Katten
KattenMuchinRosenman LLP

Corporate & Financial
Weekly Digest

October 27, 2017 Volume XII, Issue 41

SEC/CORPORATE

SEC Approves PCAOB Rule to Require Enhanced Audit Reports

On October 23, the Securities and Exchange Commission approved new audit reporting standard, AS 3101, proposed by the Public Company Accounting Oversight Board (PCAOB), which requires auditors to provide new information in public company audit reports, with the goal of making such reports more informative for investors and other financial statement users. The adoption of the PCAOB rule represents the first significant change to the auditor's report in several decades and will fundamentally change the auditors' report from a writing that consists entirely of boilerplate (in the vast majority of cases at least), into a document that contains disclosure specific to the particular filer, as discussed in more detail below. In a public statement on October 23, SEC Commissioner Kara Stein said she expects the PCAOB rule to result in auditor's reports that "provide investors with more meaningful information about the audit, including significant estimates and judgments, significant unusual transactions and other areas of risk at a company," which will "add to the total mix of information available to investors when making voting and capital allocation decisions."

Under the PCAOB rule, an auditor will be required to disclose in its audit report any critical audit matters (CAMs) arising from the current audit or affirmatively state that the auditor determined that there were no CAMs. A CAM is defined as any matter arising from the audit of financial statements that was (or was required to be) communicated to the audit committee that both (1) relate to accounts or disclosures that are material to the financial statements; and (2) involved especially challenging, subjective or complex auditor judgment (with specific factors to be considered when making that determination included in the PCAOB rule). With respect to each CAM, an auditor is required to include in the relevant audit report, among other things, the principal considerations that led the auditor to determine that the matter is a CAM and a description of how the CAM was addressed in the audit. The CAM-related provisions of the PCAOB rule will apply to audits of (1) financial statements of large accelerated filers for fiscal years ending on or after June 30, 2019; and (2) financial statements of any other company to which the PCAOB rule applies (which expressly excludes emerging growth companies, among others) for fiscal years ending on or after December 15, 2020.

Additionally, under the PCAOB rule, the auditor's report will be required to:

- include a statement disclosing the year in which the auditor began to consecutively serve as the company's auditor, as well as a statement regarding the requirement for the auditor to be independent;
- be addressed to the company's shareholders and board of directors (or equivalents);
- contain certain standardized language, including in the description of the auditor's responsibility under PCAOB standards with respect to obtaining reasonable assurance that the financial statements do not contain any material misstatement; and
- follow a standardized form, meaning that (1) the auditor's opinion will be required to appear in the first section of the auditor's report; and (2) the auditor's report must contain standardized section titles that help guide the reader.

These requirements will apply to audits of financial statements for fiscal years ending on or after December 15.

Some commenters expressed concern that the PCAOB rule's requirements could, among other things, result in frivolous litigation and antagonistic auditor-audit committee relationships. Although the SEC found, as required by the Sarbanes-Oxley Act of 2002, the PCAOB rule to be consistent with the requirements of the Sarbanes-Oxley

Act and necessary or appropriate in the public interest or for the protection of investors, SEC Chairman Jay Clayton reiterated in a public statement on October 23 that he was pleased the PCAOB intends to monitor the results of implementing the PCAOB rule, including consideration of any unintended consequences.

The full text of the adopting release is available here. The full text of the SEC Chairman's public statement is available here, and the full text of SEC Commissioner Stein's public statement is available here.

ISS Announces Results of Its 2017 Policy Application Survey

On October 19, proxy advisory firm Institutional Shareholder Services (ISS) announced the results of its Policy Application Survey (PAS). The PAS, which ran from August 3 through October 6, reflects 328 responses: 77 from institutional investors and organizations representing them, and 251 from members of the corporate community, including companies, consultants/advisors to companies, corporate directors and other trade organizations. These surveys often provide a good indication of potential changes to ISS's voting policies. It is expected that ISS will publish its draft 2018 policy updates and open its comment period in late October, and release its final policy updates in November.

Key takeaways from the PAS applicable to the United States include the following:

Outcomes-Based Compensation Measures

Noting the increased prevalence in performance-based compensation among pay programs, and the increasing use of "realized" or "realizable pay" in Compensation Discussion and Analysis disclosure to demonstrate a compensation program's emphasis on "pay-for-performance," PAS respondents were asked whether their organization supports the use of an outcomes-based measure, such as realizable pay, as part of the ISS *quantitative* pay-for-performance evaluation. Current ISS policy calculates and presents a standardized measure of "realizable pay" for CEOs of S&P 1500 companies as part of its *qualitative* analysis. Of the investor respondents, 87% supported the use of an outcome-based measure as part of ISS's quantitative screening, and of that 87%, two-thirds indicated realizable pay could be used to mitigate other pay concerns. For corporate respondents, 54% expressed support for the use of realizable pay in the *quantitative* pay-for performance screening, and of that 54%, 83% supported the use of realizable pay as a mitigating factor.

Non-Employee Director Pay

PAS respondents were asked which factors should be considered when determining whether a director pay program presents a governance concern with respect to high pay magnitude or problematic pay structures. The results of the PAS reflect that the majority of investor and corporate respondents believe that comparing a company's director pay practices against companies in the same index and Global Industry Classification Standard (GICS) (consistent with ISS's current approach) are the most effective factors to consider when evaluating director pay programs for governance concerns. In addition, respondents identified excessive perquisites, the use of performance awards and the use of stock option grants as the most significant factors in considering whether or not a problematic pay structure exists for directors.

Gender Pay Gap Reporting

ISS noted the increase in shareholder proposals asking for a report on gender pay equity and that, while a number of companies have disclosed or committed to disclose their gender pay gap, such disclosure has not been widely adopted across all sectors. PAS respondents were asked whether companies should disclose gender pay gap information. Of investor respondents, 60% supported such disclosure, while 67% of corporate respondents disagreed; however, a minority of each group noted that pay gap disclosure may not be necessary if the company provides detailed disclosure of diversity and inclusion policies or of equitable compensation practices.

Poison Pill Policy

PAS respondents were asked whether, consistent with ISS's current guidelines, their organizations would apply a case-by-case approach to initial adoptions of short-term (one-year or less) poison pills which have not been subject to a shareholder vote, when voting on director elections, using ISS's current criteria. In terms of investor

respondents, 83% supported the current ISS policy, while 56% of corporate respondents indicated that one-year poison pills are generally acceptable and votes against directors are not warranted.

A complete summary of the PAS results is available here.

BROKER-DEALER

FINRA Proposes to Make Permanent a TRACE-Reporting Exemption

On October 20, the Financial Industry Regulatory Authority (FINRA) proposed a rule change to make permanent an exemption from the Trade Reporting and Compliance Engine (TRACE) reporting requirements for TRACE-Eligible Securities transactions executed on a facility of the New York Stock Exchange (NYSE).

Currently, FINRA Rule 6730(e) offers a pilot program that exempts FINRA members from reporting transactions in TRACE-Eligible Securities to TRACE, provided such transactions are executed on a NYSE facility and reported to NYSE and disseminated publicly (subject to certain conditions). The pilot program is scheduled to expire on October 27, but FINRA's proposed amendment would make the exemption permanent. FINRA has filed the proposed rule change for immediate effectiveness.

The text of the proposed rule change is available here.

DERIVATIVES

See "CFTC Extends Swap Dealer De Minimis Threshold Until December 2019" in the CFTC section and "ESMA Agrees MiFID II Position Limits Proposed by FCA" in the EU Developments section.

CFTC

CFTC Extends Swap Dealer *De Minimis* Threshold Until December 2019

On October 26, the Commodity Futures Trading Commission issued an Order that maintains the swap dealer *de minimis* threshold at $8 billion until a new *de minimis* threshold phase-in termination date of December 31, 2019. Prior to the Order, the threshold was set to decrease to $3 billion on December 31, 2018.

The CFTC continues to consider additional amendments to the *de minimis* exception, which could be implemented in 2018.

The CFTC press release is available here.

EU DEVELOPMENTS

ESMA Agrees to MiFID II Position Limits Proposed by FCA

On October 24, the European Securities and Markets Authority (ESMA) published nine opinions on limits regarding commodity derivatives under the revised Markets in Financial Instruments Directive (MiFID II) and the Markets in Financial Instruments Regulation (MiFIR). The opinions follow the work plan agreed by ESMA and the national competent authorities of the European Union (NCAs), under which position limits will be published by the NCAs prior to ESMA publishing an opinion on such limits (for more information please see the September 29, 2017 edition of *Corporate & Financial Weekly Digest*).

The opinions agree with the position limits previously proposed by the FCA in August 2017, and concern contracts on:

- London cocoa;
- Robusta coffee;

- white sugar;
- aluminium;
- copper;
- lead;
- nickel;
- tin; and
- zinc.

ESMA found that the position limits proposed by the FCA are consistent with the objectives established in MiFID II and with the methodology developed for setting those limits.

ESMA also has published a list of liquid contracts that will receive a bespoke position limit, set by the relevant NCA.

The list is available here.

For additional coverage on financial and regulatory news, visit *Bridging the Week*, authored by Katten's Gary DeWaal.

For more information, contact:

SEC/CORPORATE

Name	Phone	Email
Mark J. Reyes	+1.312.902.5612	mark.reyes@kattenlaw.com
Mark D. Wood	+1.312.902.5493	mark.wood@kattenlaw.com

FINANCIAL SERVICES

Name	Phone	Email
Janet M. Angstadt	+1.312.902.5494	janet.angstadt@kattenlaw.com
Henry Bregstein	+1.212.940.6615	henry.bregstein@kattenlaw.com
Kimberly L. Broder	+1.212.940.6342	kimberly.broder@kattenlaw.com
Wendy E. Cohen	+1.212.940.3846	wendy.cohen@kattenlaw.com
Guy C. Dempsey Jr.	+1.212.940.8593	guy.dempsey@kattenlaw.com
Gary DeWaal	+1.212.940.6558	gary.dewaal@kattenlaw.com
Kevin M. Foley	+1.312.902.5372	kevin.foley@kattenlaw.com
Jack P. Governale	+1.212.940.8525	jack.governale@kattenlaw.com
Arthur W. Hahn	+1.312.902.5241	arthur.hahn@kattenlaw.com
Christian B. Hennion	+1.312.902.5521	christian.hennion@kattenlaw.com
Carolyn H. Jackson	+44.20.7776.7625	carolyn.jackson@kattenlaw.co.uk
Fred M. Santo	+1.212.940.8720	fred.santo@kattenlaw.com
Christopher T. Shannon	+1.312.902.5322	chris.shannon@kattenlaw.com
Robert Weiss	+1.212.940.8584	robert.weiss@kattenlaw.com
Lance A. Zinman	+1.312.902.5212	lance.zinman@kattenlaw.com
Krassimira Zourkova	+1.312.902.5334	krassimira.zourkova@kattenlaw.com

EU DEVELOPMENTS

Name	Phone	Email
Carolyn H. Jackson	+44.20.7776.7625	carolyn.jackson@kattenlaw.co.uk
Neil Robson	+44.20.7776.7666	neil.robson@kattenlaw.co.uk
Nathaniel Lalone	+44.20.7776.7629	nathaniel.lalone@kattenlaw.co.uk

* Click here to access the *Corporate & Financial Weekly Digest* archive.

Attorney advertising. Published as a source of information only. The material contained herein is not to be construed as legal advice or opinion. ©2017 Katten Muchin Rosenman LLP. All rights reserved.

www.kattenlaw.com

AUSTIN | CENTURY CITY | CHARLOTTE | CHICAGO | HOUSTON | IRVING | LONDON | LOS ANGELES | NEW YORK | ORANGE COUNTY | SAN FRANCISCO BAY AREA | SHANGHAI | WASHINGTON, DC

Katten refers to Katten Muchin Rosenman LLP and the affiliated partnership as explained at kattenlaw.com/disclaimer.