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Matters to Consider for the 2017 Annual Meeting and Reporting Season

Each company faces important decisions in preparing for its 2017 annual meeting and reporting season. Once again, we have prepared a checklist of essential areas on which we believe companies should focus as they plan for the upcoming season, including corporate governance, executive compensation and disclosure matters.

Checklist of Matters to Be Considered

Incorporate Lessons Learned From the 2016 Say-on-Pay Votes and Compensation Disclosures

We recommend that companies 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 2016 Say-on-Pay Votes

Below is a summary of the results of the 2016 say-on-pay votes and some trends over the last five years:

- Average support during the 2016 season was near 91 percent, which is consistent with prior years.
- Approximately 99 percent of companies received at least majority support, with approximately 94 percent receiving above 70 percent support.
- The 2016 failure rate of 1.5 percent was the smallest ever, down from 2.2 percent in 2015 and down more than 1 percent from 2012, which had the highest failure rate. In the aggregate, only about 6 percent of all companies have had a failed vote (less than majority support), and only about 2 percent of companies have had more than one failed vote.
- About 80 percent of companies in the Russell 3000 offer an annual say-on-pay vote and, of these companies, nearly half received over 90 percent support in each of the last five years.
- In 2016, unlike 2014 and 2015, smaller companies (those in the Russell 3000, exclusive of S&P 500 companies) performed better than larger (S&P 500) companies, notwithstanding that Institutional Shareholder Services (ISS) is approximately 50 percent more likely to issue an "against" recommendation for a smaller company. In any event, the difference in the approval rates between smaller and larger companies has been small (some 2 percent or less).
- Roughly one-quarter of companies with annual say-on-pay votes have received less than 70 percent support at least once during the preceding five years.

Negative recommendations from proxy advisory firms, particularly from ISS, again made a significant impact on the outcome of 2016 votes by lowering support by approximately 32 percent for S&P 500 companies and 27 percent for Russell 3000 companies. 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 principally by share price performance (both absolute and relative to peer companies) and company pay practices. Over the last five years, ISS has given an against recommendation for over half of the companies where there was a "high" quantitative concern level, whereas only approximately 3 percent received an against recommendation where there was a "low" concern level. An against recommendation based on low concern level was usually as a result of problematic provisions in new or amended executive agreements or poor responsiveness to shareholder concerns.

Say on Golden Parachute

Say-on-golden-parachute votes have historically received lower support than say-on-pay votes. Indeed, the 2016 failure rate of approximately 7 percent was the highest since the advent of the vote, versus a failure rate of approximately 1 percent in 2015 and an average failure rate from 2011 to 2015 of slightly over 3 percent. For the 93 percent of proposals that passed during 2016, such proposals passed on average by 84 percent. Over the last five years, the passing score has ranged from approximately 83 percent to approximately 86 percent.

Equity Plan Proposals

While equity plan proposals were generally approved with a passing score of approximately 88 percent for 2016 — consistent with the range of approximately 86 to 89 percent support over 2012 to 2015 — more equity plan proposals failed in 2016 than in prior years, albeit still only nine out of approximately 920 proposals.

The percentage of proposals supported by ISS declined from approximately 73 percent in 2015 to approximately 68 percent in 2016. In that regard, it is worth noting that 2016 marked the second year in which ISS applied its new Equity Plan Scorecard (EPSC). Its impact on ISS support rates is not entirely clear. The support rate in 2016 declined from 2015, which was the EPSC's inaugural year and which was consistent with the preceding two years, approximately 74 and 73 percent in 2014 and 2013, respectively. Modifications to the scorecard following the 2015 proxy season also may have contributed to the lower ISS support rate in 2016. In any event, companies should pay careful attention to the scorecard and secure ISS support where the company's equity plan goals are consistent with the scorecard. However, the low vote failure rate (at or below approximately 1 percent over the last five years) makes ISS support less important than in the say-on-pay context.

Change in Pay Practices Over Time

The focus on pay for performance programs has increased over the past five years, though it is difficult to determine the extent to which the advent of the say-on-pay vote affected that development. In 2015, the latest year for which ISS has reported data, the number of S&P 500 companies that paid discretionary bonuses decreased to approximately 13 percent from 17 percent in 2011, whereas approximately 86 percent of S&P 500 companies provided performance-based non-equity incentive bonus programs during each such year.

Consistent with that development, the prevalence of "full value" share equity awards made by S&P 500 companies to chief executive officers increased to approximately 74 percent in 2015 from 51 percent in 2011, whereas the use of options and stock appreciation rights decreased to approximately 26 percent in 2015 from 49 percent in 2011. Moreover, performance-based equity awards now comprise the majority of equity awards for CEOs at S&P 500 companies. In 2015, the prevalence of such awards increased to approximately 53 percent from 28 percent in 2011, whereas the prevalence of time-based equity awards for CEOs decreased to approximately 47 percent from 72 percent in 2011.

Views of Proxy Advisory Firms and Shareholder Outreach

Below are some of the areas that caused proxy advisory firms to recommend a vote against say-on-pay proposals in 2016. The first three of these areas appear to have been of more significant concern than the others:

- A "pay for performance disconnect" (as calculated using the adviser's methodology).
- Problematic pay practices, including, among other examples, renewal of agreements containing excise tax gross-ups, severance payments to an outgoing CEO in the case of a "friendly" termination, and "make-whole" arrangements or off-cycle grants intended to compensate executives for forgone compensation at a prior employer or an unexpected decline in the value of prior grants.
- Performance goals deemed by proxy advisory firms to be insufficiently challenging, particularly where goals are lower than prior year results.
- An emphasis on time-based equity award grants rather than performance-based grants.
- Retention bonuses and "mega" equity grants.
- Targeting compensation above the 50th percentile of peer group compensation.
- Bonuses that are not solely determined by a formula based on achievement of pre-specified performance criteria.

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 2016 say-on-pay proposal failed or passed without strong support.

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, including executive summaries, charts, graphs and other reader-friendly tools. These features help to achieve maximum clarity of the company's message. A number of companies also have added a summary section to the proxy statement, generally located at the beginning of the document, which highlights, among other things, business accomplishments and key compensation elements, features and decisions.

Comply With Say-on-Frequency Vote Requirement

The Dodd-Frank Act included a provision that requires companies that are subject to the SEC's proxy rules to conduct a shareholder vote on the frequency of the say-on-pay vote every six years, which is the so-called "say on frequency" vote. Most companies held initial say-on-frequency votes in 2011 and for those companies, the 2017 proxy season will mark the second occurrence of such a required vote. The vote must allow shareholders to vote for one-, two- or three-year periods between say-on-pay votes or to abstain from voting. It is expected that most companies will propose annual frequency, although some companies with a history of high shareholder support for say-on-pay proposals may seek to propose a biennial or triennial frequency.

Assess Impact of Proxy Advisory Voting Guidelines

Proxy advisory firms ISS and Glass Lewis have updated certain of their proxy voting guidelines for the 2017 proxy season. Companies should assess the potential impact of these updates, summarized below, when considering changes to corporate governance practices and documents, as well as proxy statement disclosures, which could serve as a basis for recommendations by ISS and/or Glass Lewis.

Executive Compensation Proposals

ISS updated its policies on how it will recommend votes on three executive compensation-related matters — equity compensation plan proposals, amendments to cash and equity incentive plans, and say-on-pay proposals.

With regard to equity compensation plan proposals, ISS updated the basis for its analysis under its Equity Plan Scorecard, which ISS adopted in 2015 and is based on an analysis of plan costs, plan features and general practices. Beginning in 2017, the EPSC's plan feature analysis will consider an evaluation of the payment of dividends on unvested awards. ISS has stated that "full points will be earned if the equity plan expressly prohibits, for all award types, the payment of dividends before the vesting of the underlying award (however, accrual of dividends payable upon vesting is acceptable). No points will be earned if this prohibition is absent or incomplete (*i.e.*, not applicable to all award types). A company's general practice (not enumerated in the plan document) of not paying dividends until vesting will not suffice."

ISS also modified the minimum vesting factor included in its plan feature analysis. In order to receive full points for this feature, equity plans must specify a minimum vesting period of one year for all award types. In addition, ISS will not award any points if the plan allows for individual award agreements that reduce or eliminate the one-year vesting requirement.

When considering amendments to cash and equity incentive plans, ISS revised the applicable policy guideline to clarify the framework that will be applicable to "amendment proposals presented for IRC Section 162(m) purposes only, or those involving multiple bundled amendments, amendments with or without new share requests, amendments potentially increasing cost, etc." With regard to amendments for Section 162(m) purposes only, ISS still intends to recommend against the proposal if the board committee that administers the plan does not consist entirely of "independent" directors, as defined by ISS.

Finally, ISS updated the pay-for-performance analysis it conducts when determining its voting recommendations on say-on-pay proposals. Beginning in 2017, ISS will supplement its historical total shareholder return (TSR) analysis with a consideration of a "new standardized comparison of the subject company's CEO pay and financial performance ranking relative to its ISS-defined peer group ... ." The new comparisons will be based on the "weighted average of multiple financial metrics including return on equity, return on assets, return on invested capital, revenue growth, EBITDA growth, and cash flow (from operations) growth." ISS has stated that this new "information will not impact the quantitative screening results during the 2017 proxy season, [but] it may be referenced in the qualitative review and its consideration may mitigate or heighten identified pay-for-performance concerns."

Director Compensation

ISS adopted two changes to its voting guidelines that apply to consideration of proposals related to director compensation. The first is a new policy that will apply to proposals to ratify nonemployee director compensation. ISS noted that director compensation ratification proposals have become more common because of, among other things, the increase of compensation litigation (more fully described below). When determining how to recommend that its clients vote on these proposals, ISS will consider each proposal on a case-by-case basis, based on the following factors:

- Relative magnitude of director compensation as compared to companies of a similar profile.
- Presence of problematic pay practices relating to director compensation.
- Director stock ownership guidelines and holding requirements.
- Equity award vesting schedules.
- Mix of cash and equity-based compensation.
- Meaningful limits on director compensation.
- Availability of retirement benefits or perquisites.
- Quality of disclosure surrounding director compensation.

ISS also expects to consider whether an equity plan under which nonemployee director grants are made is on the ballot and whether or not it warrants support.

ISS' other policy change regarding director compensation relates to how it assesses proposals to approve nonemployee director equity plans. In the past, ISS employed a fairly strict criteria when determining whether to recommend a vote for director stock plans that exceeded the plan cost or burn rate benchmarks, when combined with employee or executive stock plans. Under the new policy, ISS will consider the qualitative factors listed above on a case-by-case basis when making these recommendations.

Director Overboarding

In 2017, both ISS and Glass Lewis intend to recommend voting against directors who they considered to be "overboarded," based on previously announced revised standards. ISS considers directors who are not the CEO as overboarded if they sit on more than five public company boards and CEOs as overboarded if they sit on more than two outside public company boards. Glass Lewis considers directors who were not the executive officers as overboarded if they sit on more than five public company boards and directors that are executive officers as overboarded if they sit on more than one outside public company board. Glass Lewis also announced that it would considered factors other than the total number of directorships, such as size and location of the other companies where the director serves and the director's attendance record at board meetings, when making these recommendations.

Restricting Bylaw Amendments

ISS has adopted a new policy that it generally will recommend a vote against or a "withhold" vote from members of a company's governance committee if the company charter "imposes undue restrictions on shareholders' ability to amend the bylaws." Among the restrictions that ISS has identified as being undue include prohibiting the submission of binding shareholder proposals and requiring a share ownership or holding requirement that is in excess of the SEC's shareholder proposal rule (Rule 14a-8).

Prepare for Proxy Access Nominees and Bylaw Challenges

Proxy access shareholder proposals continued to dominate corporate governance matters for a second year during the 2016 proxy season. The comptroller of New York City, as trustee of various New York City pension funds, resumed its Boardroom Accountability Project from last season and submitted proxy access proposals to 72 companies. In total, over 200 proxy access resolutions were submitted by shareholders for the 2016 proxy season, nearly doubling the amount submitted during the 2015 proxy season. Consistent with last season, a majority of these proposals requested proxy access for a shareholder or group of shareholders owning 3 percent of the company's outstanding shares for at least three years. Unlike last season, however, many of this season's proposals sought to cap proxy access nominees at the greater of two directors or 25 percent of the board and contained provisions allowing a group of shareholders to act together to aggregate holdings to meet minimum ownership thresholds.

Through July 1, 2016, shareholders voted on 79 shareholder-sponsored proxy access proposals and approximately 52 percent of these proposals received majority shareholder approval. In response to this growing trend, more than 300 public companies have implemented proxy access, including more than 40 percent of S&P 500 companies, an increase from approximately a dozen companies at the end of 2014. A majority of these companies have adopted a "3-3-20" model — allowing holders of 3 percent of a company's shares for three years access to the company's proxy statement for nominees at the greater of two directors or 20 percent of the board.

SEC Staff No-Action Relief on Proxy Access

In October 2015, prior to the start of the 2016 proxy season, the staff of the Division of Corporation Finance (Staff) of the U.S. Securities and Exchange Commission (SEC) issued new guidance regarding the application of Rule 14a-8(i)(9).[1] Under the Staff's view, 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. As explained by the Staff, however, a shareholder and management proposal seeking the adoption of proxy access but with differing eligibility thresholds would not necessary result in the kind of "direct conflict" contemplated by the rule. As a result, companies instead largely turned to "substantial implementation" arguments under Rule 14a-8(i)(10) as the primary basis for no-action relief requests during the 2016 proxy season.

In early 2016, the Staff granted a series of no-action requests to companies that sought to exclude shareholder proposals requesting the adoption of proxy access from their 2016 proxy statements on the basis that the proposals had been substantially implemented by the company. In these instances, the Staff agreed that the companies had substantially implemented the proposals where each had adopted a proxy access bylaw with a 3-percent-for-three-year ownership threshold, even though the adopted provisions did not track the specific terms of the shareholder proxy access proposals in various other respects, namely, where bylaws contained an aggregation limit (*e.g.*, setting a group limit at 20 shareholders as opposed to unlimited) and capped the number of candidates who may be nominated under proxy access (*e.g.*, 20 percent of the board as opposed to the greater of two directors or 25 percent of the board). In addition, based on recent Staff no-action relief, a company may be able to exclude a proxy access proposal even if the company's proxy access bylaw includes provisions limiting the number of shareholders that may aggregate to form a nominating group or sets a lower percentage or number of board seats available to proxy access nominees than specified in the proposal. The Staff, however, has denied no-action relief

[1] See Staff Legal Bulletin No. 14H (Oct. 22, 2015), available at https://www.sec.gov/interps/legal/cfslb14h.htm.

to companies that have argued substantial implementation where an existing ownership threshold of 5 percent differed from the 3 percent ownership threshold requested by the proponent.

Further, companies must consider shareholder proxy access proposals requesting a substantive amendment to specific features of existing bylaw provisions. For example, in *H&R Block, Inc.* (July 21, 2016), the Staff denied no-action relief under substantial implementation where the proposal requested four substantive revisions to the existing proxy access bylaw: (i) the number of proxy access nominees would be the greater of 25 percent or two; (ii) loaned shares would count toward the ownership threshold so long as they are recallable; (iii) no limit on the size of the nominating group; and (iv) no restriction on the renomination of a proxy access nominee based on the number or percentage of votes received in a prior election. H&R Block relied upon its existing bylaw's provision providing for a 3-percent-for-three-year threshold requirement in arguing that the proposal was excludable under substantial implementation. The Staff, however, rejected that argument.

In contrast, the Staff recently granted no-action relief under Rule 14a-8(i)(10) in *Oshkosh Corporation* (Nov. 4, 2016), where, in response to a proxy access amendment proposal, the company successfully demonstrated that it substantially implemented the proposal with an amendment to its existing proxy access bylaw implementing three of the six requested changes: (i) reduce the ownership eligibility threshold from 5 percent to 3 percent; (ii) eliminate the requirement that a proxy access nominee receive a 25 percent vote minimum for renomination; and (iii) eliminate the requirement that the nominating shareholder provide a representation that it would continue ownership for one year following the annual meeting. The Staff granted no-action relief despite the fact that Oshkosh did not implement the other requested amendments, specifically: (iv) increase the cap on the percentage of shareholder-nominated directors to the greater of 25 percent of directors then serving or two (from the greater of 20 percent of directors or two); (v) eliminate the 20-person cap on aggregation; or (vi) eliminate a requirement relating to when loaned securities may be treated as owned securities. The Staff's denial shows that a company's original adoption of a proxy access bylaw may not be sufficient to substantially implement a proposal that seeks to amend a company's existing proxy access bylaw provision. Companies receiving no-action relief under substantial implementation in 2016, and those that have voluntarily adopted proxy access bylaws, should consider that proxy access is likely to continue to be a significant issue during the 2017 proxy season, as shareholders may consider submitting proposals to amend potentially restrictive provisions of existing proxy access bylaws.

The Staff's grant of no-action relief in *Oshkosh* reinforces the view that proxy access proposals are driven by the facts and circumstances of the specific request and existing bylaws. It remains unclear how the Staff would approach a scenario where a company fails to modify its share ownership eligibility thresholds or where a proposal only proposes changes to less controversial aspects, such as the proxy access nominee cap or limits on shareholder aggregation. In looking toward the 2017 proxy season, companies should review these issues and consider whether to modify existing proxy access provisions in response to shareholder proxy access proposals seeking to amend these provisions.

Director Nominee Submissions

Companies with proxy access bylaws should prepare for possible director nominee submissions. Such companies may be required, under 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. Companies should be able to satisfy this requirement by disclosing the deadline in the company's proxy materials, although the Staff has not confirmed this view publicly.

On November 10, 2016, GAMCO Investors, Inc. and its affiliated funds filed the first known proxy access bylaw nomination on Schedule 14N to nominate a proxy access candidate for election to the board of directors of National Fuel Gas Company (NFG). In November 2016, NFG filed a Form 8-K rejecting the nomination and noted GAMCO's several public statements from 2014 and 2015 requesting that the board engage an investment banking firm to explore a spin-off of NFG's utility segment and its presentation of an unsuccessful Rule 14a-8 divestiture proposal in 2015. Importantly, NFG concluded that GAMCO did not satisfy NFG's bylaw provision requiring a shareholder to represent that it acquired the shares used to satisfy the proxy access eligibility threshold "in the ordinary course of business and not with the intent to change or influence control of [NFG], and does not presently have such intent." In response, GAMCO filed an amended Schedule 13D withdrawing its proxy access candidate.

In light of these developments, if presented with proxy access nominations, companies should review the nominating shareholder's past conduct and current actions to assess whether it possessed an intent to change or influence control of the company when acquiring the required shares and whether it continues to possess such an intent.

Consider Shareholder Proposal Trends and Developments

In addition to continued developments in proxy access, companies should consider current trends involving independent board leadership, granting shareholders the right to call special meetings or act by written consent, and recent procedural developments involving proposals containing images.

Although the number of independent chair proposals remained high in 2016 and second only to proxy access, support remained flat at slightly below 30 percent. Despite increasing support from ISS, voting results indicate these proposals receive low levels of support, which appear to suggest that shareholders favor a flexible approach to board leadership structures, absent other controversial governance issues at the company.

There was a decline in the amount of special meeting and written consent proposals submitted during the 2016 proxy season compared to the 2015 proxy season. Voting results indicate that proposals seeking to reduce the percentage necessary to call a special meeting and/or adopt the right to act by written consent often receive much less support than proposals submitted to companies that do not provide shareholders the right to call a special meeting. As a number of S&P 500 companies currently do not permit shareholders the right to call a special meeting, these issues are likely to linger as companies continue to develop policies in response to these matters.

Although the number of political activity proposal submissions declined from 2015, two proposals relating to the policies and procedures regarding political contributions received majority support. The votes at the annual meetings of Fluor and NiSource are noteworthy, given that SEC filings indicate that government contracts constituted a significant amount of both companies' annual revenues. Overall, the declining trend from the past two proxy seasons suggests that increased corporate reporting of stand-alone political contributions and/or lobbying activities may serve as a viable deterrent.

Finally, in *General Electric Co.* (Feb. 23, 2016), the Staff addressed a proposal that consisted of text accompanied by a full-page image of a line graph addressing the relative stock performance of GE and the S&P 500. Although GE argued that the inclusion of an image in a shareholder proposal violates the 500-word limitation under Rule 14a-8(d) and that such rule allows only words and does not authorize the use of images, the Staff declined to grant no-action relief. While the Staff has not provided guidance indicating the scope of its interpretation or application of Rule 14a-8(d) as it pertains to proposals accompanied by an image or graphic, companies should be aware that an increasing number of shareholder proposals may include images.

Address Potential Impact From Recent Director Compensation Litigation

There has been an increase in lawsuits filed against company boards that allege breaches of fiduciary duties in connection with the payment of excessive director compensation.

In Delaware, the default standard of judicial review for director conduct is the business judgement rule, which is a presumption by the court in favor of director decisions. The business judgment rule does not protect directors who have an interest in, or would derive a personal financial benefit from, the decision. Consequently, claims relating to excessive board compensation are reviewed under a more onerous level of scrutiny — referred to as an entire fairness review — under which directors bear the burden of proving that their compensation decision was entirely fair to the corporation.

A board can avoid an entire fairness review and reinstate the business judgment rule, however, if the challenged decision was ratified by a vote of fully informed shareholders. In the director compensation context where equity awards are being challenged, for example, directors may argue that shareholders ratified the awards by approving the equity plan under which the awards were granted. Recent Delaware case law demonstrates that it is not enough to argue that a compensation decision was made pursuant to a stockholder-approved compensation plan; rather, the plan also must contain a meaningful limit.[2]

Against the backdrop of litigation, and to benefit from the business judgement standard of review, companies should consider director-specific compensation limitations in new equity plans or plans that are being amended. In setting a meaningful director-specific plan limitation, it is recommended that companies take into account peer compensation practices and forecast their own short- and long-term compensation requirements. Alternatively, companies may consider adopting, and seeking shareholder approval of, a stand-alone director compensation plan.

In addition, companies should consider the following best practices:

- Review existing director pay practices, including the methodology used to determine board compensation.
- Remain near market standard with regard to director compensation. In this respect, companies should consider engaging compensation consultants to assist in determining the appropriate amounts and structure of director compensation.
- Add proxy disclosure about director compensation determination methodology and any decisions taken in respect of director compensation in 2016. To the extent a company has engaged a compensation consultant to assist with the determination of director compensation, the proxy disclosure should highlight such engagement and the conclusions drawn by the compensation consultant.

[2] See, *e.g.*, *Calma v. Templeton*, No. 9579-CB (Del. Ch. Apr. 30, 2015); *Seinfeld v. Slager*, 2012 WL 2501105 (Del. Ch. June 29, 2012).

Note Proposals to Change Audit Committee Practice and Disclosure

Companies may want to consider initiating discussions with their audit committees and independent auditors in response to 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.

In July 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. In particular, the concept release concentrates on potential changes to required disclosures in the following four areas: (i) the audit committee's oversight of the auditor; (ii) the audit committee's process for appointing or retaining the auditor; (iii) the qualifications of the audit firm and certain members of the engagement team selected by the audit committee; and (iv) the location of audit committee disclosures in SEC filings. In each of these areas, the SEC asks specifically about the current requirements and potential changes and whether and why any such changes may be useful to investors. Although the comment period for this release has expired, the SEC has not announced any specific proposals to address the issues raised in the release.

Since the SEC's publication of the audit committee concept release, a number of corporate governance groups and institutional investors have continued to call for improvements in audit committee disclosures. For example, the United Brotherhood of Carpenters' Pension Fund announced that for the fifth consecutive year, it will continue sending letters to companies that request enhanced auditor independence-related disclosures in proxy statements.

In addition, the Center for Audit Quality (CAQ) and Audit Analytics have issued a report analyzing proxy disclosures of companies in the S&P 1500 index,[3] focusing on the extent that companies describe the audit committee's (i) audit firm selection, (ii) audit firm compensation, (iii) audit firm evaluation and supervision and (iv) audit partner selection. The report, issued in November 2016, is titled the "Audit Committee Transparency Barometer"[4] and reveals a continued trend of an increasing number of companies, especially the large-cap companies in the S&P 500, with such disclosures during the 2016 proxy season. Notable findings of increased disclosure in company proxy statements include the following:

- Double-digit growth since 2014, the first year of the annual study, in enhanced discussion of the audit committee's considerations in recommending the appointment of the audit firm: 31 percent of S&P 500 companies, compared to 25 percent in 2015 and 13 percent in 2014; 22 percent of mid-cap companies, compared to 16 percent in 2015 and 10 percent in 2014; and 17 percent of small-cap companies, compared to 11 percent in 2015 and 8 percent in 2014.
- Approximately 43 percent of S&P 500 companies disclose that the audit committee is involved in audit partner selection, increasing from 31 percent in 2015 and 13 percent in 2014.
- Over a third (34 percent) of S&P 500 companies disclose the evaluation or supervision of the audit firm, increasing from 24 percent in 2015 and just 8 percent in 2014.

[3] The S&P 1500 index consists of the S&P 500 (large-cap companies), the S&P MidCap 400 (mid-cap companies) and the S&P SmallCap 600 (small-cap companies).

[4] A copy of the "Audit Committee Transparency Barometer" is available at http://www.thecaq.org/2016-audit-committee-transparency-barometer.

Consider Recommendations to Increase Board Diversity

We recommend that companies consider recommendations by certain market participants to increase the diversity of their board members. The push to improve board diversity has been led by a number of institutional investors, including the California Public Employees' Retirement System (CalPERS) and California State Teachers' Retirement System (CalSTRS) and the advocacy organization Thirty Percent Coalition. But a number of other participants also have weighed in on this issue, including outgoing SEC Chair Mary Jo White, who has called publicly for an increase in board diversity and has stated that she asked the SEC Staff to prepare rulemaking proposals to change the disclosure requirements related to board diversity.[5] In addition, the state of California adopted a nonbinding resolution in 2013 that called on "publicly held corporations" in California to maintain a minimum number of women board members by December 2016.[6]

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 also has included an increasing number of shareholder proposals relating to companies' diversity policies. Those proposals generally have not received strong support. However, ISS will 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.

Companies considering changes to policies to address the concerns in this area should be mindful of the potential related disclosure requirements. Current 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 in 2009 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."

[5] A copy of Chair White's speech is available at https://www.sec.gov/news/speech/chair-white-icgn-speech.html.

[6] See California Senate Concurrent Resolution No. 62 at http://www.leginfo.ca.gov/pub/13-14/bill/sen/sb_0051-0100/scr_62_bill_20130711_introduced.pdf.

Confirm Non-GAAP Disclosures Comply With SEC Rules and Staff Guidance

The SEC Staff updated its guidance in May 2016 concerning the disclosure of non-GAAP financial measures,[7] which has had a significant impact on company disclosures. Since the issuance of the guidance, companies have experienced greater scrutiny of their use of non-GAAP financial measures by the SEC Staff. The focus has included disclosure reviews by the Staff of the Division of Corporation Finance and investigations by the staff of the SEC's Division of Enforcement into non-GAAP financial disclosures made by certain companies. The comments from the Division of Corporation Finance Staff generally have been issued in connection with its normal review of periodic and transactional filings, although some of the comments have been issued in connection with the review of recent earnings releases furnished on Form 8-K. While the Staff's review of non-GAAP disclosures continues, and it may be some time before we understand fully the final impact of this new focus, we identified a number of trends in the comments received to date. Our analysis of those trends is available in our alert titled "SEC Staff Continues to Focus on Non-GAAP Financial Disclosures." [8]

In light of the SEC Staff's increased focus on non-GAAP disclosures, companies should revisit their proxy statement disclosures to ensure compliance with the relevant rules and SEC Staff guidance. Those rules and the available guidance generally make it easier for companies to disclose non-GAAP financial measures in proxy statements and, when applicable, to comply with Regulation G and Regulation S-K Item 10(e) — the rules that govern the use of non-GAAP financial measures.

Most helpful to companies is Instruction 5 to Regulation S-K Item 402(b), which provides that neither Regulation G nor Item 10(e) applies to the disclosure of non-GAAP performance targets in the Compensation Discussion & Analysis (CD&A):

> **Instruction 5 to Item 402(b)**
>
> Disclosure of target levels that are non-GAAP financial measures will not be subject to Regulation G and Item 10(e); however, disclosure must be provided as to how the number is calculated from the registrant's audited financial statements.

Companies that rely on that instruction must, as provided above, describe how their non-GAAP targets are calculated from their audited financial statements. This normally requires a sentence or two of explanation, which may be footnoted. The SEC Staff also has clarified that the disclosure of actual results, relative to non-GAAP targets, may rely on the instruction: [9]

> **Regulation S-K CDI 118.09**
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> Question: Instruction 5 to Item 402(b) provides that "[d]isclosure of target levels that are non-GAAP financial measures will not be subject to Regulation G and Item 10(e) of Regulation S-K; however, disclosure must be provided as to how the number is calculated from the registrant's audited financial statements." Does this instruction extend to the disclosure of the actual results of the non-GAAP financial measure that is used as a target?
>
> Answer: Yes, provided that this disclosure is made in the context of a discussion about target levels. [May 16, 2013]

[7] The new guidance is available at https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

[8] A copy of our alert is available at https://www.skadden.com/insights/sec-staff-continues-to-focus-on-non-gaap-financial-disclosures.

[9] The Staff's guidance is available at https://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm.

The exception provided in Instruction 5 applies only to non-GAAP measures disclosed in the CD&A. Therefore, if non-GAAP measures are disclosed elsewhere in the proxy statement, compliance with Regulation G and Item 10(e) still is required. The SEC Staff offers some flexibility as to the location of the required non-GAAP-to-GAAP reconciliation and other information required by Regulation G and Item 10(e), however, when non-GAAP disclosures are included to explain the relationship between pay and performance or to justify amounts paid. This flexibility is described in the following SEC Staff guidance:

> **Regulation S-K CDI 118.08**
>
> Question: Instruction 5 to Item 402(b) provides that "[d]isclosure of target levels that are non-GAAP financial measures will not be subject to Regulation G and Item 10(e); however, disclosure must be provided as to how the number is calculated from the registrant's audited financial statements." Does this instruction extend to non-GAAP financial information that does not relate to the disclosure of target levels, but is nevertheless included in Compensation Discussion & Analysis ("CD&A") or other parts of the proxy statement — for example, to explain the relationship between pay and performance?
>
> Answer: No. Instruction 5 to Item 402(b) is limited to CD&A disclosure of target levels that are non-GAAP financial measures. If non-GAAP financial measures are presented in CD&A or in any other part of the proxy statement for any other purpose, such as to explain the relationship between pay and performance or to justify certain levels or amounts of pay, then those non-GAAP financial measures are subject to the requirements of Regulation G and Item 10(e) of Regulation S-K.
>
> In these pay-related circumstances only, the SEC Staff will not object if a registrant includes the required GAAP reconciliation and other information in an annex to the proxy statement, provided the registrant includes a prominent cross-reference to such annex. Or, if the non-GAAP financial measures are the same as those included in the Form 10-K that is incorporating by reference the proxy statement's Item 402 disclosure as part of its Part III information, the Staff will not object if the registrant complies with Regulation G and Item 10(e) by providing a prominent cross-reference to the pages in the Form 10-K containing the required GAAP reconciliation and other information. [July 8, 2011]

Companies that intend to rely on the above guidance by including a cross-reference to their Form 10-K should prepare in advance to ensure that the disclosures required by Regulation G and Item 10(e) are appropriately included in the Form 10-K.

Update D&O Questionnaires

Companies should review their director and officer (D&O) questionnaires to consider whether regulatory developments, including those described below, require that the questionnaires be revised.

Auditing Standard 18 (AS 18), adopted by the Public Company Accounting Oversight Board (PCAOB),[10] imposes obligations on independent auditors to evaluate a company's identification of, and accounting for, "related-party transactions," as defined by the Financial Accounting Standards Board's Accounting Standards Codification 850 (ASC 850). As a result of AS 18, companies have faced pressures to change existing internal controls and procedures, including their D&O questionnaires. Auditors have questioned whether the D&O questionnaires, which typically cover transactions with "related persons," as defined by Item 404 of Regulation S-K, adequately capture the sometimes broader group of "related parties" under ASC 850. Revising D&O questionnaires for this reason is not always necessary, as it depends on a company's own facts and circumstances, including its existing controls and procedures. On occasion, auditors have requested that companies expand their questionnaires to request whether directors and/or officers control or significantly influence any entities that engage in business with the company or any of its subsidiaries. Companies should confirm the adequacy of their approach with their auditors.

Effective August 1, 2016, Nasdaq adopted new Rule 5250(b)(3), which requires disclosure of the parties to and material terms of all arrangements between any director or nominee and any person or entity other than the company relating to compensation or other payment in connection with that person's candidacy or service as a director. Nasdaq-listed companies should consider whether the D&O questionnaire adequately addresses this new disclosure requirement. Although companies listed on the New York Stock Exchange (NYSE) are not subject to these disclosure requirements, they may want to consider whether the D&O questionnaire permits them to evaluate such arrangements. Note, however, that third-party compensation for both officers and directors is required disclosure for all companies under the SEC's executive compensation rules in Regulation S-K Item 402 and therefore, such compensation is most likely already covered by existing D&O questionnaires.

[10] Note that AS 18 will soon be renumbered as AS 2410, effective December 31, 2016, due to the PCAOB's reorganization of its auditing standards.

Comply With Updated SEC Filing Requirements

The SEC adopted new rules and the SEC Staff issued guidance that companies should consider as they prepare year-end reports and filings.

Form 10-K Summaries and New Item 16 Exhibits

On June 1, 2016, in accordance with the Fixing America's Surface Transportation (FAST) Act, the SEC issued an interim final rule amending Form 10-K by adding a new Item 16 to expressly allow, but not require, companies to provide a summary of business and financial information contained in the annual report, provided that each item in the summary includes a cross-reference by hyperlink to the related disclosure in the report to which the item relates.[11] The interim final rule is designed to offer companies flexibility to determine the length, location and specific disclosure requirements to be covered by the summary. The summary must be limited to information included in the form at the time of filing rather than incorporated by reference. Specifically, an instruction to new Item 16 clarifies that a company choosing to provide a summary is not required to update the summary to reflect information required by Part III of Form 10-K that is incorporated by reference from a proxy or information statement filed after the Form 10-K, but must state in the summary that the Part III information is not included because it will be incorporated from a later-filed proxy or information statement. The SEC's public comment period closed on July 11, 2016.[12] Given that the new summary section is not required and, as the SEC stated in the adopting release for the revised Form 10-K, "current rules do not prohibit a registrant from including voluntary information, such as a summary, in its Form 10-K," we do not expect this development to result in a change to the current approach of annual reporting.

Form 10-K Wrap

Rule 14a-3(c) requires that companies mail seven copies of their annual reports to shareholders to the SEC no later than the date on which such report is first sent or given to security holders, and Regulation S-T permits companies to satisfy the Rule 14a-3(c) requirement by furnishing the annual report to the SEC, in electronic format via EDGAR or in paper form. On November 3, 2016, the Staff issued a Compliance and Disclosure Interpretation (CDI) providing relief from the requirement to file seven hard copies of the annual report to shareholders with the SEC. According to the CDI, companies may now satisfy Rule 14a-3(c) by posting the annual report on their corporate website as long as it remains available on the site for one year.[13] NYSE companies, however, still need to consider their exchange reporting obligations, as they are required to mail three copies of the proxy materials, including the proxy card, no later than the date on which the materials are released to shareholders. Nasdaq companies, though, are not subject to similar requirements and may instead file the Form 10-K and proxy materials on EDGAR.

Proxy Card

On March 22, 2016, the Staff issued a CDI clarifying how Rule 14a-8 shareholder proposals should be described on registrant proxy cards in compliance with the requirement under Exchange Act Rule 14a-4(a)(3) that the form of proxy identify clearly and impartially each

[11] See Form 10-K Summary Release No. 34-77969 available at https://www.sec.gov/rules/interim/2016/34-77969.pdf.

[12] Comment submissions are available for review at https://www.sec.gov/comments/s7-09-16/s70916.htm.

[13] See Compliance and Disclosure Interpretations (Regarding Submission of Annual Reports to SEC) available at https://www.sec.gov/divisions/corpfin/guidance/exchange-act-rule-14a3-14c3.htm.

separate matter intended to be acted upon.[14] The CDI provides a series of examples of proxy card descriptions that would not be considered sufficiently detailed to comply with the new guidance:

- A proposal to amend our articles of incorporation, when describing a management proposal to amend a company's articles of incorporation to increase the number of authorized shares of common stock.
- A shareholder proposal on the environment.
- A shareholder proposal on executive compensation.
- Shareholder proposal #3.

Importantly, the CDI states that proxy cards should clearly identify and describe the specific action on which shareholders will be asked to vote regardless of whether the matter is a management or shareholder proposal. Given that the new guidance does not address whether a shareholder proponent's title satisfies the description requirement under Rule 14a-4(a)(3), as indicated above, companies must consider whether a shareholder proposal is adequately described on its proxy card.

[14] See Compliance and Disclosure Interpretations (Regarding Description Under Rule 14a-4(a)(3) of Rule 14a-8 Proposals) available at https://www.sec.gov/divisions/corpfin/guidance/exchange-act-rule-14a-4a3-301.htm.

Prepare for Pay Ratio Disclosures

The new pay ratio disclosures are required to be provided for fiscal years commencing on or after January 1, 2017. As a result, companies with calendar year-end fiscal years will need to begin providing pay ratio information in their registration statements, annual reports on Form 10-Ks or proxy statements filed in 2018, based on 2017 compensation.

The pay ratio rules require companies to disclose the ratio of the median annual total compensation of employees, excluding the CEO, to the annual total compensation of the CEO. 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.

On October 18, 2016, the Staff issued interpretive guidance on the pay ratio disclosure requirements. The Staff's guidance covers the use of a "consistently applied compensation measure" to identify the median employee as well as the treatment of furloughed employees and workers whose compensation is determined by an unaffiliated third party.[15]

Given the complexities of the rules and the anticipated amount of time necessary to prepare for the disclosures, companies should begin considering their methodology for identifying the median employee and determining annual total compensation. Companies should also monitor for developments regarding the possibility that the U.S. Congress may amend or repeal the pay ratio disclosure requirements.

[15] The Staff's guidance on the pay ratio rules is available at https://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm#128c.01 (Questions 128C.01 to 128C.05).

Plan for Compliance With New Resource Extraction Issuer Payment Rules

On June 27, 2016, the SEC adopted final rules under the Dodd-Frank Act, requiring resource extraction issuers to disclose payments made to U.S. federal or foreign governments for the commercial development of oil, natural gas or minerals.[16] Exchange Act Rule 13q-1 requires resource extraction issuers to file their payment information reports on Form SD. Resource extraction issuers will have to file a Form SD containing annual payment disclosure not later than 150 days after the end of the issuer's fiscal year end. The final rules provide a transition compliance period that will impose reporting obligations beginning with resource extraction issuers with a fiscal year ending on or after September 30, 2018. Companies subject to the resource extraction reporting obligations should begin reviewing processes and controls for accounting and financial reporting to determine the necessary steps to report any required annual payments.

[16] See https://www.sec.gov/rules/final/2016/34-78167.pdf.

Note Status of Dodd-Frank Act and Other SEC Rulemaking Matters

The SEC's work on the remaining Dodd-Frank Act corporate governance and disclosure rulemaking mandates has yet to be completed. It is unclear when or whether these remaining mandates — hedging disclosures, pay-versus-performance and clawback provisions — will be finalized. In fact, in light of the upcoming political transition and the Financial CHOICE Act of 2016 that was proposed in Congress to repeal provisions of the Dodd-Frank Act, it is possible these provisions may never be adopted.

The SEC's Disclosure Effectiveness Initiative, which includes the SEC Staff's in-depth review of existing disclosure requirements, such as Regulations S-K and S-X, remains ongoing. In 2016, the SEC also commenced a similar initiative to implement provisions of the FAST Act, which, among other things, requires the SEC to modernize and simplify provisions of Regulation S-K and provide a report to Congress, which the SEC issued on November 23, 2016.[17] These initiatives resulted in the following proposals in 2016:

- **Business and Financial Disclosures.** In April 2016, the SEC issued a concept release seeking feedback on ways to modernize the business and financial disclosure requirements of Regulation S-K. This follows the SEC's 2015 request for comment on Regulation S-X, which focused on the requirements for financial disclosures that companies must file about acquired businesses, affiliated entities, guarantors and issuers of guaranteed securities. The release focuses primarily on whether the SEC's current disclosure requirements continue to elicit important information for investors and how registrants can most effectively present such information. Disclosure topics on which the SEC seeks feedback in the concept release include, among others, core business information, risk and risk management, management's discussion and analysis, public policy and sustainability matters, and certain exhibit-filing requirements. The release also seeks input on the use of tools such as cross-referencing, incorporation by reference, hyperlinks and company websites, as well as other ways the disclosure requirements could improve the readability and navigability of SEC filings.
- **Subpart 400 of Regulation S-K.** The SEC announced in August 2016 that it is seeking public comment on disclosure requirements in Subpart 400 of Regulation S-K, including those relating to management, certain security holders and corporate governance matters.
- **Disclosure Update and Simplification.** In July 2016, the SEC proposed amendments to eliminate redundant, overlapping, outdated or superseded provisions, in light of subsequent changes to SEC disclosure requirements, GAAP, International Financial Reporting Standards (IFRS) and technology. The SEC also requested comment on certain disclosure requirements that overlap with GAAP to determine whether to retain, modify, eliminate or refer them to the Financial Accounting Standards Board for potential incorporation into GAAP.
- **Exhibit Hyperlinks and HTML Format.** In August 2016, the SEC proposed rule and form amendments that would require companies to include a hyperlink to exhibits in their SEC filings. The proposed amendments would require registrants that file registration statements and periodic and current reports that are subject to the exhibit requirements under Item 601 of Regulation S-K, or that file on Forms F-10 or 20-F, to include a hyperlink to each exhibit listed in the exhibit index of the filings. The amendments would also require that registrants submit all of these filings in HTML format.

On June 16, 2016, the SEC also proposed rules to modernize the disclosure requirements for mining properties with the goal of aligning standards with current industry and global

[17] A copy of the SEC's "Report on Modernization and Simplification of Regulation S-K" (Nov. 23, 2016) is available at https://www.sec.gov/reportspubs/sec-fast-act-report-2016.pdf.

regulatory practices.[18] Specifically, the proposed revisions would update disclosure requirements for mining registrants with an amendment to Regulation S-K Item 102 and the creation of new Regulation S-K Subpart 1300, which would replace the SEC's Industry Guide 7. Among other revisions, the proposed rules would provide that:

- Registrants must adopt one standard to disclose mining operations that are material to the company's business or financial condition. In determining the materiality of its operations, registrants should not only consider materiality under Securities Act Rule 405 and Exchange Act Rule 12b-2, which define "material" as a substantial likelihood that a reasonable investor would attach importance to the information in question in determining whether to buy or sell the registered securities, but also (i) qualitative and quantitative factors assessed in the context of the registrant's overall business, (ii) aggregate mining operations of all its mining operations, and a registrant shall (iii) include, for each property, as applicable, all related mining operations from exploration through extraction to the first point of material external sale, including processing, transportation and warehousing.
- A registrant's mining operations are presumed material if its mining assets constitute 10 percent or more of its total assets. A registrant's mining operations may be deemed material notwithstanding the 10 percent threshold, however, if other quantitative or qualitative factors indicate that the operations are material, *e.g.*, other financial measures, such as the registrant's total revenues, net income or operating income; evidence that the registrant's properties had a significant impact on the price of its securities; or public disclosure discussing the importance of the properties from an operational or competitive standpoint.
- Disclosure of mineral resources, mineral reserves and material exploration results must be based on documentation prepared by a "qualified person," which is defined as a person who is (i) a mineral industry profession with at least five years of relevant experience and (ii) an eligible member or licensee of a recognized professional organization at the time the technical report is prepared.
- Disclosure of mineral resources and mineral reserves must be based upon either a preliminary feasibility study or a final feasibility study.
- Registrants must file as an exhibit a technical report summary prepared by a qualified person, which identifies and summarizes the scientific and technical information and conclusions concerning material mineral exploration results, initial assessments, and preliminary or final feasibility studies used to support disclosure of mineral reserves for each material property.

[18] See https://www.sec.gov/rules/proposed/2016/33-10098.pdf. The SEC public comment period closed September 26, 2016. Comment submissions are available for review at https://www.sec.gov/comments/s7-10-16/s71016.htm.

Plan for New FASB Revenue Recognition Standard

The new Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) accounting standards applicable to revenue recognition from contracts with customers will take effect for all public companies with reporting periods beginning after December 15, 2017, that report financial results based on either GAAP or International Financial Reporting Standards (IFRS), as approved by the IASB. As a result, calendar year-end companies that must comply with the new standards will need to commence reporting under the new standard beginning with their Forms 10-Q for the quarterly period ending March 31, 2018. Those first-quarter 2018 Forms 10-Q will need to include the comparable quarterly period ending March 31, 2017, based on the revised standard.

These new revenue recognition standards, which the American Institute of Certified Public Accountants (AICPA) has characterized as "historic" and "game changing," are expected to require companies to make significant changes to their accounting policies and practices, 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. As a result, companies should begin planning for the transition. Particular attention should be paid to ensuring compliance with the company's disclosure controls and procedures during the standard change.

Comply With IRC Section 162(m)

The Section 162(m) regulations under the Internal Revenue Code (IRC) generally require that issuers seek shareholder approval every five years of the performance goals with respect to which performance-based compensation is to be paid. A company that last obtained shareholder approval of such goals in 2012 must seek shareholder approval of performance goals in 2017.

Companies also should be mindful of lawsuits 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. Moreover, any proxy disclosure relating to Section 162(m) should be carefully reviewed to ensure that the disclosure affords companies appropriate flexibility to implement executive compensation programs, including the ability to award nondeductible compensation.

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