Securities Regulation and Compliance Alert

Skadden

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December 2014

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Checklist of Matters to Be Considered for the 2015 Annual Meeting and Reporting Season

As our clients and friends once again embark on preparations for their 2015 annual meeting and reporting season, we have compiled a checklist of the corporate governance, executive compensation and disclosure matters that we believe should be considered. Unlike in recent years, there are no new U.S. Securities and Exchange Commission (SEC) corporate governance, executive compensation or disclosure rules that will specifically impact the season. But there are a number of key areas of focus that we recommend companies consider and address.

The areas covered in our checklist will not apply equally to all companies. Whether a particular item applies and how a company should address it will depend on, among other things, the company's business, shareholder base, and executive compensation plans and programs. We urge companies to consult with internal and external advisers as early in the process as possible in order to make the most appropriate decisions with respect to their corporate governance and executive compensation programs and related disclosures.

☐ **Incorporate lessons from 2014 say-on-pay results.** Once again, shareholder votes on the disclosures regarding the compensation of executive officers fueled many of the most pressing issues companies grappled with last proxy season. There are lessons from the results of those votes and the approaches companies took to prepare for and respond to shareholder concerns that we believe should be considered in preparing for the 2015 proxy season. An analysis of the proxy advisory reports, the feedback received from shareholders and concerns raised by proxy advisory firms regarding compensation programs more broadly, also are factors to be considered when determining whether changes to executive compensation plans and programs, and/or the related disclosures regarding those plans and programs, should be made. Ultimately, any changes to executive compensation programs should be a function of the company's particular circumstances and the effect those changes would be expected to have on the company's ability to attract, retain and incentivize management. Our thoughts on these considerations are summarized below.

2014 voting results. The overall voting results are a good place to begin these considerations. In 2014, say-on-pay proposals have received the following approximate levels of support:

- 73 percent passed with over 90 percent support;
- 12 percent passed with between 80 and 89 percent support;
- 6 percent passed with between 70 and 79 percent support;
- 4 percent passed with between 60 and 69 percent support;
- 2 percent passed with between 50 and 59 percent support; and
- 3 percent (55 companies) obtained less than 50 percent support.

While the overall proportions are not substantially different than those in prior years, it should be noted that within these stabilized vote levels, individual companies have seen

shifts in support of up to 30 percent or more, typically driven by year-over-year changes in proxy advisory firm recommendations. Changes from an "against" recommendation to a "for" recommendation (and vice versa) are typically driven by the results of proxy advisory firm "pay for performance" calculations, which are in turn affected by both company performance (absolute and relative to peers) and company pay practices, as more fully described below.

Proxy advisory firm recommendations. As a next step, we recommend that companies analyze any reports issued by Institutional Shareholder Services (ISS), Glass Lewis or any other proxy advisory firms. These reports can help companies better understand the concerns of the advisory firms, and companies should consider whether identified concerns can and should be addressed. Similarly, companies should review their 2014 shareholder engagement efforts to assess shareholder feedback on executive compensation and other issues and whether to address any concerns raised by shareholders. Companies also should assess whether those outreach efforts were appropriate or should be expanded or enhanced. Enhancing previous shareholder outreach programs is particularly important when a company's 2014 say-on-pay proposal failed or passed without strong support. ISS, Glass Lewis and institutional investors expect that companies in these situations will focus on shareholder outreach efforts, respond to concerns raised and include a detailed description of those efforts in the next proxy statement.

It also may be helpful for companies to consider the areas that have driven proxy advisory firms to recommend a vote against say-on-pay proposals in 2014, including:

- a "pay for performance disconnect" (as calculated using the adviser's methodology);
- an emphasis on time-based equity award grants rather than performance-based grants;
- renewal of agreements containing excise tax gross-ups;
- termination and severance payments to an outgoing CEO, particularly in the case of a "friendly" termination (such as a termination characterized as a retirement, or where the individual remains on the board of directors);
- targeting compensation above the 50th percentile of peer group compensation;
- "make-whole" payments and grants to a new CEO in order to decrease the money "left on the table" by the individual in leaving his or her prior employer;
- bonuses that are not solely determined by a formula based on achievement of pre-specified performance criteria;
- lack of shareholder outreach to solicit views on the company's compensation programs, or outreach that is not adequately described in the proxy;
- new agreements or renewed agreements with "walkaway rights," in which the CEO can terminate employment for any reason during a specified period following a change in control and receive full severance;
- performance hurdles that are deemed to be insufficiently challenging, particularly where goals are lower than prior year results;
- guaranteed future equity grants, even if those grants will be subject to performance-based vesting;
- equity award grants made outside the regular grant cycle in order to make up for awards that are "out-of-the-money" due to stock price performance; and
- "mega" equity grants, even where such grants are explicitly stipulated as being intended to make up for prior years with no equity grants.

Additional soliciting materials. Some companies in the 2014 proxy season continued to attempt to rebut negative recommendations from advisory firms by issuing additional proxy soliciting materials. As in past years, these types of filings addressed issues such as perceived misunderstandings of company arrangements, concerns regarding proxy advisory firm peer group composition and arguments against the ISS position that stock options that vest on a time-based schedule are not performance-based compensation. However, presumably because it has become apparent to companies that these supplemental filings do not change vote recommendations and have only a minor effect (if any) on compensation-related vote results, these filings have become less common.

> "ISS has significantly restructured its approach to determining its voting recommendations on equity compensation plan proposals."

Equity plan proposals. Companies intending to present new, restated or amended equity compensation plans to shareholders for approval in the coming proxy season should consider ISS' new voting guidelines regarding these proposals. ISS has significantly restructured its approach to determining its voting recommendations on equity compensation plan proposals. Understanding the new rules will be critical to maximize the chances of a "for" recommendation from ISS.

Under its previous approach, ISS would recommend "against" an equity compensation plan proposal if the company failed any one of a series of pass/fail tests: whether the cost of the company's equity plans, taking into account the new plan, is reasonable, based on a proprietary ISS measurement of shareholder value transfer (SVT); whether the three-year burn rate exceeds an ISS-determined cap; whether the company has a pay-for-performance misalignment; and whether the plan contains certain problematic features (*e.g.*, permitting repricing).

The new policy (which ISS has named the Equity Plan Scorecard, or EPSC) represents a shift to a more holistic analysis based on the following factors, which will be weighted as follows for companies in the S&P 500 and Russell 3000:

Plan cost (45 percent). This factor measures SVT relative to peers (determined based on industry and market capitalization), calculated in two ways: first, based on new shares requested plus shares remaining for future grants; and second, based on new shares requested plus shares remaining for future grants, plus outstanding unvested/ unexercised grants.

Plan features (20 percent). This factor evaluates the following plan features: single trigger vesting on a change in control; discretionary vesting authority; liberal share recycling (*e.g.*, returning to the plan shares withheld to cover taxes); and minimum vesting periods for grants made under the plan.

Grant practices (35 percent). This factor focuses on three-year burn rate relative to peers; vesting requirements in the most recent CEO equity grants (based on a three-year lookback); estimated duration of the plan; the portion of the CEO's most recent equity grants subject to performance conditions; whether the company has a clawback policy; and whether the company has established post-exercise/vesting holding periods for the shares received.

Some key points to note are as follows:

- Unlike under the current series of pass/fail tests, under the EPSC approach, a low score in one area can be offset by a high score in another. As such, a plan with a cost that is somewhat higher than that of peer plans could potentially still receive a "For" recommendation if plan feature and grant practice considerations are higher. Conversely, a lower plan cost may not be sufficient to receive a "For" recommendation if the plan includes too many problematic provisions or if past grant practices raise concerns.
- Many of the grant practice measures are historical in nature, which may be problematic for companies introducing new equity plans for the very purpose of improving their compliance with current governance standards. It is unclear what weighting these historical practices will be given within the "Grant Practices" analysis.

- For a company with no clawback or shareholding period requirements, the adoption of such policies is a straightforward way to boost the EPSC score.
- ISS sells a service through its consulting arm under which it provides assistance in determining whether the SVT-based cost of a proposed plan is acceptable. It is widely anticipated that ISS will introduce consulting service offerings relating to the proposed EPSC system.

We expect that additional details regarding the Equity Plan Scorecard will be included in the ISS Frequently Asked Questions update. The update is expected to be published this month.

Other potential changes. If changes are not made in response to shareholder concerns, companies should consider including in their 2015 proxy materials a description of the concerns, as well as disclosure that the concerns were reviewed and considered and, if appropriate, an explanation of why changes were not made. More generally, we also recommend that companies consider whether their proxy materials could be revised to more effectively communicate the company's executive compensation plans and programs. In the last few years, many companies have incorporated useful features into the executive compensation disclosures in their proxy statements to achieve maximum clarity of the company's message. These features have included executive summaries, charts, graphs and other reader-friendly tools. A number of companies also have included a summary section in the proxy statement. These summaries generally are included in the beginning of the proxy statement and highlight key points about the disclosures, such as the date, time and location of the meeting, the agenda for the meeting, the nominees to the board (including summary biographical information for each nominee), business highlights and key compensation elements, features and decisions.

☐ **Confirm transition to new internal control integrated framework.** In 2013, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released a revised "Internal Control — Integrated Framework" that is effective as of December 15, 2014. The revised framework replaces COSO's 1992 version, which was widely adopted by SEC reporting companies as the "suitable, recognized control framework" required for management's evaluation of the company's internal controls. COSO has described the new framework as reflecting "considerations of many changes in the business and operating environments over the past several decades, including:

- expectations for governance oversight;
- globalization of markets and operations;
- changes and greater complexities of business;
- demands and complexities in laws, rules, regulations, and standards;
- expectations for competencies and accountabilities;
- use of, and reliance on, evolving technologies; and
- expectations relating to preventing and detecting fraud"[1]

The changes to the framework have generally been described by industry experts as enhancing and improving the components of the framework, but not as impacting its core tenets. Nevertheless, companies will need to determine whether changes should be made to their internal controls to address the changes. It is expected that most companies will conclude that some changes are necessary. The most time-intensive component of the

[1] Additional information about the 2013 framework is available on COSO's website at: http://www.coso.org/IC.htm.

transition to the new framework will most likely be the process used to document compliance with the new principles. Companies should confirm that the proper time, attention and staff resources are dedicated this process. Special attention should be paid to confirming that the company's external auditors have been consulted regarding the transition plans and have agreed to the chosen approach.

Companies that have transitioned to the new framework in 2014 will need to note that point in their internal control disclosures in the Form 10-K. Those disclosures will also need to include a description of any material changes in the company's internal controls as a result of the transition to the new framework. Companies that have not transitioned to the revised framework for periodic reports filed with the SEC after the December 15, 2014, transition date, will need to disclose that fact in their Forms 10-K. Those companies should also be prepared to respond to comments from the SEC staff about whether the 1992 framework remains suitable and recognized.

☐ **Prepare for shareholder proposals.** We recommend that companies consider a number of recent trends as they prepare for another season of shareholder proposals submitted for inclusion in company proxy materials. As in the past, we expect a substantial portion of shareholder proposals to focus on corporate governance, executive compensation and social and environmental matters. Some of those matters, as more fully described below, are more likely than others to receive significant shareholder support in the upcoming proxy season.

Corporate political activity — the subject of the largest number of shareholder proposals in 2014 and of a rulemaking petition that has attracted more than a million comments — is expected to remain high on the list of proposal topics in the upcoming proxy season. Most corporate political activity proposals have requested a report on the company's policies and procedures for either making political contributions or engaging in lobbying activities, including grassroots lobbying. Although these proposals generally receive less than 30 percent shareholder support, in 2014, four political activity resolutions obtained a majority of votes cast. Companies that could be the target of these proposals should consider adopting or revising standalone political and/or lobbying spending policies and amending appropriate board committee charters to designate responsibility for analyzing and determining which political and/or lobbying activities, if any, the company will engage in.

"We expect calls for independent board leadership to remain among the most popular shareholder proposal topics."

With non-independent chairs serving at 72 percent of the S&P 500 companies,[2] we expect calls for independent board leadership to remain among the most popular shareholder proposal topics in the upcoming proxy season. In 2014, independent chair proposals represented the greatest number of governance-related proposals. Overall, 63 of these proposals landed on the ballot in 2014, according to ISS, and while average support remained only slightly above 30 percent, four proposals received majority support. Further, ISS recently announced that beginning in 2015, it will generally recommend in favor of independent chair proposals, taking into consideration certain factors that include, among others, the current board leadership structure and the company's five-year performance relative to peers and the market as a whole. ISS also indicated that it will support proposals, absent a compelling rationale, where there is an executive or non-independent chair in addition to the CEO, or the chair and CEO roles have recently been recombined. Therefore, companies that have or are considering the appointment of a non-independent chair should consider the new factors outlined by ISS and determine whether governance changes should be made.

Since Exchange Act Rule 14a-8 was revised to make it easier to submit proxy access shareholder proposals, the number of those proposals to make it on the ballot has remained

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[2] Based on Spencer Stuart's 2014 Board Index, available at: https://www.spencerstuart.com/research-and-insight/spencer-stuart-us-board-index-2014.

relatively low (14, 11 and 17 proposals in 2014, 2013 and 2012, respectively). This year, the number is expected to be much higher, due in part to the Board Accountability Project (BAP) — a multi-year activist project led by the New York City Comptroller's Office.[3] The BAP is focused on companies with perceived risks related to climate change, board diversity and excessive CEO compensation and already is responsible for proxy access proposals delivered to 75 U.S. companies for their 2015 annual shareholder meetings. The BAP's form proposal requests a bylaw amendment that would permit shareholders owning 3 percent of company stock for three years to include their director nominees in company proxy materials. Proxy access proposals similar to the one submitted by the BAP — which tracks the thresholds of an SEC rule vacated in 2011 — have proven difficult to exclude under Rule 14a-8. Such formulation also has been the most successful, averaging nearly 55 percent support when voted on by shareholders. As a result, recipients of the BAP proposal may have to decide whether to let the proposal go to a vote or to offer their own form of proxy access.

Requests for declassified boards, a majority voting standard in director elections, and the reduction or elimination of supermajority voting requirements round out the list of major governance-related shareholder proposals to expect in 2015. These proposals continue to average well-above majority support and are expected to receive similar levels of approval this upcoming season. Companies that receive these proposals should be proactive in their response and should weigh the benefits and burdens of taking pre-emptive measures that might afford them flexibility in implementing governance changes.

☐ **Prepare for 2014 conflict minerals disclosure reporting.** Although the next set of conflict minerals disclosures to be made on Forms SD is not required to be filed with the SEC until June 1, 2015 — the Monday after the annual May 31 due date — companies should begin the process of preparing for the filing now. As 2013 was the first year covered by the conflict minerals reports, companies grappled with a number of difficult decisions when making the filings in 2014. Those decisions included the proper scope and level of due diligence to conduct and the disclosures to include in their conflict minerals reports. We recommend that companies revisit those decisions to determine whether their compliance programs need to be strengthened and the planned disclosures in their filings revised.

We also recommend that companies monitor developments related to the legal challenge to the SEC's conflict minerals disclosure rules. The D.C. Court of Appeals decided in November 2014 to reconsider its April 2014 decision that deemed the requirement for companies to label their products in the conflict mineral disclosures as not "DRC conflict free" unconstitutionally compelled speech in violation of the First Amendment. At the time of its decision, many people thought the SEC would stay compliance with the rules pending the resolution of the litigation. The SEC, however, only issued a partial stay, and the SEC's Division of Corporation Finance issued interim guidance that relieved companies from having to label their products as originally prescribed by the rules and, in some instances, having to obtain an independent private sector audit until the SEC or a court took further action. Most companies relied on this guidance when preparing their conflict mineral disclosures. It is possible that the D.C. Circuit could reverse its decision. If it does, companies may be required to label their products as originally required by the rules and to obtain an audit of their disclosures.

Finally, we recommend that companies be mindful of the guidance provided by the SEC staff regarding the 2013 conflict minerals reports. The SEC staff has not issued any written guidance regarding the reports, and the staff is not expected to issue comments to companies regarding the reports, but the staff has made certain limited public comments about

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[3] Additional information about the Board Accountability Project is available at: http://comptroller.nyc.gov/boardroom-accountability.

them. The staff has noted that it disagrees with the view that the description required in the conflict minerals report of the facilities used to process the necessary conflict minerals in a company's products did not require a list of the company's smelters. Many companies only provided a general description of the types of facilities used in the 2013 reports. It is our understanding that those companies believed that if smelters were required to be disclosed, the rules would have specifically included this requirement. Nevertheless, we recommend that companies reconsider the decision not to name their smelters. The staff has also noted that it believes certain companies used language in their conflict minerals reports to label their products and that this language could be viewed as a determination by the company that its products were conflict-free. The staff stated in public guidance that companies could only disclose that their products were conflict-free if an independent third-party audit of their conflict mineral disclosures was conducted. As a result, companies should be careful to consider the staff guidance in this area before filing their 2014 conflict minerals reports.

☐ **Assess potential impact from recent compensation-related litigation.** We recommend that companies continue to be mindful of potential compensation-related litigation and advise their board and committee members of the potential impact on the company's annual meeting schedule and proxy statement disclosures. In the past several years, there have been a number of lawsuits alleging breaches of fiduciary duties by management and directors in connection with allegedly inadequate disclosures in the annual meeting proxy statement regarding compensation-related proxy proposals. Those lawsuits generally attacked proposals involving say on pay and increases to the number of shares reserved under equity compensation plans. More recently, there has been a near-disappearance of investigations — generally the first step toward litigation by plaintiff lawyers — with respect to say-on-pay proposals, and a significant decrease in investigations with respect to equity plan proposals.

Unfortunately, plaintiff firms have begun to test the waters with claims regarding compensation determinations made by boards with respect to director compensation. The theory behind these claims is that directors who approve their own compensation are by definition "self-interested." As such, plaintiffs claim that a shareholder is entitled to bring a derivative action without making a pre-suit demand that the board of directors bring an action on behalf of the corporation. Further, they claim that the directors must prove their loyalty to the company based on the "entire fairness" standard of review (*i.e.*, they must prove that the decisions in question were entirely fair to the corporation), instead of the plaintiff having to overcome the strong presumptions of the business judgment rule, a hurdle that is extremely difficult for plaintiffs to meet. The allegations made to date in these lawsuits are that director compensation is excessive in the context of a company having little to no revenue, or that it is disproportionate in comparison with peer companies, in light of comparative revenues, income or stock price performance. We recommend that companies monitor developments in these cases and consider undertaking a peer company analysis when compensation decisions are made with respect to directors and consider including director-specific compensation limits in equity plans and compensation policies. Companies should also consider describing in the annual meeting proxy statement the process it undertook to set director compensation.

"We encourage companies to carefully monitor their equity grant practices and processes and to consult with … advisers in order to remain in compliance."

Lawsuits involving claims that companies had failed to meet the requirements of Section 162(m) of the Internal Revenue Code also continued to be filed. The claims in these lawsuits have been based on, among other things, award grants in excess of an equity plan's stated per-person limits or failure to obtain shareholder re-approval of performance goals every five years. In response to these claims, some companies have rescinded previously made equity grants and rescheduled the date of the annual meeting. Unfortunately, these Section 162(m) based claims will likely continue to be a risk, and we encourage companies to carefully monitor their equity grant practices and processes and to consult with internal and external advisers in order to remain in compliance with all relevant laws and the terms of the company's plans and arrangements.

☐ **Evaluate recommendations for improvements to audit committee communications.** We recommend that companies consider requests for improved disclosures regarding audit committee duties, composition and decisions. In late 2013, a group of corporate governance organizations, including the Center for Audit Quality, National Association of Corporate Directors and the Association of Audit Committee Members, issued a "Call to Action" that requested public company audit committees to "voluntarily and proactively improve their public disclosures to more effectively convey to investors and others the critical aspects of the important work that they currently perform."[4] The additional disclosures requested by this group, which they highlight have already been provided by "leading audit committees," included information about the scope of the audit committee duties, the composition of the audit committee and the factors considered by the audit committee when it:

- selects or reappoints an audit firm;
- selects the lead audit engagement partner;
- determines auditor compensation; and
- oversees and evaluates the performance of the external auditor.

The group believes that this more robust disclosure can improve communication with investors relating to audit committee responsibilities, increase investor confidence in audit committee oversight and provide helpful information for shareholders considering whether to ratify the selection of the external auditor. The United Brotherhood of Carpenters pension funds have also pushed for increased disclosure regarding audit committees and audit firms.

Although all of these requests for additional disclosures have not been uniformly or pervasively adopted, a report issued by Ernst & Young[5] in August 2014 notes that an increasing number of companies are including expanded nonrequired disclosures in their annual meeting proxy statements about their audit committees and audit committee practices. For example, in a review of 2014 proxy statements of Fortune 100 companies, EY noted that:

- 46 percent of the companies explicitly identified the selection of the external auditor as in the best interest of the company;
- 31 percent of the companies explained the rationale for appointing their auditors, including factors used in assessing the auditor's quality and qualifications;
- 80 percent of the companies noted that they consider non-audit services and fees when assessing the independence of the external auditor; and
- 50 percent of the companies disclosed auditor tenure.

Although no new disclosures regarding the audit committee or its functions have been proposed or are expected in the near term, the then-chief accountant of the SEC weighed in on this debate when in February 2014 he stated publicly that he encouraged audit committees to "think critically about disclosures to investors about the committee's work." The Investor Advisory Group of the Public Company Accounting Oversight Board (PCAOB) has also identified disclosure of the audit committee's operational effectiveness and role in financial reporting, as well as potential auditor evaluation of the objectivity of the audit committee, as areas that should be considered for potential rulemaking. More recently, SEC

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[4] A copy of the "Call to Action" is available at: http://www.thecaq.org/docs/audit-committees/enhancing-the-audit-committee-report-a-call-to-action.pdf?sfvrsn=2.

[5] A copy of EY's report is available at: http://www.ey.com/Publication/vwLUAssets/ey-lets-talk-governance-august-2014/$FILE/ey-lets-talk-governance-august-2014.pdf.

Chair Mary Jo White announced in October 2014 that the SEC plans to issue a concept release in early 2015 on ways to elevate the work of audit committees.

We encourage companies to evaluate these recommendations for improvements to audit committee communications and to discuss the possibility of expanding current proxy statement disclosures with their audit committee members.

☐ **Determine impact of SEC staff disclosure initiatives.** The staff of the Division of Corporation Finance continues to review and comment on periodic and transaction-related SEC disclosures. In 2014, the Division reviewed approximately 4,300 filings. The areas of concern for the staff in these filing reviews have general remained consistent. The staff has specifically focused on issues arising in connection with the identification and aggregation of operating segments, disclosure of known trends and uncertainties in the MD&A section, use of unusual non-GAAP (generally accepted accounting principles) measures or measures that are not reconciled to the equivalent GAAP measures, information about how disclosed performance metrics are calculated and tied to company performance and financial statement disclosure issues such as goodwill impairment, income taxes and contingencies. We recommend companies consider these areas of staff focus and take proactive steps to address these issues in their periodic filings.

In addition to its filing reviews and pending Dodd-Frank and JOBS Act rulemaking agenda, the Division staff is reviewing the requirements of Regulations S-K and S-X to identify ways to improve company disclosures. The initial set of recommendations from this "Disclosure Effectiveness Project"[6] are expected to focus on business and financial disclosure in periodic and current reports. Any changes that might result from the Division's recommendations are not likely to become effective until 2016 at the earliest. In the meanwhile, the SEC staff has encouraged companies to re-evaluate their disclosures to identify ways to make them more effective.[7] The staff has suggested that companies find ways to reduce disclosures that may be repeated in different sections of their reports, such as the disclosures regarding the company's significant accounting policies included in a footnote to the financial statements that are often repeated in the discussions of critical accounting estimates included in the MD&A section. The staff also noted that disclosures that are immaterial or outdated should be deleted, though those disclosures may have been included in earlier filings in response to a staff comment. We recommend companies consider whether any of their disclosures can be eliminated because they are outdated, immaterial or unnecessarily repeated.

Finally, we remind companies that in 2013, the SEC announced plans to reinvigorate its enforcement efforts with respect to accounting issues.[8] As expected, this renewed effort by the SEC staff has led to an increase in the number of accounting investigations and subsequent enforcement actions. SEC Chair White's "broken windows" enforcement strategy, a view that pursuing even the smallest infractions of the securities laws will reap important benefits, further supports the need for companies to be vigilant when considering and documenting accounting policies and judgments and making key disclosure decisions. An example of the SEC's current focus, are the actions the SEC brought against 10 companies in November 2014 for failure to file current reports on Form 8-K related to the execution of financing arrangements resulting in dilution to existing shareholders. The SEC also settled actions in September 2014 against 28 officers, directors and major shareholders for viola-

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[6] Additional information about the SEC's Disclosure Effectiveness Project is available at: http://www.sec.gov/spotlight/disclosure-effectiveness.shtml.

[7] Additional information about the SEC staff's views on ways companies can improve their disclosures is available at: http://www.sec.gov/News/Speech/Detail/Speech/1370541479332#.VHvcCNJOWyk.

[8] Additional information about the SEC's renewed scrutiny on accounting cases is available on our website at: http://www.skadden.com/insights/secs-renewed-scrutiny-accounting-cases-expected-focus-areas-and-how-companies-can-prepare.

"These actions are key reminders of the importance of companies maintaining and cultivating a strong culture of compliance."

tions related to Schedules 13D and 13G and Forms 3, 4 and 5 filings. These actions are key reminders of the importance of companies maintaining and cultivating a strong culture of compliance.

☐ **Assess requests for additional shareholder engagement efforts.** We recommend that companies assess certain recent requests for additional shareholder engagement and consider whether changes to current practices should be initiated. In particular, there have been requests for improvements to shareholder engagement with board members. In 2014, a task force formed by The Conference Board issued a set of guidelines for board-shareholder engagement that provided suggestions for ways to develop an effective engagement strategy that the task force believed should be "based on each company's and investor's objectives and resources and should be reviewed periodically as circumstances change." Another group that has highlighted this issue is the Shareholder-Director Exchange (SDX), an organization of independent directors and representatives from some of the largest and most influential long-term institutional investors, including BlackRock, State Street and Vanguard. SDX issued a 10-point protocol in 2014 that offers guidance to public company boards and shareholders on when director engagement is appropriate, and how to make these engagements valuable and effective.[9]

The SDX protocol recommends, among other things, that companies and investors:

- adopt a clear policy on how they will approach shareholder-director engagement;
- identify topics appropriate for shareholder-director engagement, such as board composition and leadership, executive succession and takeover defenses;
- establish a primary contact for receiving engagement requests; and
- determine how best to engage.

SDX has reported that it sent letters in July 2014 to the lead directors and corporate secretaries of all Russell 1,000 large-cap companies introducing them to the protocol and urging them to endorse it. More recently, Vanguard's CEO, R. William McNabb III, suggested in a speech on October 30, 2014, that boards consider creating standing shareholder relations committees to gather outside perspectives. Vanguard is expected to push this concept of a board "shareholder liaison committee" in 2015.

Although it is not clear what, if any, impact these requests for additional engagement activities will have on company efforts, we recommend that companies consider the recommendations and discuss the need for changes to engagement policies and procedures with the board committee responsible for corporate governance matters. Companies should also consider whether any disclosures should be made in the annual meeting proxy statement or on their websites to highlight any changes in response to these matters. It is our understanding that SDX is not expecting a specific response to the letters it sent to companies.

☐ **Consider recent trends in compensation recoupment policies.** We recommend that companies consider recent trends in support of the adoption of compensation recoupment policies, also commonly referred to as clawback policies, and whether the company should adopt a clawback policy or revise its existing policy. It has now been several years since the Dodd-Frank Act directed the SEC to require the national securities exchanges to adopt listing standards requiring companies to implement a clawback policy to recoup executive compensation in the event of a financial restatement. As more fully described below in the Dodd-Frank Act status item, it is unclear when the SEC will take action on the clawback rule.

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[9] A copy of SDX's protocol is available at: http://www.sdxprotocol.com/download-pdf.

In the meanwhile, ISS has been promoting clawback policies as a best governance practice and has been taking the existence of such policies into account when making voting recommendations on annual say-on-pay proposals. In addition, under ISS' new equity plan scorecard system (more fully described above in the say-on-pay results item), ISS will take into account the existence of a clawback policy when it reviews proposals with respect to new and amended equity plans. And as more fully described above in the shareholder proposals item, shareholder proposals on recoupment policies have become more popular.

Companies considering adopting a clawback policy or amending an existing policy should note that most current company clawback policies vary from the Dodd-Frank Act requirement in one or more key ways. For example, the policy may cover a group smaller than all executive officers, apply to only a subset of forms of incentive compensation, require affirmative misconduct on the part of the individual whose compensation is being affected, and/or permit broad discretion on the part of the board as to whether to seek recoupment of the amounts. A company policy with these variances will need to be revaluated when the SEC takes final action on its clawback rule. Finally, companies should be careful to consider the accounting implications of the terms of any clawback policy. Some accounting firms have stated that a clawback provision that gives the company discretion over equity compensation grants could require that such grants be accounted for using a variable — as opposed to fixed — method. The results of this difference in accounting treatment would subject the company to risks of changing compensation expenses.

We recommend that companies considering the adoption of a clawback policy or changes to an existing policy consult with both legal and accounting advisers as to the terms of the policy and as to any other recent developments in this continually developing area.

☐ **Consider recommendations to increase board diversity and limit board tenure.** We recommend that companies consider recommendations by certain market participants to increase the diversity of their board members and to limit the length of board member terms. The push to improve board diversity has most recently been led by institutional investors California Public Employees' Retirement System (CalPERS) and California State Teachers' Retirement System (CalSTSRS), and the advocacy organization Thirty Percent Coalition. Supporters of more diverse boards note the perceived benefits to shareholder value, and cite research to back their claims. For example, a recent analysis by Credit Suisse concluded that over a six-year period, companies with one or more women on the board delivered higher average returns on equity, better average growth and higher stock price or book value.

> **"The drive to improve diversity on corporate boards has included … shareholder proposals relating to companies' diversity policies."**

In September 2014, SEC Chair White gave a speech in which she stressed the importance of increasing the number of women in the boardroom and discussed academic studies and regulatory and investor-driven efforts in this area. While the primary focus in this area is on gender diversity, proponents also highlight the importance of diversity of age, ethnicity, culture, experience and education. ISS' policy is to recommend a vote against members of the nominating committee who have failed to establish gender and/or racial diversity on the board. The drive to improve diversity on corporate boards has included an increasing number of shareholder proposals relating to companies' diversity policies. Those proposals have not received strong support. ISS will, however, generally recommend a vote in favor of shareholder proposals that request that the company take steps to nominate more women and racial minorities to the board or that ask that a report on board diversity be issued annually.

A related issue that has drawn increased attention recently is director tenure. While academic studies are somewhat split as to the virtues of long-tenured directors, a 2013-14 survey by ISS revealed that 74 percent of institutional investors believe long director tenure to be problematic, in contrast to the 84 percent of companies that responded that the length

of a director's tenure should not be presumed to be problematic. ISS does not have a voting policy relating to director tenure, and indeed in 2014 generally advised against adopting shareholder proposals attempting to impose director term limits or mandatory retirement ages. But ISS is currently seeking comments relating to potential approaches to the director tenure question.

In addition to calls to sweep out longer-serving directors to make room for directors with fresh and diverse viewpoints, concerns have been raised about the potential effect of length of service on director independence. For example, ISS' Governance QuickScore, which uses specific governance factors and technical specifications to rate public company governance, notes ISS' view that a tenure of more than nine years is considered to potentially compromise a director's independence and that "ISS believes that a balanced board that is diverse in relevant viewpoints and experience is ideal." Similarly, the Council of Institutional Investors encourages boards to weigh whether "a seasoned director should no longer be considered independent."

Companies considering changes to policies to address the concerns in this area should be mindful of the potential related disclosure requirements. SEC rules require that companies state in their annual meeting proxy statements whether, and if so, how, a nominating committee considers diversity in identifying nominees for director. Those rules also require that companies disclose any policies that require the consideration of diversity in identifying director nominees and how the nominating committee (or the board) assesses the effectiveness of these policies. The term "diversity" for purposes of these SEC disclosure requirements has not been defined. The SEC explained when it adopted these requirements that it had chosen not to define diversity for purposes of the regulation, because "some companies may conceptualize diversity expansively to include differences of viewpoint, professional experience, education, skill and other individual qualities and attributes that contribute to board heterogeneity, while others may focus on diversity concepts such as race, gender and national origin."

☐ **Evaluate potential steps to address abusive litigation.** As a means of reducing litigation burdens, we believe that public companies should consider the adoption of an exclusive forum charter or bylaw provision requiring all stockholder derivative suits, fiduciary duty claims and other intra-corporate actions to be brought in the courts of the state in which the company is incorporated. Adoption of such a provision is motivated largely by the desire to reduce the burden and significant expense of multijurisdictional stockholder litigation, in which stockholder lawsuits are brought against the corporation and its board of directors in multiple jurisdictions on behalf of the same class of stockholders. In 2013, the Delaware Court of Chancery ruled that exclusive forum provisions in director-enacted bylaws are valid and enforceable under Delaware law. Since that ruling, exclusive forum provisions are becoming a common tool for Delaware companies to reduce the cost and risk of multijurisdictional stockholder litigation.

Some companies may also consider the adoption of a fee-shifting bylaw provision which would require all litigation expenses of the defendant corporation (and perhaps other defendants in their corporate capacities) to be paid by the plaintiff shareholders who sued unsuccessfully. Companies, however, should proceed with caution when considering adopting these fee-shifting provisions, as they have created a significant amount of controversy and may be prohibited for Delaware corporations if legislation pending in the Delaware legislature is approved.[10]

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[10] An overview of the considerations for evaluating the adoption of a fee-shifting bylaw is available on our website at: https://www.skadden.com/insights/fee-shifting-bylaws-current-state-play.

In evaluating whether to adopt a forum selection or fee-shifting provision, companies should consider the potential impact on the voting recommendations of proxy advisory firms if such provisions are adopted. Both ISS and Glass Lewis have expanded their voting policies to address bylaw provisions that impact shareholders' ability to bring lawsuits against companies. ISS will evaluate the unilateral board adoption of bylaw provisions that impact shareholders' ability to bring lawsuits against the company, including exclusive forum bylaws and fee-shifting bylaws, under a recently codified policy on board adoption of amendments that materially limit shareholder rights. Under this policy, following amendments of the company's charter or bylaws made without shareholder approval, ISS will recommend voting against or withholding from incumbent director nominees where ISS views such amendments as materially diminishing the rights of shareholders or otherwise adversely impacting shareholders. Glass Lewis may recommend voting against the chair of the governance committee or the entire governance committee if a board adopts an exclusive forum or fee-shifting provision without shareholder approval or against the chair of the governance committee if the board is seeking shareholder approval of a forum selection bylaw pursuant to a bundled bylaw amendment rather than as a separate proposal.

☐ **Plan for transition to new revenue recognition standard.** In May 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) adopted new standards applicable to revenue recognition from contracts with customers. These new, converged standards will apply to companies that report financial results based on either U.S. GAAP or International Financial Reporting Standards (IFRS), as approved by the IASB, and will replace current and various GAAP revenue recognition requirements for specific transactions and industries. As a result, most companies are expected to be impacted by the new standards.

Although the new standards will not apply to public companies until reporting periods beginning after December 15, 2016, companies should begin planning for the transition. A number of significant changes are expected to result from implementation of the new standards, including changes to the amount and timing of revenue recognized, the process used to document contracts with customers, the internal controls applicable to revenue recognition, and compensation arrangements based on revenue metrics. The new standards also include new, comprehensive disclosure requirements.

☐ **Comply with IRC Section 162(m).** Internal Revenue Code Section 162(m) generally limits a public company's deduction for compensation paid to its CEO and its next three most highly compensated officers (excluding the CFO) to $1 million each per year. However, performance-based compensation (PBC), which is compensation paid pursuant to a plan or other arrangement and is payable only upon the attainment of objective performance targets set in advance by a committee of two or more outside directors based on shareholder approved performance goals, is not subject to the $1 million deduction cap. There are a number of important documentary and procedural compliance requirements under Section 162(m) that companies should ensure have been satisfied.

Stock options and stock appreciation rights will constitute PBC without satisfying the otherwise applicable rules under Section 162(m) if:

- they are granted by outside directors (as that term is defined in the rule and explained more fully below) under a shareholder-approved plan that contains a limit on the number of awards that an individual can receive in any specified period, and
- the grants have an exercise price that is not less than the fair market value of the stock subject to the award on the grant date.

Reapproval of Section 162(m) plans. Importantly, the Section 162(m) regulations require that shareholders reapprove every five years the performance goals with respect to which PBC is paid. This means that companies that obtained shareholder approval of such goals in

2010 or earlier must resubmit their goals for shareholder approval in 2015. This five-year reapproval requirement does not apply to stock options and stock appreciation rights. However, many public companies grant performance-based equity awards, such as restricted stock or restricted stock units, under the same equity incentive plan adopted in 2010 or earlier and used for stock option and stock appreciation right grants. Unless a company's equity incentive plan's performance goals are reapproved in 2015, future performance-based equity awards granted under the plan will not qualify as PBC under Section 162(m). Likewise, performance goals applicable to cash bonus awards intended to qualify as PBC under Section 162(m) (which awards may be authorized under omnibus incentive plans or paid under separate plans) also must be reapproved every five years.

Section 162(m) compliant plans. Companies intending to compensate executives with cash bonuses or equity-based compensation other than options and stock appreciation rights should consider adopting plans designed to comply with the requirements of Section 162(m) and submitting them to shareholders for approval in 2015. If a company is submitting other equity incentive plan amendments to shareholders for approval in 2014, it should consider adding provisions sufficient to qualify other cash bonuses and equity compensation payable under the plans as PBC under Section 162(m).

Outside directors. Compensation qualifies as PBC only if it is awarded and administered by outside directors, generally defined as board members who are not employees or current or former officers and who do not receive remuneration other than director compensation from the company (directly or indirectly through entities of which such directors are employees or owners), unless it qualifies as "de minimis remuneration" under narrow and complex rules. Public companies should make certain at least annually that the directors administering their PBC plans continue to qualify as outside directors.

Grandfathered plans. Under certain circumstances, compensation plans that are effective before a company becomes publicly held are subject to special transition rules that defer compliance with Section 162(m) for between one and three years after the company becomes publicly held, depending on whether the company becomes public through an initial public offering, spin-off or otherwise. Adoption of material amendments to such grandfathered plans can shorten the transition period. Companies that went public in 2014 or earlier should check to see whether compliance is now required for 2015 and thereafter.

Litigation. As noted in the "Assess potential impact from recent compensation-related litigation" item above, companies also should be mindful of lawsuits that have been filed based on failures to meet the requirements of Section 162(m). We strongly encourage companies to monitor their equity award granting processes carefully and ensure that in-house and outside counsel are afforded an opportunity to review proposed executive compensation actions, particularly with respect to significant grants to executives and new hires.

☐ **Note the status of additional Dodd-Frank Act requirements.** As noted above, there are no new SEC corporate governance, executive compensation or disclosure rules that will impact the 2015 reporting season. We expected the SEC to make progress in 2014 on the corporate governance and disclosure provisions in the Dodd-Frank Act. In particular, action by the SEC on its proposed pay ratio — the ratio of compensation of the chief executive officer to the compensation of the median employee — disclosure rules was expected by the end of 2014. Alas, those rules, and the rules related to the disclosure of mandatory compensation clawback provisions and other compensation matters, such as pay-for-performance and the hedging activities of company employees and directors, are not expected to be in effect any earlier than the 2016 proxy season. Companies may want to advise their board committee members about the status of these potential new rules. We also recommend that companies continue to plan for compliance with these rules.

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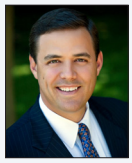

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2015 Compensation Committee Handbook

Our Executive Compensation and Benefits Group recently published its *Compensation Committee Handbook*, which is focused principally on companies traded on the NYSE and Nasdaq (though many of the matters discussed have broader application). The *Handbook* is intended to help compensation committee members understand and comply with the duties imposed upon them, and we believe it will also be a useful resource for compensation committee advisers. A copy of the *Handbook* is available on our website at: http://www.skadden.com/eimages/2015_Compensation_Committee_Handbook_111814b.pdf.

If you have any questions regarding the matters discussed in this memorandum, please contact one of the attorneys listed or your regular Skadden contact.

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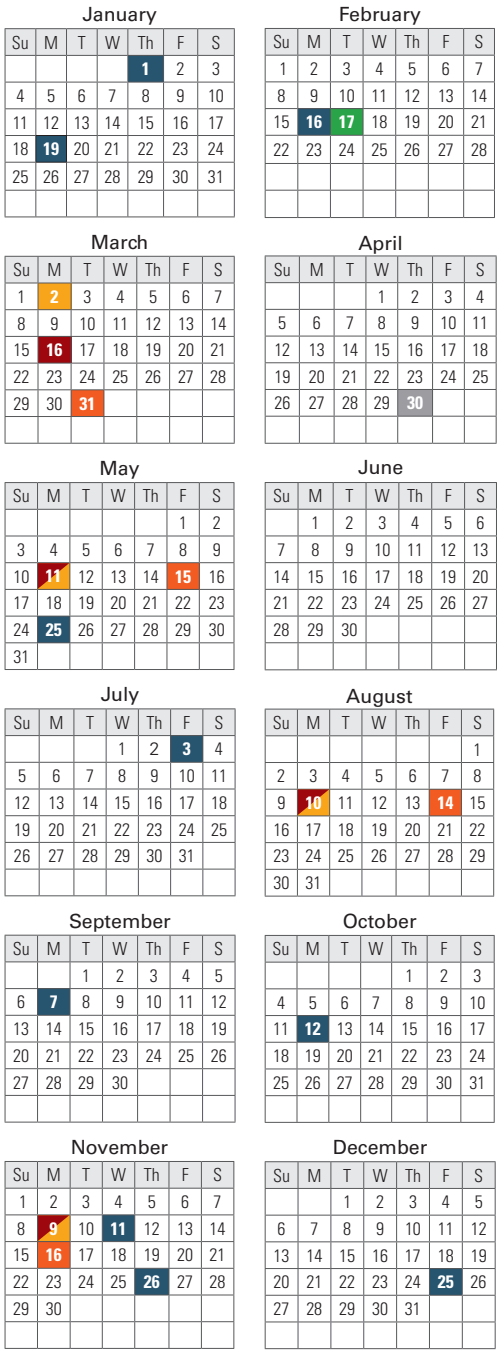

2015 SEC Filing Deadlines for Companies With December 31, 2014, Fiscal Year End

10-K for Year Ended December 31, 2014		
March 2	Large Accelerated Filers	60 days after fiscal year end*
March 16	Accelerated Filers	75 days after fiscal year end
March 31	Non-Accelerated Filers	90 days after fiscal year end
April 30	Definitive proxy statement (or information statement) if Part III of Form 10-K incorporates information from proxy by reference	120 days after fiscal year end
Form 20-F for Year Ended December 31, 2014		
April 30	Form 20-F (foreign private issuers)	4 months after fiscal year end
10-Q for Quarter Ended March 31, 2015		
May 11	Large Accelerated and Accelerated Filers	40 days after fiscal quarter end*
May 15	Non-Accelerated Filers	45 days after fiscal quarter end
10-Q for Quarter Ended June 30, 2015		
August 10	Large Accelerated and Accelerated Filers	40 days after fiscal quarter end*
August 14	Non-Accelerated Filers	45 days after fiscal quarter end
10-Q for Quarter Ended September 30, 2015		
November 9	Large Accelerated and Accelerated Filers	40 days after fiscal quarter end
November 16	Non-Accelerated Filers	45 days after fiscal quarter end*
Other Filing Deadlines		
Form 3	Within 10 days of becoming an officer, director or beneficial owner of more than 10% of a class of equity registered under the Exchange Act; however, if the issuer is registering equity for the first time, then by the effective date of the applicable registration statement.	
Form 4	2 business days after the transaction date.	
Form 5	45 days after fiscal year end (February 17).*	
Schedule 13G	45 days after calendar year end (February 17).*	
Schedule 13D	10 days after acquiring more than 5% beneficial ownership; amendments due promptly after material changes.	
Form 13F	45 days after calendar year end and after each of the first 3 quarter ends.	
Form 11-K	90 days after the plan's fiscal year end, provided that plans subject to ERISA may file the plan statements within 180 calendar days after the plan's fiscal year end.	
Form SD	June 1, 2015.*	

EDGAR filings may be made between 6:00 a.m. – 10:00 p.m. (ET) on weekdays (excluding holidays). Filings submitted after 5:30 p.m. receive the next business day's filing date (except Section 16 filings and Rule 462(b) registration statements, which receive the actual filing date).

* Reflects deadline in light of weekends and holidays. When the filing date falls on a weekend or holiday, the deadline is extended to the next business day. See Exchange Act Rule 0-3(a).