated provisions that require any company whose securities are listed on a national securities exchange to adopt and enforce a policy requiring the clawback of incentive-based compensation from current and former executive officers in the event of an accounting restatement (the Clawback Rules). The SEC has instructed the stock exchanges to file proposed listing rules to implement the Clawback Rules no later than 90 days after publication of the final rule, and that those rules be effective no later than one year after that publication date. Listed issuers would then be required to adopt a clawback policy no later than 60 days following the date on which the exchanges' final rules become effective. Although the comment period on the proposed Clawback Rules has expired, the SEC has not issued a final rule, and it is not clear when it will do so.

As proposed, the Clawback Rules direct national securities exchanges to promulgate listing standards requiring the recovery of incentive-based compensation during the three fiscal years preceding the date on which the listed company is required to prepare an accounting restatement to correct a material error. Under these circumstances, the issuer could recover the amount of any incentive-based compensation erroneously awarded to an executive officer. The amount recoverable by the issuer is the amount of incentive-based compensation received by the executive officer for up to three years that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the company's financial results as restated.

Under the proposed rules, an issuer is required to pursue recovery unless it would be impracticable because it would impose undue costs on the issuer or its shareholders or would violate non-US home country law. Any decision on impracticability needs to be made by the committee of independent directors that is responsible for executive compensation. Before concluding that it would be impracticable to recover amounts due, the issuer would first need to make a reasonable attempt to recover such compensation and would be required to document its attempt to recover and provide such documentation to the relevant stock exchange. The listed issuer would also be required to disclose its clawback policy, disclose information about actions taken pursuant to its policy, and file its policy as an exhibit to its annual report.

ACTION ITEMS

The ability of a company to recoup certain incentive compensation previously paid to its executive officers has been on the SEC radar for quite some time. Although the proposed Clawback Rules will not be effective for the 2017 proxy season, registrants should consider undertaking the following actions:

- Registrants with an existing clawback policy should consider what additional details about the policy could be required.
- Review and consider revising existing incentive-based compensation plans and programs, and the forms of award agreements and employee communication relating thereto, to include a general condition that the compensation awards (such as bonuses, equity awards, and long-term cash compensation) are granted subject to any clawback policy that the company may adopt in the future to comply with Dodd-Frank Act or stock exchange rules.
- Review corporate governance and executive compensation documentation.
- Review bylaws, indemnification policies, and committee charters in light of the proposed Clawback Rules.

4. Pay-for-Performance Disclosure

On April 29, 2015, the SEC proposed its long-awaited pay-for-performance rules. The proposed rules (new Item 401(v) of Regulation S-K) would require a new table in any proxy or information statement comparing "executive compensation actually paid" to the "total shareholder return" (TSR) of the company and its peers, as well as a discussion of the relationship between these amounts. Although the comment period on the proposed pay-for-performance rules has expired, the SEC has not issued a final rule, and it is not clear when it will do so. As a result, the proposed rules will not be effective for the 2017 proxy season.

The proposed rules would require tabular disclosure in a prescribed format of "executive compensation actually paid," total compensation as disclosed in the Summary Compensation Table, TSR, and peer group TSR. The proposed rules require a description of (1) the relationship between the executive compensation actually paid and TSR and (2) the relationship between TSR and peer group TSR, in each case over each of the five most recently completed fiscal years. The proposed rules would permit disclosure of information in addition to what the proposed rules specifically require, so long as the information is not misleading and does not obscure the required information. This would appear to permit, for example, companies that make executive compensation decisions utilizing EBITDA or other performance measures (but not TSR) to provide additional disclosure regarding the relationship between such measures and the amounts actually paid to executive officers. The proposed rules provide that the peer group to be used for the TSR comparison may be selected by the company and may be the peer group identified by the company in its CD&A or used by the company for its stock performance graph.

Companies subject to the proposed rule would be required to provide information on the prior three years the first time the new disclosure is provided, with an additional year of information provided in each of the two subsequent annual proxy or information statements, until information covering a total of five years is provided.

ACTION ITEMS

- Review the performance metrics used by the Compensation Committee with the proposed rules in mind.
- Prepare a sample table to see how the company's tabular disclosure would appear, and consider additional disclosures that would need to be made based on that result or on the company's current compensation metrics.

5. Hedging Disclosure

On February 9, 2015, the SEC proposed rules that would require a public company to disclose whether its employees (including officers) and directors are permitted to hedge or offset any decrease in the market value of company equity securities and whether such securities were granted to such persons by the company as compensation or are otherwise held, directly or indirectly. The proposed rules apply to all companies subject to the federal proxy rules, including smaller reporting companies, emerging growth companies, business development companies, and registered closed-end investment companies with shares listed and registered on a national securities exchange (the rules would not apply to foreign private issuers or registered investment companies that are not closed-end). Although the comment period on the proposed rules has expired, the SEC has not issued a final rule, and it is not clear when it will do so. Accordingly, the proposed rules will not be effective for the 2017 proxy season.

The proposed rules are intended to inform shareholders as to whether employees or directors are allowed to engage in transactions to mitigate or avoid the risks of long-term stock ownership (thereby eliminating the incentive alignment associated with equity ownership). Public companies are already required to disclose any policies on hedging by named executive officers. The proposed rule would require disclosure, in any proxy or information statement relating to the election of directors, of whether any employee or director (or any of their designees) is permitted to purchase any financial instruments or otherwise engage in transactions that are designed to, or have the effect of, hedging or offsetting any decrease in the market value of equity securities that are granted to the employee or director by the company as compensation or held, directly or indirectly, by the employee or director. The rule proposal does not require companies to prohibit hedging by employees or directors. Disclosure under the proposed rule would require identification of the particular types of hedging transactions that the company permits and those it prohibits. Companies would also be required to specify whether any permissions or prohibitions apply to some, but not all, persons covered by the proposed rules. ISS views any amount of hedging of company stock by directors or executives as a "failure of risk oversight" that may lead to voting recommendations against individual directors, committee members or the full board of directors.

ACTION ITEMS

- Review existing hedging policy taking into account the proposed rules.
- Review existing disclosure taking into account the proposed rules.

6. Voluntary Disclosures on Audit Committee Matters

Enhanced disclosure regarding auditors and audit committees has been an area of focus in recent years. In July 2015, the SEC published a concept release seeking public comment regarding audit committee reporting requirements, with a focus on the audit committee's reporting of its responsibilities with respect to its oversight of the independent auditor and enhancing the information provided to investors about the audit committee's responsibilities and activities. The concept release summarized concerns expressed by investors, organizations representing audit committee members, and auditors as to whether improvements can be made to provide investors with relevant information that more transparently conveys these oversight responsibilities.

Public companies have received shareholder proposals focusing on these issues and many have begun including voluntary disclosures in their proxy statements to improve their disclosures in this area, or even to preempt shareholder proposals. Potential topics for disclosure include the audit committee's role in negotiating auditor fees, consideration of non-audit services when making auditor independence determinations, consideration of auditor tenure, and consideration of specific factors in assessing the auditor's quality and qualifications.

ACTION ITEMS

- Review current practices with respect to the audit committees engagement with the company's outside auditor.
- Enhance proxy statement disclosure to highlight good practices.

7. Form 10-K Amendments

On June 1, 2016, the SEC approved an interim final rule (Release No. 34-77969) to amend Part IV of Form 10-K to add a new Item 16 that expressly allows a registrant, at its option, to include a summary of business and financial information in its Form 10-K. The interim final rule implements a provision of the Fixing America's Surface Transportation (FAST) Act, which was enacted in December 2015 and includes several provisions related to federal securities laws. Section 72001 of the FAST Act directs the SEC to issue regulations to permit registrants to submit a summary page on Form 10–K, but only if each item on such summary page includes a cross-reference (by electronic link or otherwise) to the material contained in Form 10–K to which such item relates. To implement the statutory requirement that each item in the summary be accompanied by an electronic or other cross-reference, new Item 16 requires that each summary topic be hyperlinked to the related, more detailed disclosure item in the Form 10-K.

The interim final rule provides registrants with flexibility in preparing the summary and does not prescribe the length of the summary, specify the Form 10-K disclosure items that should be covered in the summary, or dictate where the summary must appear in the Form 10-K. A registrant may determine which items to summarize as long as the information is presented fairly and accurately. The summary should provide more information than a table of contents, which is typically included in a registrant's Form 10-K.

ACTION ITEMS

- The SEC's current rules do not prohibit a registrant from voluntarily including a summary in its Form 10-K, so the new Item 16 will not necessarily have an immediate impact on the current disclosure practices of registrants. Nevertheless, registrants will want to keep an eye on their peers and monitor developments relating to the use and acceptance of such summaries. Companies now commonly include an executive summary to lead off and provide context to the Compensation Discussion and Analysis sections of their proxy statements – similarly, a 10-K summary could well be a useful new disclosure tool and one that may be appreciated by investors.

8. Universal Proxy Card

In October 2016, the SEC issued proposed rules to require the use of universal proxy cards in all non-exempt solicitations in connection with contested elections of directors. If enacted, these rules would require each soliciting party to distribute a universal proxy that includes the names of all candidates – not merely the soliciting party's slate of candidates – for election to the board. The goal of the proposed universal proxy system is to permit shareholders to select a combination of nominees rather than limiting shareholders' choice to a slate of candidates chosen by a party in the contest.

The SEC also found that some company proxy statements contained ambiguities and inaccuracies in their disclosures about voting standards in director elections, particularly with respect to the correct usage and effect of "against" and "withhold" as alternatives to voting "for" a nominee. The proposed rules would amend the voting option and disclosure requirements in the form of proxy to provide shareholders with a better understanding of the effect of their votes.

In light of the timing of the comment period and potential changes in SEC priorities under the incoming administration, it is unlikely that the universal proxy card would be required for the 2017 proxy season.

ACTION ITEMS

- Watch for guidance on SEC's position on final universal proxy card rules.
- Review your company's disclosures regarding voting options and standards for the 2017 proxy season.
- Continue to engage with long-term shareholders, in order to build investor support and reduce the likelihood of proxy contests.

9. Virtual-Only Annual Meeting

In 2016, nearly 150 companies held virtual-only annual meetings, up from 90 in 2015 and 53 in 2014. While some investors disfavor this type of shareholder meeting because it tends to limit the ability of shareholders to participate in the meeting or engage with management, advocates of virtual-only meetings have strong arguments in their favor and the adoption of this approach is expected to increase in popularity.

Benefits	Objections
Virtual-only meetings can improve shareholder attendance. Many companies regularly conduct meetings at which fewer than a handful of shareholders bother to attend. Virtual-only meetings enable shareholders that might not otherwise be able to travel to a physical meeting to attend online, and to attend multiple meetings scheduled during a short period of time. Virtual-only meetings should be expected to achieve greater shareholder attendance.	*Virtual-only meetings can limit shareholder access.* While the potential for shareholder attendance may be greater, face-to-face access to management and the board is no longer available.
Management has greater control over the meeting. Even though more shareholders may attend a meeting, management may feel more in control, by being able to require the submission of questions in advance, preparing thoughtful responses to questions, and eliminating duplicative or non-relevant topics.	*Shareholders have more limited opportunities to ask questions.* More control means that management may avoid questions on difficult topics that could be raised in person at a physical meeting.
Companies can save on costs. With a virtual-only meeting, the days of renting a hotel ballroom for the benefit of the three shareholders who show up are over.	Companies can suffer from lack of voting certainty. Virtual-only meetings may negatively affect the ability to have an orderly voting process. With the ability to attend virtually, shareholders may be less inclined to submit proxies in advance, or more inclined to change their votes, leading to less certainty in advance of the meeting about voting outcomes.

ACTION ITEMS

If a company seeks to hold a virtual-only meeting, it should consider the following:

- Whether applicable law and its corporate documents permit the holding of a virtual-only meeting and, if so, the rules or guidelines pursuant to which it must be conducted.
- Whether holding a virtual-only meeting can be expected to improve such factors as shareholder participation or cost savings. In reviewing these issues, a company should also consider the views of its principal investors, because some large institutions, such as CalPERS, and some advisory groups, such as CII, oppose virtual-only meetings.
- Whether corporate purposes might be better served by having a physical meeting, such as when a proposal is expected to be contested and a more orderly voting process is desired.
- Establishing a process for conducting the virtual-only meeting that properly protects the ability of shareholders to participate in the meeting and engage with management and the board.

GENERAL PUBLIC COMPANY ISSUES

1. No More Mailing Annual Reports to SEC

There is no longer a need to mail to the SEC seven paper copies of the annual report sent to security holders with the proxy statement. (This is usually just the 10-K wrapped in glossy pages.) Companies can now simply post the annual report on their corporate website. The annual report must be posted by the date it is first sent to shareholders and kept up on the site for at least one year. Here is the SEC interpretation providing this relief. Most companies have been posting their annual reports on their website for years. We suggest updating task and responsibility checklists to replace the SEC mailing requirement with a website posting requirement.

2. Elimination of "Tandy" Reps in Filing Reviews

Companies no longer need to include "Tandy letter" representations in their responses to Staff comments. Here is the Corp Fin announcement. They are also no longer required in Securities Act registration acceleration requests.

3. Private Offering Updates

While detailed summaries of private offering updates are beyond our scope, many companies follow these matters out of general interest and with a view to updating their D&O questionnaires or other processes so they may pursue private offerings rapidly. In 2016, several updates were made to private offering rules, including:

- Updating and modernizing Rule 147, the safe harbor for intrastate offerings under Section 3(a)(11) of the Securities Act
- Adopting a new Rule 147A, which differs from Rule 147 primarily in that there is no in-state formation requirement and general solicitation is permitted, presenting the possibility that it be used alongside state-level crowdfunding exemptions
- Increasing to $5 million the aggregate offering amount limitation in Rule 504
- Adding "bad actor" disqualifications to Rule 504
- Repealing the little used and now largely redundant Rule 505
- Allowing companies to conduct a Rule 506(b) offering (no general solicitation) and then a Rule 506(c) offerings (with

general solicitation), without integration, provided that the company complies with all applicable requirements of each respective offering during the time it is conducting that offering.

4. Nasdaq "Golden Leash" Rule

In July 2017, new Nasdaq Listing Rule 5250(b)(3) became effective, which requires public disclosure of the material terms of compensation and other payments provided by third parties to directors or director nominees. Nasdaq has indicated these terms are construed broadly, for example covering items such as non-cash compensation and other payment obligations, such as health insurance premiums or indemnification, made in connection with a person's candidacy or service as a director. Given the overlap with Item 402 of Regulation S-K, many D&O questionnaires already adequately address this topic – but, if not, Nasdaq companies should expand their director compensation questions so that responses identify all types of compensation and other payments.

5. Approval of 162(m) Performance Standards

Each year, we suggest public companies consider whether they should include in their proxy materials an approval of performance-based compensation arrangements intended to be exempt under Section 162(m) of the Internal Revenue Code. In this regard, remember that, to qualify for the exemption, the material terms of performance goals under performance-based compensation plans generally must be reapproved by shareholders every five years.

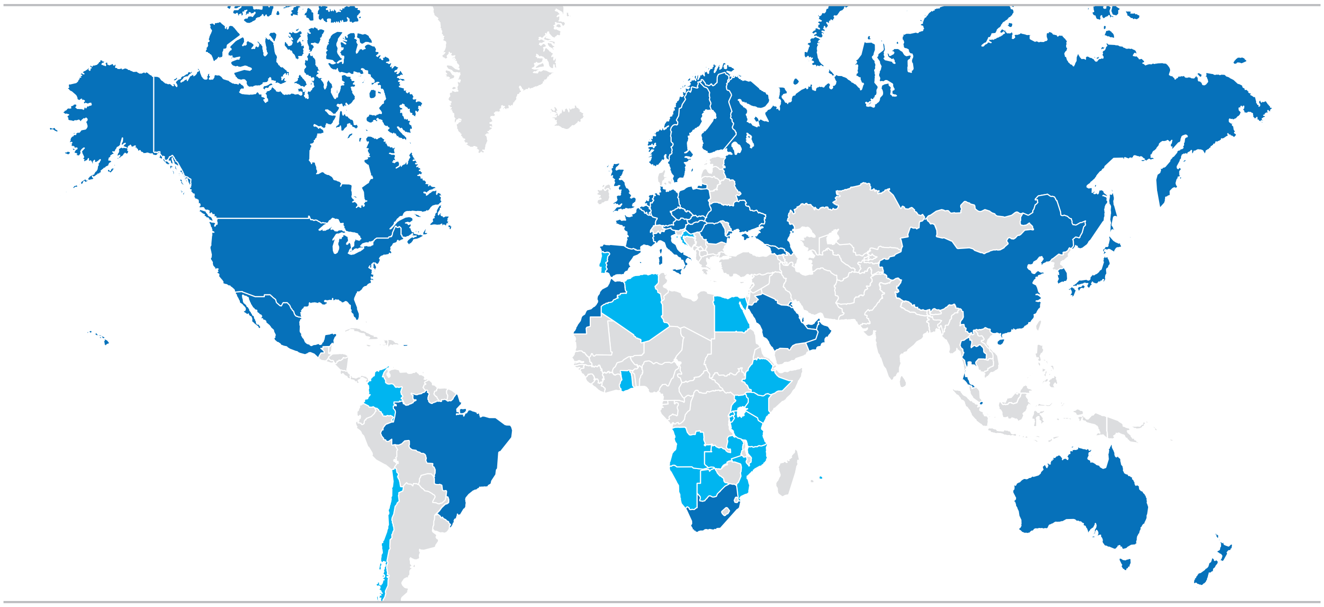
6. Resource Extraction Payments Disclosure

In 2016, the SEC amended its disclosure rules to require public companies that engage in the commercial development of oil, natural gas, or minerals ("resource extraction issuers") to include in an annual report on Form SD information relating to payments in excess of $100,000 made to a foreign government or the US federal government for the purpose of the commercial development of oil, natural gas, or minerals. These rules will require a Form SD to be filed on EDGAR no later than 150 days after the end of the issuer's most recent fiscal year, starting for fiscal years ending after September 30, 2018.

7. Equity Incentive Planning and Form S-8 Considerations

As companies begin their annual meeting planning process, they should consider whether it is time to adopt a new equity incentive plan or to increase the number of shares available under existing plans. Many equity incentive plans have fixed ten-year terms and, in any event, incentive stock options can only be granted under plans for a period of ten years from plan inception. Adopting a new plan generally requires preparing a Form S-8, and changes to existing plans will require sending a prospectus supplement to plan participants informing them of the changes (which, while part of the Form S-8 prospectus, do not need to be filed with the SEC). In addition, any increases in the number of shares available for issuance under an existing plan will need to be reflected in a new Form S-8 registration statement filed with the SEC. Finally, companies that have registered the sale of interests in stock purchase plans are required to file annual reports for such plans on Form 11-K, which are due 90 days after the end of the fiscal year of the plan or 180 days after the end of the fiscal year for plans subject to ERISA.

OUR GLOBAL REACH



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