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Planning for the 2016 Annual Meeting and Reporting Season

Each company faces important decisions in preparing for its 2016 annual meeting and reporting season. We have prepared a checklist of essential areas we believe companies should focus on as they plan for 2016, including corporate governance, executive compensation and disclosure matters.

Checklist of Matters to Be Considered

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Incorporate Lessons From 2015 Say-On- Pay Votes and Compensation Disclosures

We recognize that companies should consider recent annual say-on-pay votes and disclosure best practices when designing their compensation programs and communicating about their compensation programs to shareholders. We have summarized a number of the key areas below that we believe companies should consider.

Results of 2015 Say-On-Pay Votes

Following are the approximate results of the 2015 say-on-pay votes:

- 77 percent passed with more than 90 percent support
- 15 percent passed with between 70.1 and 90 percent support
- 5 percent passed with between 50 and 70 percent support
- 3 percent (54 companies) obtained less than 50 percent support

Overall, these results reflect slightly higher levels of support than existed during the 2014 proxy season. Demonstrating how quickly moods can change from year to year, however, nearly three in four (74 percent) of the companies that received a failing say-on-pay vote in 2015 had received a passing vote in 2014. Negative recommendations from proxy advisory firms, particularly from Institutional Shareholder Services (ISS), made a significant impact on the outcome of those votes by lowering support by approximately 32 percent. Changes from an “against” recommendation to a “for” recommendation (and vice versa) often are driven by the results of proxy advisory firm “pay for performance” calculations, which are influenced by both share price performance (both absolute and relative to peer companies) and company pay practices.

Views of Proxy Advisory Firms

Areas that caused proxy advisory firms to recommend a vote against say-on-pay proposals in 2015 included:

- 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;
- retention bonuses and “mega” equity grants;
- performance goals deemed by proxy advisory firms to be insufficiently challenging, particularly where goals are lower than prior year results;
- 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;

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- guaranteed future equity grants, even if those grants will be subject to performance-based vesting; and
 - 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.

In addition, ISS, Glass Lewis and institutional investors expect companies to focus on shareholder outreach efforts, respond to compensation-related concerns raised by shareholders and include a detailed description of those efforts in the next proxy statement. Such efforts are particularly important when a company’s 2015 say-on-pay proposal failed or passed without strong support.

Enhanced Efforts to Explain Existing Compensation Programs

When companies have not changed their compensation plans or programs in response to major shareholder concerns, a best practice has included providing in the proxy materials a brief description of those concerns, as well as a statement that the concerns were reviewed and considered and, if appropriate, an explanation of why changes were not made. In addition, many

companies have incorporated useful features into their executive compensation disclosures, helping 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 added a summary section to the proxy statement, generally located at the beginning of the document, that highlights, among other things, business accomplishments and key compensation elements, features and decisions.

Use of Additional Soliciting Materials

Some companies in the 2015 proxy season continued attempts to rebut negative recommendations from advisory firms by issuing additional proxy soliciting materials. These types of filings generally address 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 vesting on a time-based schedule are not performance-based compensation. Despite the continued use of supplemental filings by some companies, their use has become less common, as they have generally been unsuccessful in reversing vote recommendations and have had minimal, if any, impact on compensation-related vote results.

Assess Impact of Changes to ISS' Equity Compensation Plan Voting Guidelines

Companies intending to present new, restated or amended equity compensation plans to shareholders for approval in the coming proxy season should consider ISS' voting guidelines regarding these proposals, which were significantly restructured for 2015. Understanding these restructured rules will be critical for maximizing the chances of a "for" recommendation from ISS on an equity plan proposal.

As a reminder, 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, was reasonable, based on a proprietary ISS measurement of shareholder value transfer (SVT); whether the three-year burn rate exceeded an ISS-determined cap; whether the company had a pay-for-performance misalignment; and whether the plan contained certain problematic features (*e.g.*, permitting repricing).

ISS' current policy, named the Equity Plan Scorecard, or EPSC, represents a shift to a more holistic analysis based on the following factors, which were weighted as follows in 2015 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.

Understanding the Equity Plan Scorecard

Companies should note the following about ISS' new analysis regarding equity compensation proposals:

- A low score in one area can be offset by a high score in another. For example, 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 score 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 share-holding 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.

Assess Impact of Changes to Proxy Voting Guidelines

Proxy advisory firms ISS and Glass Lewis recently updated their proxy voting guidelines for the 2016 proxy season. Companies should assess the potential impact of key changes, summarized below, when considering changes to corporate governance practices and documents, as well as proxy statement disclosures (which may serve as a basis for recommendations by ISS and/or Glass Lewis).

Director Overboarding

Both ISS and Glass Lewis updated their historical views on when they believe a director serves on too many public company boards. Starting in 2016, ISS will consider directors who are not CEOs to be “overboarded” if they sit on more than five public company boards, down from the current standard of six boards, and will note the same in its analysis. Likewise, Glass Lewis will do the same for directors who are not executive officers. Commencing in 2017, both ISS and Glass Lewis intend to recommend voting “against” directors who exceed these new limits. ISS has not changed its policy for a public company CEO, who would be “overboarded” if he or she sits on more than two “outside” boards.

During the 2016 proxy season, Glass Lewis intends to “closely review director board commitments and may note as a concern instances of directors” exceeding its new lower limits:

- directors who serve on more than five public company boards, a decrease from the current limit of six; and
- directors who are executive officers and serve on more than one other public company board, a decrease from the current limit of two.

Unilateral Board Amendments to Bylaws or Charter

Unless the board reverses an adverse, unilateral amendment or submits it to a binding shareholder vote, ISS will recommend “against” directors who have unilaterally amended the bylaws or charter to (a) classify the board, (b) require a supermajority vote to amend the bylaws or charter, or (c) eliminate shareholders’ ability to amend the bylaws. In subsequent years, unless the board reverses the adverse provision or submits it to a binding shareholder vote, ISS will assess director nominees on a case-by-case basis.

ISS also clarified its views by providing a separate approach for newly public companies where the pre-initial public offering board took such unilateral actions in connection with the IPO. In such cases, ISS will evaluate whether to provide an adverse recommendation at the annual meeting following an IPO based on the following factors:

- the company’s or the board’s rationale for adopting the provision;
- the impact on the ability to change the governance structure in the future, such as limitations on shareholder rights or supermajority vote requirements to amend the bylaws or charter;
- the existence of a classified board structure versus the shareholders’ ability to hold directors accountable through annual director elections; and
- a public commitment to put the provision to a shareholder vote within three years of the date of the IPO.

Unless the board reverses the adverse provision or submits it to a vote by public shareholders, ISS will also assess director nominees on a case-by-case basis in subsequent years.

Exclusive Forum Provisions

Glass Lewis will no longer recommend a vote against the chairperson of the nominating and corporate governance committee where an exclusive forum bylaw is adopted in connection with an IPO. For such companies, Glass Lewis will weigh the forum bylaw against other provisions that limit shareholder rights, such as supermajority vote requirements, classified boards and fee-shifting bylaws. Presumably, if Glass Lewis finds the entirety of the provisions to be unduly restrictive of shareholder rights, it will recommend a vote against the chairperson of the nominating and corporate governance committee. Glass Lewis intends to continue to recommend voting against the nominating and corporate governance committee chairperson when an exclusive forum bylaw is adopted without shareholder approval outside of a spin-off, merger or IPO. For its part, ISS will recommend a vote against the board if it unilaterally adopts a bylaw amendment that “materially diminishes shareholder rights.” ISS generally takes the view, however, that provisions establishing the state of incorporation as the exclusive forum are not materially adverse to shareholders.

Keeping Up With Ongoing Changes

Companies should continue to monitor for additional guidance from ISS and Glass Lewis to assess the impact during the 2016 proxy season, as well as any transition leading up to the 2017 proxy season.

Plan for Proxy Access Proposals and Nominees

The signature corporate governance issue of the 2015 proxy season was far and away the proxy access shareholder proposals submitted to companies by certain investors. The Office of the New York City Comptroller, in its capacity as trustee of various pension funds, launched its “Boardroom Accountability Project” by submitting proxy access proposals to 75 companies. Combined with proposals from other institutional investors, as well as from individual investors, over 100 proxy access proposals were submitted to a vote for 2015 annual shareholder meetings. The vast majority of the proposals submitted for shareholder approval conformed to the “3-3-25” model — granting holders of 3 percent of a company’s shares for three years access to the company’s proxy statement for nominees for up to 25 percent of the board. Approximately 60 percent of these proposals received majority shareholder approval.

Companies should consider the potential impact these proxy access initiatives may have in 2016 and plan accordingly. Companies that have not adopted a proxy access bylaw should consider whether to act in advance of possibly receiving a proxy access shareholder proposal for the 2016 season. Any determination in this regard should include an analysis of the voting patterns and preferences of the company’s shareholder base and the corporate governance profile of the company, as well as any particular concerns about the board nominee process shared with the company by its shareholders. Of course, if a company’s shareholders voted on a proxy access proposal in the past, the results of that vote are a key factor in deciding how to proceed. If a majority of shareholders approved a proxy access proposal, there is a very high risk of negative vote recommendations against board members by the proxy advisory firms for a failure to respond to the shareholder vote. Companies should also consider any additional guidance that ISS provides in its forthcoming “FAQ” document — expected to be released in December 2015 — that is anticipated to describe proxy access bylaw provisions that ISS considers overly restrictive.

Educating Board Governance Committee Members

Regardless of whether a company chooses to act in advance of receiving a proxy access proposal, we recommend that the board governance committee members be apprised of developments in this area and the key features to be considered when adopting proxy access bylaws, so they are informed in determining the proper action in response to a shareholder proposal submission or otherwise.

Excluding Shareholder Proposals Under Rule 14a-8(i)(9)

Companies that choose not to act in advance of possibly receiving a proxy access shareholder proposal for the 2016 season should note that the staff of the SEC’s Division of Corporation Finance (the Staff) has established a new, heightened standard for excluding a shareholder proposal under Exchange Act Rule 14a-8(i)(9), which permits a company to exclude a proposal if “the proposal directly conflicts with one of the company’s own proposals to be submitted to shareholders at the same meeting.”¹ Under the new standard, a “direct conflict” exists between a shareholder proposal and 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.” For example, where a company does not allow proxy access, a proposal that would permit a shareholder holding at least 3 percent of

¹ SEC Staff of Division of Corporation Finance, Staff Legal Bulletin No. 14H (Oct. 22, 2015).

the company's outstanding stock for at least three years to nominate up to 20 percent of the directors would not directly conflict with a management proposal that would allow shareholders holding at least 5 percent of the company's stock for at least five years to nominate for inclusion in the company's proxy statement for 10 percent of the directors.

Under those facts, according to the Staff's guidance, the shareholder proposal would not be excludable under Rule 14a-8(i)(9) because both proposals share the "similar objective" of allowing proxy access. As a result, companies seeking to exclude a shareholder proposal under Rule 14a-8(i)(9) may need to demonstrate to the Staff that a shareholder proposal and a management proposal do not seek a "similar objective" and that they cannot both be implemented if approved. For companies that do not currently provide proxy access, the new guidance appears to foreclose the possibility of excluding a shareholder proposal on proxy access under Rule 14a-8(i)(9) based on the argument that the ownership thresholds in management's proposal differ from those in the shareholder proposal.

Director Nominee Submissions

Finally, companies that have adopted a proxy access bylaw should prepare for possible director nominee submissions.

First, it appears that those companies may be required, pursuant to Item 5.08 of Form 8-K, to disclose the date by which a nominating shareholder or nominating shareholder group must submit the notice on Schedule 14N — generally no later than 120 calendar days before the anniversary of the date that the company mailed its proxy materials for the prior year's annual meeting. The instructions to Form 8-K state that the Item 5.08 filing must be made within four business days after the company determines the anticipated meeting date. Presumably, however, companies should be able to satisfy this requirement by disclosing the deadline in the company's proxy materials. The Staff, however, has not confirmed this view publicly.

Companies also should consider how they intend to evaluate whether proxy access eligibility terms have been satisfied and, if they are not satisfied, how they expect to handle those nominations. Most of the proxy access bylaws that have been adopted by companies to date include a number of key eligibility terms. In addition to the "3-3-25" requirements, shareholders intending to rely on the proxy access provisions often need to satisfy other requirements, such as meeting specific deadlines (including filing a Schedule 14N, as required by Exchange Act Rule 14a-18, by the date noted above) and making certain representations (including that they acquired the shares in the ordinary course and have no intent to change or influence control).

Consider Shareholder Proposal Trends and Developments

This year, once again, companies will need to consider current trends and recent Staff guidance as they prepare for shareholder proposals submitted for inclusion in company proxy materials.

Most Common Shareholder Proposal Topics and Trends

In addition to proxy access proposals, we expect calls for independent board leadership and increased transparency of corporate political activity to remain among the most popular shareholder proposal topics in the upcoming proxy season. Collectively, those three topics were the subject of over 200 proposals appearing on company ballots in 2015, according to ISS.

- **Independent Chair Proposals.** Independent chair proposals remained a perennial favorite last year, falling second only to proxy access proposals. While average support for such proposals dropped slightly in 2015 to just below 30 percent, two proposals received majority support, according to ISS. Companies that have or are considering the appointment of a non-independent chair should consider the factors outlined by ISS late last year, which generally favored independent chair proposals, and determine whether governance changes should be made. Companies also should take note that ISS will support such 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.
- **Corporate Political Activity Proposals.** Corporate political activity proposals tend to request a report on a company's policies and procedures for either making political contributions or engaging in lobbying activities, including grassroots lobbying. Some proposals focus on other areas, however, including perceived inconsistencies between a company's stated policies and its actual political and/or lobbying activities. Overall, corporate political activity proposals have continued to receive less than 30 percent shareholder support in 2015, with no proposals receiving majority support (down from two proposals in 2014), according to ISS. Nonetheless, companies that could be the target of such proposals may consider adopting or revising standalone political and/or lobbying spending policies used for determining which political and/or lobbying activities, if any, the company will engage in.
- **Environmental and Social Proposals.** More generally, proposals concerning environmental and social issues exceeded the number of governance and compensation-related proposals in 2015. According to ISS, approximately 474 environmental and social resolutions were submitted to companies in 2015, compared to approximately 453 governance proposals and 126 compensation-related proposals over the same period. Despite the high number of environmental and social proposals submitted last year, average support for those proposals continued to hover around 20 percent, with only one proposal, which requested a sustainability report, garnering majority support in 2015. While some environmental and social proposals can be challenging to exclude under Rule 14a-8, companies should consider engaging with willing proponents to determine whether a negotiated withdrawal is possible. According to ISS, more than 40 percent of the environmental and social proposals submitted to companies last year were amicably withdrawn.

New Guidance Issued in Staff Legal Bulletin No. 14H

As noted above, in October 2015 the Staff published Staff Legal Bulletin No. 14H (SLB 14H), which provides important guidance for companies that may receive shareholder proposals during the upcoming proxy season.

- **Reaffirmed Application of Rule 14a-8(i)(7).** SLB 14H reaffirmed the Staff's historical approach for determining whether a shareholder proposal could be omitted under the Rule 14a-8(i)(7) ordinary business exclusion. In particular, the Staff noted that the two-part test of the Third Circuit Court of Appeals majority opinion in *Trinity Wall Street v. Wal-Mart Stores, Inc.*² differs from the SEC's statements on the ordinary business exclusion and its historical practice. The Third Circuit majority opinion established a new two-part test for determining whether the significant policy exception to the ordinary business exclusion applied, concluding that the shareholder proposal submitted to Wal-Mart was excludable under Rule 14a-8(i)(7) because it related to the company's decisions on which products to sell. The court concluded that "a shareholder must do more than focus its proposal on a significant policy issue; the subject matter of its proposal must 'transcend' the company's ordinary business" and found that to transcend a company's ordinary business, the significant policy issue must be "divorced from how a company approaches the nitty-gritty of its core business." This new test represented a departure from the Staff's historical approach to analyzing proposals under the ordinary business exclusion.

In response, the Staff reiterated the SEC's view that proposals focusing on a significant policy issue are not excludable under the ordinary business exclusion "because the proposals would transcend the day-to-day business matters and raise policy issues so significant that it would be appropriate for a shareholder vote." In the Staff's view, a proposal may transcend a company's ordinary business operations even if the significant policy issue relates to the "nitty-gritty of its core business," which the Third Circuit has said would not be the case. Therefore, proposals that focus on a significant policy issue transcend a company's ordinary business operations and are not excludable under Rule 14a-8(i)(7). The Staff stated that it will apply Rule 14a-8(i)(7) in this manner when considering Rule 14a-8(i)(7) no-action requests. In light of SLB 14H, companies should not expect any change in the Staff's no-action positions on Rule 14a-8(i)(7) as a result of the Trinity decision.

- **Revised Application of Rule 14a-8(i)(9).** As described in the section above on proxy access proposals and nominees, SLB 14H also provides new guidance regarding the application of Rule 14a-8(i)(9). This new guidance will impact non-proxy access proposals including those relating to executive compensation. Thus, companies may need to rethink whether their submission of a proposal that shares the same subject as, but different terms than, a shareholder proposal matter could result in the exclusion of the shareholder proposal under Rule 14a-8(i)(9). Presumably, the new Staff guidance will eliminate the ability of companies to exclude many of those proposals unless companies can satisfy the heightened standard that "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."

²792 F.3d 323 (3d Cir. 2015).

Evaluate Requests for Improvements to Audit Committee Practice and Disclosures

We recommend that companies consider requests for improved disclosures regarding audit committee duties, composition and decisions in light of the SEC's and corporate governance groups' continued focus on the need for such disclosures.

Potential Changes to SEC Disclosure Requirements

On July 1, 2015, the SEC issued a concept release soliciting public comment on possible revisions to its existing disclosure requirements related to audit committees. The release focuses on an audit committee's reporting of its responsibilities with respect to oversight of independent auditors. The concept release focuses on potential changes to required disclosures in the following four areas:

- the audit committee's oversight of the auditor;
- the audit committee's process for appointing or retaining the auditor;
- the qualifications of the audit firm and certain members of the engagement team selected by the audit committee; and
- the location of audit committee disclosures in SEC filings.

In each of these areas, the SEC asks very specific questions about the current requirements and potential changes and whether and why any such changes may be useful to investors. Those questions include:

- Would disclosure of the name of the engagement partner be useful to investors?
- Should the audit committee's report include information about the length of the audit relationship?
- Should there be disclosures regarding the nature or substance of the required communications between the auditor and the audit committee?
- What types of disclosures could be made regarding the process the audit committee undertook to evaluate the external audit and performance and qualifications of the auditor, including the rationale for selecting or retaining the auditor?³

Examining "Leading Audit Committees" Disclosures

The SEC's publication of the audit committee concept release follows requests from a number of groups for improvements in disclosures in this area. For example, in late 2013, a group of corporate governance organizations, including the Center for Audit Quality, the 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." 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.

³A copy of the "Call to Action" is available at <http://www.thecaq.org/reports-and-publications/enhancing-the-audit-committee-report-a-call-to-action>.

Voluntary Disclosure by Companies Increases

Perhaps in response to these requests, an increasing number of companies are including expanded voluntary disclosures in their annual meeting proxy statements about their audit committees and audit committee practices. According to a November 2015 report from the Center for Audit Quality and Audit Analytics, growing numbers of audit committees are responding to evolving market needs by providing more meaningful information around the audit committee's role in overseeing the external auditor.⁴ For example, according to the report:

- 54 percent of S&P 500 companies included disclosures about the length of time that the audit firm was engaged;
- 31 percent of S&P 500 companies included statements that the audit committee is involved in the selection of the audit engagement partner;
- 26 percent of S&P 500 companies disclosed that the audit engagement partner rotates every five years;
- 25 percent of S&P 500 companies included enhanced discussions of the audit committee's considerations in appointing an audit firm;
- 24 percent of S&P 500 companies provided more detailed discussions of the criteria used by the audit committee in evaluating the audit firm; and
- 16 percent of S&P 500 companies disclosed that the audit committee is responsible for the audit firm's compensation.

These results are generally consistent with the findings of a September 2015 report by Ernst & Young, which reviewed proxy statements filed by *Fortune* 100 companies from 2012 to 2015. It noted that *Fortune* 100 companies have significantly increased the information available about how they appoint, compensate and oversee their external auditors during this period.⁵

- 71 percent of companies specified that the audit committee is responsible for the appointment, compensation and oversight of the auditor, compared to 41 percent in 2012.
- 61 percent of companies disclosed that the audit committee was involved in the selection of the audit firm's lead engagement partner (in comparison, no companies did this in 2012).
- 80 percent of companies noted that they consider non-audit services and fees when assessing the independence of the external auditor, compared to 11 percent in 2012.
- 21 percent of companies disclosed that the audit committee was responsible for the auditor's fee negotiations. In 2012, none of the companies provided this disclosure.

Discussing Improvements to Audit Committee Communications

Given the continued interest in audit committee disclosures and the SEC's recent focus on this topic, we encourage companies to consider possible improvements to audit committee communications and to discuss the possibility of expanding current proxy statement disclosures with their audit committee members.

⁴A copy of the "2015 Audit Committee Transparency Barometer" is available at <http://www.thecaq.org/docs/default-source/reports-and-publications/2015-audit-committee-transparency-barometer.pdf?sfvrsn=2>.

⁵A copy of Ernst & Young's report is available at [http://www.ey.com/Publication/vwLUAssets/EY-audit-committee-reporting-to-shareholders-in-2015/\\$FILE/EY-audit-committee-reporting-to-shareholders-in-2015.pdf](http://www.ey.com/Publication/vwLUAssets/EY-audit-committee-reporting-to-shareholders-in-2015/$FILE/EY-audit-committee-reporting-to-shareholders-in-2015.pdf).

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.

Board Determinations Regarding Director Compensation

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 include claims 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.

What Companies Should Consider

- Including director-specific compensation limits in equity plans and compensation policies while continuing to monitor developments in these cases.
- Undertaking a peer company analysis with respect to compensation of directors.
- Describing in the annual meeting proxy statement the process it undertook to set director compensation.

Meeting Section 162(m) Requirements

Plaintiff firms also continue to file lawsuits involving claims that companies had failed to meet the requirements of Section 162(m) of the Internal Revenue Code (IRC). The claims in these lawsuits have been based on, among other things, awards in excess of an equity plan's stated per-person limits or failure to obtain shareholder reapproval of performance goals every five years as is required by Section 162(m). In response to these claims, some companies have been forced to rescind previously made equity grants and reschedule the date of the annual meeting. Unfortunately, these Section 162(m)-based claims will likely continue to be a risk.

What Companies Should Consider

- Carefully monitoring equity grant practices and processes.
- Consulting 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.

Review Forward- Looking Disclaimer Disclosures and Practice

A recent D.C. Circuit Court of Appeals opinion serves as an important reminder to review disclosures so that forward-looking statements are “accompanied by *meaningful* cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement,” as required by the “safe harbor” of the Private Securities Litigation Reform Act of 1995 (PSLRA). Relying on reasoning from the Third and Fifth Circuits, the D.C. Circuit held that a cautionary statement is “meaningful” only if it is “tailored to the forward-looking statement that it accompanies.”

The PSLRA safe harbor is an effective way for defendants to win dismissal of shareholder claims early in securities litigation, such as claims based on disclosures regarding a company’s financial condition. In *In re Harman International Industries Inc. Securities Litigation* (June 23, 2015)⁶, the D.C. Circuit reversed the district court’s dismissal and held that the “safe harbor” was not available because the cautionary language was misleading and not tailored to the specific forward-looking statements the company made.

In particular, the court cited the use of general disclaimers during analyst calls. For example, the moderator warned that “certain statements made by the Company during this call are forward-looking statements ... includ[ing] the Company’s beliefs and expectations as to future events and trends affecting the Company’s business[,] and are subject to risks and uncertainties.” The call participants also were advised to review the company’s SEC filings “regarding these risks and uncertainties.”

The court held that such “cautionary statements” were not tailored to the forward-looking statements made by the company because they were “misleading in light of historical facts” and did not address certain unique risks to the company that could cause actual results to differ from the forward-looking statements. Thus, the forward-looking statements were not entitled to safe harbor protection.

Meeting PSLRA ‘Safe Harbor’ Requirements

Given the fact-intensive nature of the safe harbor when subject to court interpretation, companies should avoid boilerplate language and continue to review their disclaimers to ensure they are meaningful and address specific risks, which may require a more frequent than quarterly update.

⁶See opinion at [https://www.cadc.uscourts.gov/internet/opinions.nsf/1B7208ADC298E6C985257E6D00539C76/\\$file/14-7017-1559106.pdf](https://www.cadc.uscourts.gov/internet/opinions.nsf/1B7208ADC298E6C985257E6D00539C76/$file/14-7017-1559106.pdf).

Determine Impact of SEC Staff Disclosure Initiatives

The Staff continues to review and comment on SEC disclosures in periodic reports and transactional filings. In 2015, the Staff reviewed over half of reporting companies pursuant to the Sarbanes-Oxley mandate and registration statements of over 600 IPOs. The areas of concern for the Staff in these filing reviews have remained generally consistent. The Staff continues to focus on issues arising in connection with the identification and aggregation of operating segments; disclosure of known trends and uncertainties in the MD&A; revenue recognition; use of unusual non-GAAP measures or measures that are not reconciled to the equivalent GAAP measures; information about how disclosed performance metrics are calculated (compared to industry practice) and tied to company performance; and financial statement disclosure issues such as goodwill impairment and income taxes. We recommend companies consider these areas of Staff focus and take proactive steps to address these issues in their periodic filings.

In addition, the Staff is continuing its review of the requirements of Regulations S-K and S-X as part of its “disclosure effectiveness” project to identify ways to improve company disclosures. In September 2015, the SEC issued the first product from this effort in the form of a request for public comment on the need for possible changes to Regulation S-X. The release focuses on the form and financial disclosures that companies must file with the SEC about acquired businesses, affiliated entities, guarantors, and issuers of guaranteed securities. Questions for which the SEC is soliciting public input include:

- recommendations for improving the usefulness of pro forma financial information provided in a significant acquisition of another business;
- the need for changing the current significance tests that trigger the financial disclosure requirements of Rule 3-05 of Regulation S-X for acquired businesses; and
- whether investors need different or additional information about guarantors and issuers of guaranteed securities.

The input on these questions will be a significant factor in determining whether the SEC will propose changes to Regulation S-X. The Staff also is expected to complete its review of the business and financial information requirements for annual and quarterly reports in the near future, with an emphasis on any duplication between Regulation S-K and GAAP, the elimination of outmoded disclosure requirements, and the consideration of principles-based disclosure requirements.

Making Disclosures More Effective

The Staff has continued to encourage companies to re-evaluate their disclosures to identify ways to make them more effective. 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, even 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 as a result of being outdated or immaterial or involving unnecessary repetition.

Prepare for 2016 Conflict Minerals Reporting

In 2014, the D.C. Circuit Court of Appeals ruled that the SEC's conflict minerals rules violated the First Amendment to the extent those rules required companies to state whether certain minerals contained in their products finance or benefit armed groups in the Democratic Republic of the Congo or any of its adjoining countries. Shortly following the court's ruling, Division of Corporation Finance Director Keith Higgins released written guidance indicating that companies would not be required to describe their products as "DRC conflict free," having "not been found to be 'DRC conflict free'" or "DRC conflict undeterminable," as those terms are defined in the rules. Director Higgins also indicated that, pending further action, only companies that voluntarily described one or more of their products as "DRC conflict free" — meaning that the conflict minerals contained in such products have not directly or indirectly benefited or financed armed groups in the DRC region — would be obligated to obtain an independent private sector audit (IPSA) as originally required by the rules.

More recently, the D.C. Circuit denied a petition by the SEC for an *en banc* rehearing. The SEC now has until early February 2016 to seek review by the U.S. Supreme Court. If the SEC declines to seek review, or its petition for review is denied, the case will be remanded to the district court for further proceedings. Thus, it is unlikely that the litigation will be resolved by the time the next round of conflict minerals disclosures become due on May 31, 2016. In light of these subsequent developments, Director Higgins has confirmed that his prior guidance regarding product descriptions and the IPSA requirement continues to apply.

What Companies Should Consider

Companies should continue their good faith efforts to identify the conflict minerals contained in their products, as well as the source of those minerals, and be prepared to provide appropriate disclosures, including a show of progress from their prior efforts.

Ensure Disclosure of Proper Shareholder Voting Standards

We recommend that companies review their existing disclosures in the proxy statements regarding the voting standards for electing directors and consider the need for enhancements to this disclosure to avoid any shareholder confusion. Certain investor groups, such as the Council of Institutional Investors (CII), have recently submitted rulemaking petitions to the SEC regarding the need for SEC action to improve company's disclosures of the requisite voting standard in director elections.⁷ These groups expressed concerns that companies have described the voting standard incorrectly or ambiguously in their proxy statements. For example, CII noted that some companies have described a "plurality plus" voting standard, which requires the tendering of a resignation of any director nominee who received more "abstain" votes than "for" votes, as a majority voting standard. It also noted that some companies' proxy statement disclosures mentioned the ability to vote "against" a director nominee, but the proxy card itself did not offer an "against" voting choice.

In response to these concerns, the Staff conducted a review of the disclosures provided by 150 Russell 3000 companies and concluded that there were indeed instances of imprecise descriptions of the voting standards. In public remarks, the Staff has indicated that it is monitoring this matter to determine whether further action is needed.

Clarifying Voting Standard Descriptions

We recommend that companies take a fresh look at their existing proxy statement disclosures regarding the requisite voting standards and the voting choices on their proxy cards to determine whether clarification or enhanced disclosures are needed.

⁷ A copy of the CII's rulemaking petition to the SEC is available at <http://www.sec.gov/rules/petitions/2015/petn4-686.pdf>.

Comply With IRC Section 162(m)

Importantly, the Section 162(m) regulations require that issuers seek shareholder reapproval every five years of the performance goals with respect to which performance-based compensation (PBC) is to be paid. Generally, this means that companies that obtained shareholder approval of such goals in 2011 or earlier must have submitted 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 units or restricted stock, under the same equity incentive plan adopted in 2011 and earlier and used for stock option and stock appreciation right grants. Unless such a company's equity incentive plan's performance goals are reapproved in 2016, 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.

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 2016. If a company is submitting other equity incentive plan amendments to shareholders for approval in 2016, it should consider adding provisions sufficient to qualify other cash bonuses and equity compensation payable under the plans as PBC under Section 162(m).

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 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.

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 IPO, spin-off or otherwise. Adoption of material amendments to such grandfathered plans can shorten the transition period. Companies that went public in 2015 or earlier should check to see whether compliance is now required for 2016 and thereafter.

Reviewing Proposed Executive Compensation Actions

As noted in the "Assess potential impact from compensation-related litigation" section 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.

Confirm Compliance With Stock Market Material News Release Rules

Companies listed on the New York Stock Exchange (NYSE) should confirm compliance with the amended material news release rules, which became effective in September 2015. Under the NYSE's "Material News Policy," found in Section 202.05 of the Listed Company Manual, listed companies are expected to release quickly to the public any news or information that might reasonably be expected to materially affect trading in their securities. The revised rule in Section 202.06 provides the following procedures for public release of information under the Material News Policy:

- **Premarket Notification to NYSE.** Previously, Section 202.06 required listed companies to notify the NYSE at least 10 minutes before releasing material news "shortly before the opening or during market hours," which start at 9:30 a.m. This notification window was expanded to material news released between 7 a.m. and 4 p.m., consistent with the existing premarket window (starting at 7 a.m.) in Nasdaq Stock Market Rule 4120(a)(1).
- **Methods of Releasing Material News.** Companies releasing material news should either: (a) include the news in a Form 8-K or other SEC filing; or (b) issue the news in a press release to the major news wire services, which include, at a minimum, Dow Jones, Reuters Economic Services and Bloomberg Business. Previously, this policy stated that companies can disclose material news via any Regulation FD-compliant method with advisory text on the best way to release material news to ensure immediate and wide-spread coverage. The amendment also adds advisory language as applicable to companies that intend to issue material news after the closing of NYSE trading to delay doing so until the earlier of publication of such company's official closing price or 15 minutes after the close of trading, in order to facilitate an orderly closing process to trading on the exchange.
- **Trading Halts.** NYSE now has additional authority to halt trading during premarket hours at the request of a listed company or when the NYSE believes it is necessary to request certain information from listed companies, such as material news, the company's compliance with the NYSE continued-listing requirements, or any other information that is necessary to protect investors and the public interest. Previously, the NYSE's authority to halt trading was limited to when a listed company intended to release material news during market hours.

Nasdaq also issued similar guidance through an alert in October 2015,⁸ advising that if companies prefer to release material information after the close of the regular market at 4:00 p.m. ET, companies should wait until at least 4:01 p.m., after the Nasdaq closing cross has been calculated, and preferably until 4:05 p.m. As a result, Nasdaq recommends that issuers not release material news between 4:00 p.m. and 4:01 p.m. ET, unless there are specific circumstances where the company needs to act immediately.

Releasing Information Publicly

Listed companies should review their existing policies and procedures to ensure compliance with the revised rules.

⁸See <http://nasdaq.cchwallstreet.com/nasdaq/pdf/nasdaq-issalerts/2015/2015-001.pdf>.

Consider Impact From New PCAOB Related Parties Auditing Standard

The Public Company Accounting Oversight Board's (PCAOB) adoption of Auditing Standard 18 (AS 18) may require changes to existing internal controls and procedures.

AS 18, which requires independent auditors to evaluate a company's identification of, and accounting for, "related party transactions," as defined by Accounting Standards Codification 850 (ASC 850), became effective for audits of fiscal years beginning on or after December 15, 2014. Independent auditors may specifically request companies to consider whether the director and officer (D&O) questionnaires, which typically cover transactions with "related persons," as defined by Item 404 of Regulation S-K, adequately capture "related parties" under ASC 850. For example, the auditor may suggest revising form D&O questionnaires to include a more fulsome list of immediate family members as potential "related parties" under ASC 850.

Given that the Item 404 definition generally captures all "immediate family members" under ASC 850, however, companies should be comfortable that the information obtained through the current forms is sufficient to assist their auditors in complying with the requirements of AS 18. Expanding the list of related parties for purposes of D&O questionnaires, therefore, should not be necessary. Nevertheless, companies should confirm with their auditors this approach and that other documents, policies or procedures do not require changes in connection with the implementation of AS 18.

Comply With SEC Proxy Filing Requirements

In addition to filing the proxy statement and furnishing the annual report to shareholders, companies should confirm that a copy of the proxy card, the required “Notice of Internet Availability of Proxy Materials,” and any other written communication materials used in connection with the annual meeting solicitation are filed with the SEC. We note that the Staff has taken the view that timely filing of all reports required under Exchange Act Section 14(a), which governs the proxy materials filing requirements, affects a company’s eligibility to use Form S-3, the short-form Securities Act registration statement.⁹ Information included with the “glossy” annual report (such as a letter to shareholders), however, is not considered soliciting materials or required to be filed with the SEC.

⁹ See Securities Act Forms Compliance and Disclosure Interpretations Question 115.04.

Note the Impact of Changes to SEC Disclosure Requirements From Advancements in U.S. International Relations

Notwithstanding the recent advancements in U.S. diplomatic relations with Iran and Cuba, SEC disclosure requirements have generally not been impacted.

Since 2012, when Congress added Section 13(r) to the Exchange Act pursuant to The Iran Threat Reduction and Syria Human Rights Act (ITRA), public companies have been required to disclose in their Forms 10-Q, 10-K and 20-F filings whether they (or any of their affiliates) “knowingly engaged” in certain activities, transactions or dealings relating to Iran or certain “specially designated nationals.” The SEC’s Office of Global Security Risk (OGSR) has also been monitoring public company disclosures, since 2004, for business activities relating to countries classified as state sponsors of terrorism and has issued comment letters to companies engaged in such activities, as well as to companies that disclose sales in or business within the areas surrounding such countries.

In July 2015, the U.S. together with the European Union, China, France, Germany, Russia and the United Kingdom entered into an agreement with Iran. This agreement, the Joint Comprehensive Plan of Action, provides for reduced sanctions against Iran, contingent upon Iran’s satisfaction of certain nuclear-related commitments. On October 18, 2015, the U.S. took preparatory steps toward sanctions relief when the secretary of state issued contingent waivers of certain sanctions relating to specific activities involving Iran, including certain petroleum-related transactions, which are among the types of activities underlying the Section 13(r) disclosure obligations. If Iran satisfies its obligations and the contingent waivers become effective, the subject activities may be pursued without the threat of U.S. sanctions, as long as companies remain compliant with the other restrictions. Significantly, however, those activities subject to disclosure under the existing reporting requirements under Section 13(r) will continue to require disclosure.

In addition, the recent advancements in relations with Cuba have resulted in Cuba being removed from the list of state sponsors of terrorism by the U.S. State Department. Because Cuba was removed from the list, companies should no longer receive comments from OGSR relating to Cuba. Iran, Sudan and Syria remain the only designated state sponsors of terrorism.

Note the Status of Additional Dodd-Frank Act Requirements

The SEC continues to work toward fulfilling the rulemaking mandate of the Dodd-Frank Act regarding corporate governance and disclosure topics. Although none of the SEC's rule-making efforts in that regard will impact 2016 reporting, there are a few things to make note of for subsequent years.

On August 5, 2015, the SEC adopted a final rule implementing the CEO pay ratio disclosure requirements that were mandated by Congress pursuant to Section 953(b) of the Dodd-Frank Act. The pay ratio rule amends existing rules by requiring companies to disclose:

- the median of the annual total compensation of all of its employees, except the CEO;
- the annual total compensation of its CEO; and
- the ratio of those two amounts.

In addition, companies will be required to provide a brief description of the methodology used to identify the median employee, as well as any material assumptions, adjustments or estimates used to determine the median employee or annual total compensation. These disclosures will be required in any annual report, proxy or information statement, or registration statement that requires executive compensation disclosure pursuant to Item 402 of Regulation S-K. The requirement will not, however, apply to emerging growth companies, smaller reporting companies or foreign private issuers. Companies must begin providing pay ratio disclosures in their 2018 proxy statements, for the first fiscal year commencing on or after January 1, 2017, *i.e.*, first appearing in 2018 proxies. Although the pay ratio rule will not impact the 2016 reporting season, we recommend that companies begin preparing for its implementation now. With 2017 only a year away, companies are advised to begin developing a plan to meet the pay ratio rule's disclosure requirements.

Companies should also be aware of three other compensation-related rules proposed by the SEC during 2015. As proposed:

- **Hedging Disclosure.** The hedging disclosure rule would implement Section 955 of the Dodd-Frank Act by requiring companies to disclose whether directors, officers or other employees are permitted to hedge or offset any decrease in the market value of a company's equity securities granted by the company as compensation or held, directors or indirectly, by employees or directors.
- **Pay-Versus-Performance Disclosure.** The pay-versus-performance disclosure rule would implement Section 953(a) of the Dodd-Frank Act by requiring companies to clearly disclose the relationship between executive compensation actually paid and the financial performance of the company.
- **Clawback Requirement.** Pursuant to Section 954 of the Dodd-Frank Act, the clawback rule on executive compensation would direct national securities exchanges and associations to establish listing standards requiring companies to adopt policies that require executive officers to pay back incentive-based compensation that is later shown to have been awarded erroneously.

Although all of these proposed rules attracted significant public comments, the latter two were particularly controversial.

Keeping an Eye on Other Compensation- Related Rules

Because the SEC has not yet announced final rules, these rules will not impact 2016 disclosure. However, companies should look for further developments in the near future.

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