Matters to Consider for the 2018 Annual Meeting and Reporting Season

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Companies have important decisions to make as they prepare for their 2018 annual meeting and reporting season. We have prepared the following overview of key corporate governance, executive compensation and disclosure matters that we believe companies should focus on as they plan for the upcoming season. As always, we welcome any questions you have on any of these topics or other areas related to annual meeting and reporting matters.

Checklist of Matters to Be Considered for the 2018 Annual Meeting and Reporting Season

Finalize Pay Ratio Disclosures

The rules adopted by the U.S. Securities and Exchange Commission (SEC) that mandate pay ratio-related disclosures have gone into effect and apply to fiscal years commencing on or after January 1, 2017. As a result, companies with compensation payable with respect to fiscal years ending on December 31, 2017, will need to begin providing pay ratio information in their registration statements, annual reports on Forms 10-K or proxy statements filed in 2018, based on 2017 compensation.

As a reminder, the pay ratio rules require companies to disclose the ratio of the annual total compensation of the median company employee to the annual total compensation of the CEO. In addition, companies are 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. There are certain aspects of the pay ratio disclosure requirements on which companies have been primarily focused. We provide an overview of those areas below.

Use of Reasonable Estimates, Assumptions and Methodologies

According to guidance released by the SEC and its staff on September 21, 2017, companies have significant flexibility in identifying their median employee and calculating total annual compensation. The guidance acknowledged exercising this flexibility should not provide a basis for an SEC enforcement action, as long as the company uses reasonable estimates, assumptions and methodologies (unless the company lacked a reasonable basis for the disclosure or it was not made in good faith). Several important features of the guidance are addressed below:

- Certain types of workers are excluded from the pay ratio rules (*e.g.*, independent contractors and leased workers who are employed by, and whose compensation is determined by, an unaffiliated third party). A company should not infer that the explicit exclusion of these workers represents the sole basis for excluding them from coverage under the pay ratio rules. When determining whether its workers are employees for purposes of the pay ratio rules, a company may apply a widely recognized test from another area of law, such as employment or tax law.
- In identifying its median employee, a company may use existing internal records that reasonably reflect employees' annual compensation. The records do not need to include every element of compensation, such as equity awards widely distributed to employees.

Calculating the Median Employee

The pay ratio rules permit registrants to calculate the median employee using "reasonable methods," yet the final rules do not specify what methods are considered reasonable. The SEC's September 21, 2017, guidance addresses this uncertainty by:

- Outlining several acceptable sampling methodologies and other reasonable methods, including simple random sampling, stratified sampling, cluster sampling and systematic sampling.
- Providing examples of situations where a company's use of reasonable estimates would be appropriate, such as: (i) analysis of the composition of the company's workforce (*e.g.*, by geographic unit, business unit or employee type); (ii) evaluation of the likelihood of significant changes in employee compensation from year to year; and (iii) calculating a consistent measure of compensation and annual total compensation or elements of the annual total compensation of the median employee.
- Confirming that companies may combine the use of sampling methods with estimates and other methods.

While the SEC appears to remain committed to the idea of promoting substantial flexibility in the pay ratio calculation, it is important to remember that companies must clearly explain their chosen methodology.

Treatment of Non-US Employees

Unless one of the two limited exemptions discussed below applies, a company must include non-U.S. employees in its calculation of total annual compensation and the median employee.

The first exemption applies if a country's data privacy laws or regulations prohibit the transfer of compensation data outside a country's borders, making it impossible for the company to compile the information necessary to calculate the pay ratio. If this occurs, a company may exclude employees located in the specified jurisdiction so long as the company: (i) discloses the excluded jurisdiction and the pertinent data privacy law or regulations; (ii) makes reasonable efforts to obtain the information (including seeking an exemption from the applicable data privacy laws or regulations); (iii) obtains a legal opinion certifying its failure to obtain the requested information; and (iv) attaches the legal opinion as an exhibit to the filing containing the pay ratio disclosure.

Under the second exemption, which is commonly referred to as the "de minimis rule," a company may exclude all non-U.S. employees when identifying its median employee, if non-U.S. employees constitute 5 percent or less of their total workforce. Utilization of the exemption bars the inclusion of any non-U.S. employees in the median employee calculation; therefore, if a company chooses to exclude any non-U.S. employees under this exemption, it must exclude all non-U.S. employees.

Investors Intend to Use Pay Ratio Disclosures

In its 2017 benchmark voting policy survey, Institutional Shareholder Services, Inc. (ISS) revealed that nearly 75 percent of the 131 investor respondents indicated that they intend to use pay ratio disclosures as one factor in their analysis of compensation issues. The investors intend to analyze a company's pay ratio by comparing it to that of other companies in its industry, by assessing year-over-year changes in the company's ratio, or both. These results suggest that, in addition to making the required disclosures, companies should be cognizant of potential investor, employee and media reaction to the disclosed pay ratio. In addition, companies should be prepared to engage with shareholders if their pay ratio substantially departs from that of their peers, or significantly changes from year to year.

Incorporate Lessons Learned From the 2017 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 several key areas below that we believe companies should consider.

Results of 2017 Say-on-Pay Votes

Below is a summary of the results of the 2017 say-on-pay votes and some trends over the last six years since the initial adoption of the say-on-pay rules:

- Average support for the 2017 season was near 92 percent, which is the highest since voting began. The percentage of companies receiving support above 90 percent was also slightly higher than any prior year.
- Approximately 99 percent of companies received at least majority support, with approximately 93 percent receiving above 70 percent.
- The 2017 failure rate of 1.3 percent was the smallest ever, down from 1.5 percent in 2016, and 2.2 percent in 2015.
- While overall support is high, 10 percent of Russell 3000 companies with vote results in each year have failed a say-on-pay vote at least once.
- There was a sharp decrease in failure rates at smaller companies (those in the Russell 3000 that identify as SmallCap 600 companies). In 2016, the failure rate was 32 percent. In 2017, it dramatically improved to 18 percent. The performance of S&P 500 companies was more consistent, reporting a 15 percent failure rate in 2017, down from 17 percent in 2016.
- Almost one-third of companies with annual say-on-pay votes have received less than 70 percent support at least once during the preceding six years.

Say on Golden Parachute

Say-on-golden-parachute votes have historically received lower support than annual say-on-pay votes. The 2017 failure rate of 15 percent was the highest since the advent of the vote and more than double the failure rate of 7 percent in 2016. Average support for golden parachute proposals fell to 79 percent, an all-time low. In fact, ISS issued a negative vote recommendation on 44 percent of the proposals, up from 26 percent in 2016, and the difference in average support between "for" and "against" recommendations from ISS was 37 percent in 2017, the highest on record (up from 28 percent in 2016). Notably, the median CEO golden parachute payment rose close to 75 percent, from $5.2 million in 2016 to $9 million in 2017.

Equity Plan Proposals

Equity plans were approved with an average passing score of 89 percent in 2017, an increase from 88 percent in 2016, and higher than the 2012-15 range of approximately 86 to 89 percent. ISS supported 70 percent of the equity plan proposals in 2017, an increase from 68 percent in 2016. ISS issued an "against" recommendation at a rate of 9 percent in 2017, down from 13 percent in 2016. Eight equity plan proposals failed in 2017, compared to the five-year high of nine proposals in 2016. Among the factors resulting in a failed proposal, the cost of the plan was cited most frequently.

2017 marked the third year in which ISS applied its Equity Plan Scorecard (EPSC). This year's fewer number of "against" recommendations may be a product of companies incorporating more of the scorecard practices, but the impact of the EPSC on the shareholder approval rating is not entirely clear. In December of each year, ISS publishes Frequently Asked Question (FAQ) documents to help stakeholders understand changes to ISS compensation-related methodologies.[1] In November 2017, ISS provided a preliminary set of FAQs highlighting the following updates to EPSC methodology for the 2018 reporting season:

- For companies subject to the S&P 500 scoring model, the passing score for the EPSC will increase to 55 points. For all other EPSC models, the passing score will remain 53 points.
- The change in control vesting factor will be simplified, scoring companies on a basis of full credit or no credit. A company will earn full credit if a company's equity plan contains both of the following provisions:
  - For performance-based awards, acceleration is limited to actual performance achieved, a pro rata of the target based on the performance period, or a combination of both.
  - For time-based awards, acceleration upon a change in control cannot be discretionary or automatic single-trigger.
- The holding requirement factor will be simplified, permitting a company to earn either full credit or no credit. The timeline for receiving full credit on this factor will change from a 36-month holding period to a 12-month holding period. Any holding period of less than 12 months will result in no credit.
- The CEO vesting requirement factors also will be simplified to a vote of full credit or no credit. To receive full credit, the vesting requirement threshold will decrease from greater than four years to at least three years from the date of grant until all shares from the award vest.

Companies should continue to pay careful attention to the EPSC and secure ISS support where the company's equity plan goals are consistent with the EPSC. However, the historically low failure rate arguably makes ISS support less important with respect to equity plan proposals than in the say-on-pay context.

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 2017. The first two of these areas appear to have been of more significant concern than others:

- A "pay for performance" disconnect (as calculated using the advisor'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 years' results.
- Insufficient shareholder outreach and disclosure, including inadequate response to compensation-related concerns raised by shareholders.
- An emphasis on time-based equity grants, rather than performance-based grants.
- Special bonuses and "mega" equity grants.
- Targeting compensation above the 50th percentile of peer compensation groups.
- Bonuses that are not solely determined by a formula based on achievement of pre-specified performance criteria.

In addition, ISS recently provided a preliminary set of FAQs highlighting quantitative changes to be included in ISS' 2018 pay-for-performance calculations, including screen thresholds, the calculation of total shareholder return and the inclusion of a financial performance assessment test.[2] ISS plans to release final FAQs on its U.S. compensation policies in December 2017.

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, a statement that the concerns were reviewed and considered, and, if appropriate, an explanation why changes were not made. In addition, many companies incorporate 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, that highlights, among other things, business accomplishments and key compensation elements, features and decisions.

Companies also should consider whether to make any updates to the compensation benchmarking peers included in ISS' database. ISS uses these company-selected peers when it determines the peer group it will use for evaluating a company's compensation programs. ISS will accept these updates until Friday, December 8, 2017.[3]

[1] A copy of ISS' preliminary FAQs are available at https://www.issgovernance.com/file/policy/Preliminary-U.S.-Compensation-FAQ.pdf.

[2] A copy of ISS' preliminary FAQs are available at https://www.issgovernance.com/file/policy/Preliminary-U.S.-Compensation-FAQ.pdf.

[3] Information about this process is available at https://www.issgovernance.com/company-peer-group-feedback.

Monitor Potential Changes in Pay Practices Due to the Tax Cuts and Jobs Act

Under the Tax Cuts and Jobs Act as currently proposed in the House and Senate as of November 28, 2017, the current tax law treatment of the most widely used forms of executive compensation would remain in effect. However, prior drafts of the House and Senate versions of the Tax Cuts and Jobs Act did include proposals that would have a dramatic effect on compensation practices and disclosures in upcoming years. Proposed changes included eliminating deferred compensation and the essential tax rules governing most stock options.[4] While it now appears unlikely that these proposed changes will be included in any final bill that may be approved by Congress, we recommend companies continue to monitor the proposals to ensure they are prepared for any possible changes.[5]

[4] For more information about the potential impact, please see our November 2, 2017, memorandum titled "Executive Compensation Under the Tax Cuts and Jobs Act: The End of Executive Compensation As We Know It."

[5] For more information about the current state of play of these proposed tax reforms on executive compensation, please see our November 20, 2017, memorandum titled "Preparing for Tax Reform: The Current State of Play on Proposed Changes to Executive Compensation and Employee Benefits."

Note Results of Say-on-Frequency Votes and Reporting Requirements

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. For companies that held an initial say-on-frequency vote in 2011 (the first year in which say-on-pay was applied), the 2017 proxy season marked the second occurrence of such a required vote.

In 2017, shareholders supported annual say-on-pay frequency voting in 91 percent of companies. This marks a 10 percentage-point increase from the initial say-on-pay frequency vote of 81 percent in 2011. Triennial say-on-pay frequency voting received 8 percent approval in 2017, down from 19 percent approval in 2011. Biennial say-on-pay voting received less than 1 percent approval in 2017, which is consistent with the 2011 results.

For companies that held an initial say-on-frequency vote in 2012, the 2018 proxy season will mark the second occurrence of such a required vote. Shareholders may vote for one-, two- or three-year periods between say-on-pay votes or to abstain from voting. While it is expected that most companies will propose annual frequency, a company with a history of high shareholder support for say-on-pay proposals may seek to propose biennial or triennial frequency.

Within four days following the annual meeting of the shareholders, a company must file a Form 8-K disclosing the results of the say-on-frequency vote. The disclosure must state the number of votes cast for each of "one year," "two years," and "three years," as well as the number of abstentions. Although the say-on-frequency vote is advisory in nature, companies also must disclose the decision of the board of directors regarding the frequency of future say-on-pay votes in an 8-K filing. The SEC permits a company up to 150 calendar days after the annual shareholder meeting (but no later than 60 days prior to the deadline for shareholder proposals for the next year) to decide and disclose their decision on future say-on-pay frequency votes.

Finalize Adoption of New Revenue Recognition Standards

The much-discussed new revenue standards jointly issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) to harmonize revenue recognition standards between U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS) will become effective for annual reporting periods beginning after December 15, 2017. As a result, calendar year companies will need to commence reporting under the new standard beginning with their Forms 10-Q for the quarterly period ending March 31, 2018. The new common revenue recognition standard is set forth in Accounting Standards Update No. 2014-09, "Revenue From Contracts With Customers (Topic 606)" and IFRS 15, "Revenue From Contracts With Customers."

Adoption Methods

Companies may choose between two adoption methods. Under the modified retrospective method, a company is required to reflect the cumulative effects of the new standard on its financial statements in its first-quarter 2018 Form 10-Q, but does not need to revise historical periods that pre-date adoption. Accordingly, the company's 2017 and 2016 financial statements will not need to be revised at the time it files its 2018 Form 10-K. Under the full retrospective method, a company is required to revise all historical periods included in the reported financial statements to reflect the new standard. For example, a company that uses the full retrospective method will be required to apply the new standard to its first-quarter 2018 financial statements in its Form 10-Q and retrospectively revise the comparable first-quarter 2017 financial statements therein. Similarly, in its 2018 Form 10-K, the company will be required to apply the new standard to its 2018 financial statements and retrospectively revise its 2017 and 2016 financial statements therein.

Transition Disclosure

It appears that many calendar year companies have heeded the various public admonitions from the SEC staff and used the third-quarter Form 10-Q to provide expanded disclosure of their progress on implementation of the new standard, as well as the quantitative (to the extent reasonably estimable) and qualitative impacts of the new standard. The 2017 Form 10-K will represent the last chance for these companies to revisit and enhance, as needed, their transition disclosures. As part of these efforts, companies are reminded that the audit committee should be involved to ensure that the proper internal controls over financial reporting and disclosure controls and procedures are in place to monitor the application of the new standard.

Impact on Form S-3

Companies that opt to use the full retrospective method need to consider the impact, if any, of the adoption of the new accounting standard on their access to the capital markets. As a general matter, companies are required to update previously issued historical financial statements incorporated by reference into a *new* Form S-3 to reflect a subsequent change in accounting principle. As such, companies that use the full retrospective method to adopt the new standard will be required to provide retrospectively revised historical financial statements in any *new* Form S-3 (or post-effective amendment thereto) that includes financial statements covering a period reflecting adoption of the new standard (*i.e.*, first quarter 2018 or later). To illustrate, a company that adopts the new standard as of January 1, 2018, will be required to retrospectively revise its 2017, 2016 and 2015 financial statements to reflect the new standard in a Form S-3 filed after its first-quarter 2018 Form 10-Q is filed with the SEC. Typically, this would be accomplished by filing a Form 8-K under Item 9.01 to include the revised financial statements as an exhibit. The Form 8-K automatically would be incorporated by reference into the Form S-3. It should be noted that the company in this example will be required to retrospectively revise its 2015 financial statements even though it would not otherwise be required to retrospectively revise this “fourth year” of financial statements at the time of filing its 2018 Form 10-K.

A company may conduct a shelf takedown off an effective Form S-3 filed prior to the full retrospective adoption of the new standard without revising its historical financial statements unless the company concludes that the adoption of the new standard represents a “fundamental change” under Item 512(a) of Regulation S-K (which traditionally is viewed as a very high bar). Companies, however, should confirm that their independent auditors will agree to provide comfort on the historical financial statements that have not been recast.

Assess Impact of Proxy Advisory Voting Guidelines

Proxy advisory firms ISS[6] and Glass Lewis[7] have updated certain of their voting guidelines for the 2018 proxy season. Companies should assess the potential impact of such 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.

Director Compensation

ISS has adopted a new policy providing for adverse voting recommendations for members of the board committee responsible for approving or setting nonemployee director compensation where there is a pattern (over two or more consecutive years) of "excessive" nonemployee director pay without a compelling rationale or other mitigating factors. ISS has not defined "excessive" for this purpose. Because of the two-year pattern requirement, however, this new policy will not impact ISS voting recommendations in 2018. Glass Lewis has not added a similar policy to its guidelines.

Director Attendance

ISS revised its policy regarding director attendance to exempt completely new directors, rather than analyzing their attendance on a case-by-case basis. Glass Lewis has taken a similar approach and typically does not recommend against a director who has served less than a year.

Shareholder Rights Plans (Poison Pills)

ISS has updated its policy to provide adverse voting recommendations for all directors in uncontested elections at companies where the board adopted or renewed a shareholder rights plan that was not approved or ratified by public shareholders. ISS continues to emphasize the plan's term, which is categorized as follows:

- Long-term rights plans (terms of more than one year): all nominees will receive adverse voting recommendations every year that such plan is in place without a shareholder vote, no longer distinguishing between classified and annually elected boards. In addition, a board's commitment to put a long-term rights plan to a shareholder vote will no longer be a mitigating factor.
- Short-term rights plans (terms of one year or less): the adoption of short-term rights plans will be evaluated on a case-by-case basis with emphasis on the board's disclosed rationale for adopting the rights plan without a shareholder vote.

ISS also will apply this updated policy to grandfathered companies that had adopted a rights plan before 2009. Glass Lewis has not updated its policy on rights plans, which are evaluated on a case-by-case basis based on a number of factors.

Board Responsiveness

Glass Lewis updated its guidelines on board responsiveness to company proposals that receive low shareholder support, lowering its threshold from 25 to 20 percent of adverse shareholder votes. This threshold applies to adverse votes on company proposals, such as

[6] A copy of the ISS updates are available at https://www.issgovernance.com/policy-gateway/latest-policies. For more information, please see our November 20, 2017, memorandum titled "ISS Announces 2018 Updates to US Proxy Voting Guidelines."

[7] A copy of Glass Lewis' updated guidelines are available at http://www.glasslewis.com/wp-content/uploads/2017/11/US_Guidelines_2018.pdf.

director elections or management sponsored-proposals, as well as votes in favor of shareholder proposals. Glass Lewis will continue to consider this threshold in determining the board's responsiveness to shareholder concerns when recommending for or against management's recommendations.

Other Updates

As covered in other sections of this checklist, ISS and Glass Lewis also have announced other changes. Both have formalized their positions regarding board diversity and updated their policies regarding shareholder proposals, such as those that concern climate change risk and gender pay gap. ISS also formalized its position on recommending negative votes against committee members who oversee excessive pledging, and Glass Lewis announced its approach on virtual annual shareholder meetings.

Prepare for Changes to Auditor Reports

In October 2017, the SEC approved the Public Company Accounting Oversight Board's (PCAOB) new model for auditor reports required to accompany audited financial statements in SEC filings. As a result, auditor reports related to audited financial statements for fiscal years ending on or after December 15, 2017, including in annual reports on Form 10-K, will need to reflect a number of changes. Those changes, which are intended to make auditor reports more useful to investors, include:

- a statement disclosing the year in which the auditor began serving consecutively as the company's auditor;
- a statement that the auditor is required to be independent;
- the phrase "whether due to error or fraud," when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financials are free of material misstatements;
- titles for each section of the report;
- the pass/fail opinion as the first section of the report under the heading "Opinion on the Financial Statements," immediately followed by a section titled "Basis for Opinion"; and
- the company's shareholders and board of directors or equivalents as the report's addressees (additional addressees are permitted).

As we discussed in our June 7, 2017, memorandum titled "Accounting Oversight Board Adopts New Model for Auditor Reports," a more significant addition to auditor reports — mandatory disclosure of "critical audit matters" (CAMs) from the current period audit or a statement that there were no CAMs — also was proposed by the PCAOB and subsequently approved by the SEC. That addition, however, will not be required until the filing of audited financial statements for fiscal years ending on or after June 30, 2019 (for large accelerated filers) or fiscal years ending on or after December 15, 2020 (for all other filers subject to the CAMs requirement).

In anticipation of the more immediate requirements, companies should consult with their auditors to understand how precisely their auditor reports will change and request the opportunity to review a draft of the report sufficiently in advance of its filing with the SEC. In addition, audit committees of companies with long-tenured auditors should consider enhancing their audit committee reports to explain the benefits of maintaining a long-term relationship with their auditors, such as greater institutional knowledge, higher-quality audits and fee efficiency, and describing the controls in place to ensure auditor independence. Finally, we recommend that companies consider requesting auditors provide insights into what CAMs could have been included in the auditor reports issued in connection of the audit of the 2017 and 2018 financial statements. This process will give audit committees an opportunity to plan for when the CAM disclosures will be required.

Reconsider SEC Guidance and Recent Trends in Cybersecurity-Related Matters

There have been a number of companies recently impacted by high-profile cybersecurity matters. Those matters have raised questions about whether additional and earlier public disclosures should have been made, company policies and procedures should be revised, and the SEC should amend its rules in response to these continued threats. Indeed, in connection with an announcement of a cybersecurity incident involving the SEC's EDGAR (Electronic Data Gathering, Analysis and Retrieval) filing system, SEC Chairman Jay Clayton reminded companies that they "should consider whether their publicly filed reports adequately disclose information about their risk management governance and cybersecurity risks, in light of developments in their operations and the nature of current and evolving cyber threats" and "must take their periodic and current disclosure obligations regarding cybersecurity risks seriously."[8]

It is unclear whether the SEC will take further steps to address the increased cybersecurity risks. Certain senior SEC staff members have recently stated that consideration is being given to this issue. In the meanwhile, we recommend that companies reconsider prior SEC staff guidance related to cybersecurity matters and whether any of the company's disclosure, communication, insider trading or other policies should be revised to address cybersecurity risks.

In October 2011, the staff of the SEC's Division of Corporation Finance issued guidance to assist companies in assessing what disclosures should be provided with respect to cybersecurity risks and cyber incidents and how cybersecurity risks and their impact should be described in SEC filings.[9] Although there is no SEC disclosure requirement explicitly referring to cybersecurity risks and cyber incidents, the staff guidance noted that a number of existing disclosure requirements may impose an obligation to disclose such matters. Those requirements could include the disclosures related to risk factors, management discussion and analysis (MD&A), the business and legal proceedings descriptions, and the notes to the financial statements.

Companies also should reevaluate disclosure policies and internal communication protocols to ensure that cybersecurity incidents are considered in a timely manner by company personnel with the required expertise to advise on these matters and that information regarding these incidents is shared internally with those individuals at the company responsible for disclosure decisions, trading restrictions and other related matters. Decisions as to whether or when to publicly disclose information regarding a cybersecurity incident or to restrict trading in company securities should be carefully evaluated by senior management.

[8] *Statement on Cybersecurity*, issued by Chairman Jay Clayton (Sept. 20, 2017).

[9] CF Disclosure Guidance: Topic 2 (Cybersecurity), Oct. 13, 2011.

Assess Recent Trends in Proxy Access Proposals and Bylaw Provisions

For the third straight year, proxy access topped the list of most common governance-related shareholder proposals submitted to companies. Proposals seeking adoption of a proxy access bylaw almost universally achieve majority support (excluding controlled or quasi-controlled companies and proposals not opposed by the board), receiving approximately two-thirds of votes cast. At the one company where the proposal fell short of majority support, the proposal nevertheless received support at 49.6 percent of votes cast. In contrast, shareholder proposals seeking amendments to proxy access bylaws containing customary provisions have universally failed to achieve majority support.

Response From Shareholders

The voting results above demonstrate a level of investor satisfaction with "middle of the fairway" proxy access bylaws. Such bylaws generally include: an ownership requirement of at least 3 percent of a company's shares for at least three years; an ability to nominate candidates for up to 20 percent of board seats, with a minimum of two nominees; a 20-shareholder limit on the ability of shareholders to aggregate to meet the 3 percent ownership requirement (with related funds counting as one shareholder for aggregation limit purposes); and loaned shares counting toward the ownership requirement so long as the shares are recallable upon reasonable notice.

In addition, although proxy access provisions may vary somewhat with respect to secondary elements of proxy access bylaws, most have similar characteristics. In particular, most require some minimum level of support for a nominee to be eligible to be renominated in subsequent years (typically 10-25 percent); most address "proxy access creep" either by counting recently elected access nominees whom the board renominates toward the maximum number of access nominees allowed in a particular year, placing a "cooling off" period on the nominating shareholders whose access nominee is elected, or both; and most address concerns regarding concurrent proxy contests, either by "cutting off" access in the event of such a contest or by reducing the number of access nominees for that annual meeting by the number of advance notice nominees submitted for the same meeting (sometimes providing for a minimum of one access nominee).

Nearly half of the shareholder proposals to amend existing proxy access bylaws in 2017 sought only a single amendment — to change the aggregation limit from 20 shareholders to 40 or 50 shareholders, or to eliminate the aggregation limit altogether. The other approximately half sought multiple amendments — typically elimination of any aggregation limit, an increase of the number of access nominees from 20 percent of board seats to 25 percent, and removal of any limitations on the renomination of proxy access candidates. For those amendment proposals that made it to the ballot, average voting results were substantially similar for both types of proposals — approximately 28 percent of votes cast.

SEC Staff Response

For companies seeking to exclude proxy access proposals from their proxy statements, the SEC staff's no-action process regarding such proposals may have attained some degree of predictability (with the important caveat that every proposal and response should be analyzed on its own merits). In this respect, companies have continued to be able to exclude as "substantially implemented" proposals to adopt proxy access (typically 3 percent, three years, 25 percent of the board and no aggregation limit) by adopting a proxy access bylaw with 3 percent/three-year ownership requirements, a 20-shareholder aggregation limit and providing access for 20 percent of board seats. Companies also have been able to exclude as "substantially implemented" proposals to amend aggregation limits from 20 shareholders to 40 or 50 shareholders by providing company-specific data to support the view that the company already has provided its shareholders with a meaningful proxy access right. In comparison, companies have been unable to exclude proposals as "substantially implemented" whenever the proposal sought only to eliminate a shareholder aggregation limit or when the company has not shown it adopted at least some of the proposed changes.

Consider Shareholder Proposal Trends and Developments

We also recommend that companies consider recent trends and SEC staff guidance in preparing for non-proxy access-related shareholder proposals submitted for inclusion in company proxy materials.

Governance Proposals

After proxy access, requests for an independent board chair were the most common governance-related shareholder proposal in 2017, with approximately 50 proposals submitted to a shareholder vote in 2017. Average support continues to remain around 30 percent of votes cast, however, with no proposals receiving majority support during the season.

Requests for the right of shareholders to call a special meeting and the right to act by written consent also were popular among shareholder proposal governance topics. Three of the four proposals seeking a new right to call a special meeting received majority support in 2017. Generally, companies require shareholders to hold 25 percent of the company's outstanding common stock to call a special meeting. Nineteen proposals sought to reduce the 25 percent ownership requirement to 10 percent or 15 percent, but with average support for these proposals just below 41 percent, only one of these proposals received majority support during 2017.

Proposals calling for the ability to act by written consent generally have not passed at companies already affording shareholders the right to call a special meeting. All three of the 15 written consent proposals that received majority support in 2017, however, were at such companies, showing that a special meeting right alone may not be sufficient to defeat such proposals. More broadly, average support for written consent proposals increased over four percentage points in 2017 to over 45 percent of votes cast.

Other successful governance-related shareholder proposals continue to include calls for the elimination of supermajority voting requirements, majority voting in uncontested director elections and board declassification. Averaging majority support, all three categories of proposals generally pass when included on a company's ballot.

Board Diversity Proposals

Approximately 37 proposals calling for a report on steps to increase board diversity or for the adoption of a board diversity policy were submitted to companies in 2017, compared to 28 proposals in 2016. Consistent with the prior year, most of the board diversity proposals in 2017 were withdrawn by proponents following shareholder engagement and agreements to enhance disclosure and/or policies related to board recruitment. Two of the nine proposals that went to a vote received majority support (the boards of both companies did not have any female members) in 2017, and average levels of support increased almost six percentage points year-over-year to just over 28 percent in 2017. Given that board diversity is identified by a number of large institutional investors as a priority for portfolio companies, similar proposals and support levels are expected this upcoming season.

Climate Change Proposals

Despite a number of shareholder proposals on climate change having been submitted to companies over the past decade, proposals focusing on the subject have not fared well. In 2016 and 2017, for instance, a total of 103 proposals related to climate change went to a vote, yet those proposals averaged only 25 percent support. This past season, one variety of climate change proposal introduced in 2016 fared much better than the rest of its class. That proposal — which generally sought a report assessing the impact on the companies' portfolios of technological advances and governmental policies to limit global warming to well below 2 degrees Celsius — averaged almost 45 percent support among shareholders at 16 companies. Notably, the proposal received majority support at three companies (ExxonMobil, Occidental Petroleum and PPL Corporation). As with board diversity, climate change has been identified as a priority among certain large institutional investors, and ISS and Glass Lewis have updated their policies regarding climate change risk shareholder proposals to generally recommend in favor of proposals seeking disclosure on how the company identifies, measures and manages climate change risks. Accordingly, similar proposals and support levels are expected this upcoming season.

Other Noteworthy Proposal Topics

Political contributions and lobbying activities remain high on the list of proposal topics — with around 100 proposals submitted in each of the last six years. Despite their prevalence, proposals that make it to a vote receive on average only about 25 percent support.

Finally, proposals concentrating on diversity outside of the boardroom and on gender pay equity are on the rise. ISS has highlighted such concerns and announced that ISS would review shareholder requests for gender pay information on a case-by-case basis by considering factors that include the company's current diversity and inclusion policies, any recent instances of gender pay gap controversies or actions, and how the company compares to its peers.

Twenty-nine proposals related to discrimination and diversity issues were submitted in 2017, compared to 17 proposals in 2016; and 21 proposals concerning gender pay equity were submitted in 2017, compared to 13 proposals in 2016. Slightly more than half of those proposals did not make it to a vote in 2017, as many companies that received such proposals agreed to revise their policies and/or enhance their disclosures to address proponents' concerns. The nine (of 10) diversity proposals that made it on the ballot and with respect to which voting results have been published averaged slightly more than 30 percent support, and the 13 gender pay proposals that went to a vote in 2017 averaged approximately 13 percent support.

New Staff Guidance on Rule 14a-8

In early November 2017, the staff of the SEC's Division of Corporation Finance issued important new guidance concerning the review of no-action requests to exclude shareholder proposals.[10] In particular, Staff Legal Bulletin No. 14I (SLB 14I) expresses the SEC staff's views related to the application of the ordinary business and relevance exclusions; proposals submitted on behalf of shareholders; and the use of graphs and images in proposals. Below are highlights from SLB 14I.[11]

- **Ordinary business and relevance exclusions.** SLB 14I expresses the view that a board's consideration of the issues raised by a shareholder proposal may be helpful to the staff's analysis of whether a proposal focuses on a significant policy issue with a sufficient nexus to a company's business under Rule 14a-8(i)(7) and/or whether a proposal is "otherwise significantly related to the company's business" under Rule 14a-8(i)(5). As a result, companies will need to consider whether having the board or a board committee consider, and make a determination regarding, the significance of an issue to the company's business would benefit the company's chances of excluding a shareholder proposal.
- **Proposals by proxy.** SLB 14I states that it may be possible to exclude a proposal purportedly submitted on behalf of a shareholder (known as a "proposal by proxy" submission) when the proponent does not provide sufficient proof of an agency relationship between itself and the shareholder. In order to exclude a proposal on this basis, a company must notify the proponent of the specific deficiency within 14 calendar days of receiving the proposal so that the proponent has an opportunity to cure the defects. SLB 14I provides a brief list of documentation that the staff generally would expect to sufficiently demonstrate that a proponent has the authority to submit a proposal on a shareholder's behalf.
- **Graphs and images in proposals.** Consistent with no-action letter precedent, SLB 14I expresses the view that graphs and images do not violate the 500-word limit in Rule 14a-8(d). The staff noted, however, that words contained in graphs and images would be counted toward the 500-word limit and that graphs and images still may be excludable under Rule 14a-8(i)(3) if they are materially false and misleading.

[10] Staff Legal Bulletin No. 14I (November 1, 2017) is available at https://www.sec.gov/interps/legal/cfslb14i.htm.

[11] For more detail, please see SLB 14I (link available above) and our November 6, 2017, memorandum titled "SEC Staff Issues New Shareholder Proposals Guidance."

Assess Recent Requests for Increased Environmental, Social and Governance Reporting

Requests for companies to focus on environmental, social and governance (ESG) reporting processes, oversight and disclosure have grown recently as certain investors have increasingly argued that ESG factors have become integrated into financial analysis as a means to evaluate risks and opportunities.[12] For purposes of these matters, "ESG" generally refers to a wide range of issues, including climate change and measures of a company's carbon emissions, labor and human rights policies, and board diversity and shareholder engagement initiatives under the corporate governance component. Large institutional investors, including BlackRock, Vanguard and State Street Global Advisors, have encouraged companies to adopt specific ESG strategies, report on climate change issues, and enhance climate competency at the management and board levels.[13]

SEC Request for Feedback

The SEC also has requested feedback as to whether it should adopt specific rules related to ESG reporting. In April 2016, the SEC issued a concept release titled "Business and Financial Disclosure Required by Regulation S-K" (Concept Release) seeking public input on modernizing the disclosure requirements in Regulation S-K.[14] In that release, the SEC requested "feedback on which, if any, sustainability and public policy disclosures are important to an understanding of a registrant's business and financial condition and whether there are other considerations that make these disclosures important to investment and voting decisions." The SEC has not announced any plans to propose new rules based on the feedback it has received in response to this request. And, under the current SEC leadership, we do not expect any such new rules to be proposed.

Matters to Consider

We believe companies should assess these requests for additional ESG reporting and changes to company processes and determine if any actions should be taken in response. As part of those considerations, companies should identify whether any of their shareholders have called for additional reporting or changes and, if so, engage with those shareholders to better understand what specific steps those investors think the company should take. For instance, there are a number of ESG reporting standards that a company could choose to adopt. The Sustainability Standards Board (SASB) is one of the organizations that has established sustainability accounting standards relating to the public disclosure of material sustainability information. The Global Reporting Initiative (GRI) has published another set of sustainability reporting standards. Moreover, the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) published an international framework with recommendations for voluntary climate-related financial disclosures in June 2017, which resulted from the TCFD's study of stakeholder engagement on ESG issues and existing climate-related disclosure regimes.[15] Companies that decide to provide additional ESG reporting will need to assess the potential materiality of any ESG-related disclosures and determine whether they should adopt established standards and industry recommendations.

[12] See SEC's Concept Release titled "Business and Financial Disclosure Required by Regulation S-K" (April 13, 2016) available at https://www.sec.gov/rules/concept/2016/33-10064.pdf. For additional guidance, refer to BlackRock, Inc.'s article titled "Exploring ESG: A Practitioner's Perspective" (June 2016) available at https://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-exploring-esg-a-practitioners-perspective-june-2016.pdf.

[13] For additional information, refer to https://www.blackrock.com/corporate/en-gb/about-us/investment-stewardship and https://www.blackrock.com/corporate/en-us/investor-relations/larry-fink-ceo-letter; https://about.vanguard.com/investment-stewardship/governance-letter-to-companies.pdf; https://www.ssga.com/investment-topics/environmental-social-governance/2017/2016-Annual-Stewardship-Report-Year-End.pdf.

[14] https://www.sec.gov/rules/concept/2016/33-10064.pdf.

[15] https://www.fsb-tcfd.org/publications/final-recommendations-report.

Consider Recommendations to Increase Board Diversity

We recommend that companies consider recommendations by certain market participants to increase the diversity of their board members, as well as enhance related disclosures in the annual proxy statement. While the gender of board members has been the primary focus of these diversity efforts, proponents also continue to highlight the importance of the age, race, ethnicity, culture, experience and education of board members. Board diversity is expected to be a key corporate governance focus of the 2018 proxy season.

Investor Interest

The push to improve board diversity remains the focus of a number of institutional investors. BlackRock has emphasized gender balance in the boardroom as one of its engagement priorities for 2017-18, indicating that it may vote against members of the nominating committee "if there is no progress within a reasonable time frame." State Street announced a similar position and, in 2017, voted against re-election of board members at nearly 400 companies that did not have at least one female director. Vanguard has announced that it expects companies to discuss — in both their public disclosures and their engagement with investors — their plans to incorporate appropriate diversity over time in their board composition.

Several institutional investors also have contacted companies directly to engage on the topic of board diversity. The California Public Employees' Retirement System (CalPERS) sent letters to over 500 Russell 3000 companies requesting each company to develop and disclose corporate board diversity policies and implementation plans. In addition, the Office of the New York City Comptroller continued its campaign to make boards "more diverse, independent, and climate-competent" through its "Board Accountability Project 2.0." The comptroller sent letters to 151 companies that either adopted proxy access or had a majority-supported proxy access proposal in 2017, requesting disclosure of specific qualities of their directors in a standard matrix, including, among other things, gender and race.

Legislative and Regulatory Actions

The topic of board diversity also has been the subject of increased legislative focus at the federal and local levels. A growing number of members of Congress, including several from the House of Representatives, have called on new SEC Chairman Jay Clayton to continue efforts by his predecessor, Mary Jo White, to develop and propose new corporate board diversity rules to expand company disclosure requirements. Although the SEC has not yet proposed any changes, Chairman Clayton's statements during his nomination process indicate his support for gender diversity specifically and board diversity more generally. State and municipal legislatures also continue to propose measures in support of increased board diversity. Following in the steps of California, Illinois and Philadelphia, Pennsylvania, the commonwealth of Massachusetts has called on companies to put at least three women on their boards sized nine or greater by the year 2018 through a nonbinding resolution that was passed by unanimous vote in 2015.

Response to Shareholder Proposals

In addition, an increasing number of shareholder proposals relate to companies' diversity policies, which have generated greater shareholder engagement and support. Of the proposals that reached a vote last year, two received majority support from shareholders. Although overall support is limited, ISS' 2017-18 Governance Principles Survey suggests that 69 percent of investor respondents may consider it problematic if there are no female directors on a public company board, in which case many of those respondents indicated that they may consider it appropriate to engage with the company. Although ISS announced that it will not make an adverse vote recommendation if a board lacks such diversity, ISS will identify in its reports where a board has zero female directors, and a focus on general board diversity is now included in ISS' fundamental voting principles for director nominees.

Similarly, Glass Lewis has announced that it will continue to consider board gender diversity as a factor when evaluating the oversight structures of companies. In 2018, Glass Lewis will not make voting recommendations solely on the basis of board diversity, but, starting in 2019, it will generally recommend voting against the nominating committee chair of a board with no female members.

Companies considering whether to adopt or change board diversity policies should be mindful of the related SEC disclosure requirements, which require companies to state in their annual proxy statements whether, and if so how, diversity is considered in identifying director nominees, as well as describe 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.

Assess Impact of SEC Staff Comments and Enforcement Trends

Although a recent study by EY indicates that the annual number of comment letters issued by the SEC Division of Corporation Finance staff on company filings has decreased approximately 40 percent since 2014,[16] more than 50 percent of SEC registrants received comments from the staff on their filings in the last year. Those comment letters continue to focus on certain key topics in their filing reviews. The most common of those topics are non-GAAP financial measures and MD&A disclosures.

Non-GAAP Financial Measures

As is commonly known, the SEC staff provided updated guidance in May 2016 concerning the disclosure of non-GAAP financial measures that resulted in a significant impact on company disclosures. The issuance of that guidance was followed by greater scrutiny of the use of non-GAAP financial measures by the SEC staff. The staff has recently announced that it believes that its guidance had the impact the staff intended and, as a result, it does not believe that the topic will continue as a focus of filing reviews. Nevertheless, companies should continue to ensure that disclosures of non-GAAP measures comply with the applicable SEC rules and staff guidance.

MD&A Disclosures

In addition to Division of Corporation Finance staff comments on filing reviews, the SEC Division of Enforcement staff has continued to focus on disclosure-related matters. Those matters have included actions based on the alleged failure to comply with the SEC requirements for disclosures related to loss contingencies, MD&A and non-GAAP financial measures. In one recently settled matter involving the alleged failure of the CEO and CFO to adequately address the company's liquidity and capital resources in the MD&A,[17] the SEC relied on its 2003 interpretative guidance that requires the MD&A to include disclosure of trends and uncertainties "unless a company is able to conclude either that it is not reasonably likely that the trend, uncertainty or other event will occur or come to fruition, or that a material effect on the company's liquidity, capital resources or results of operations is not reasonably likely to occur."[18] This disclosure threshold is different from the general materiality standard of probability and magnitude.

Companies should continue to revisit their MD&A disclosures to ensure that they appropriately emphasize material information and describe all known trends and uncertainties reasonably likely to have a material effect on the company's financial condition or results of operations. As the SEC highlighted in the settled matter described above, known trends and uncertainties should be disclosed when it is reasonably likely they will occur. Companies also should review other areas of their disclosures, such as their risk factors, to determine whether these other disclosures suggest the existence of known trends and uncertainties not discussed in MD&A and revise their disclosures accordingly.

[16] EY's SEC Reporting Update — 2017 Trends in SEC Comment Letters (Sept. 25, 2017).

[17] https://www.sec.gov/litigation/admin/2017/34-80947.pdf.

[18] SEC Release No. 33-8350 (Dec. 19, 2003).

Review and Consider Updates to D&O Questionnaires

Companies should annually review their director and officer (D&O) questionnaires to consider any regulatory or other updates. Although there have been no significant regulatory developments in 2017 that require revision for compliance purposes, companies may want to consider revisions relating to key corporate governance trends, including those described below.

Proxy Access

Companies that have adopted proxy access bylaws, which now include over 60 percent of S&P 500 companies, should consider whether such bylaws (or related changes) require director nominees to make certain representations that should be made as part of the D&O questionnaire. Such bylaws may require director nominees, including those nominated by a shareholder or the company's board of directors, to make certain undertakings or representations in order to be eligible for election or re-election as director of the company. For example, a nominee may be required to agree not to enter into any arrangement with a third party to receive any compensation, reimbursement or indemnification or to vote on a specific matter than as otherwise previously disclosed to the company. Revisions to D&O questionnaires for this reason are not always necessary, as it depends on a company's own facts and circumstances, including its existing procedures for onboarding director nominees.

Diversity and Skills

In light of recent pressures from institutional investors and other stakeholders to advance board diversity, companies that plan to provide more robust disclosures in their annual proxy statements should revise D&O questionnaires accordingly. For example, if companies intend to disclose a form of the diversity and skills matrix requested by the Office of the New York City Comptroller, the company will need certain additional information from each director, including specific skills and experiences, board tenure, sexual orientation, gender, age, race or ethnicity. Companies may want to solicit such information through the D&O questionnaire process.

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.

Cover Page

On March 31, 2017, the SEC adopted technical amendments to existing rules and forms to conform them to certain provisions of the JOBS Act and related SEC staff interpretations.[19] Importantly, the technical amendments result in changes to the cover pages of certain registration statements and Securities Exchange Act (Exchange Act) reports, including annual reports on Forms 10-K and 20-F, to require the addition of two check boxes to allow companies to indicate (i) whether, at the time of filing, the company is an "emerging growth company" (EGC) and (ii) whether it has elected not to use the extended transition period for an EGC to comply with any new or revised financial accounting standards. All companies must comply with the modified cover pages when filing the affected forms regardless of their EGC status. As a result, companies should ensure they are using the new SEC form cover pages that include these two new EGC-related boxes when filing their upcoming annual reports.

In addition, the SEC adopted new rules to implement the statutory inflation adjustments, as required under the JOBS Act, to revise the definition of an EGC under Rule 12b-2 of the Exchange Act to raise the annual gross revenue threshold to qualify as an EGC from $1 billion to $1.07 billion. The adjustments fulfill a JOBS Act mandate to index to inflation every five years the annual gross revenue threshold to determine EGC status.

For additional information regarding the scope of the impacted forms and other technical amendments for certain self-executing provisions of the JOBS Act and certain related SEC staff interpretations that exempt EGCs from, or subject them to reduced, compliance with certain regulatory requirements, refer to our April 6, 2017, memorandum titled "SEC Adopts EGC Inflation Adjustments and Other Technical Amendments Under the JOBS Act."

Exhibit Hyperlinks

The SEC rules requiring hyperlinked exhibits in SEC filings took effect for most public companies on September 1, 2017.[20] The rules apply to a number of specified filings, including annual reports on Form 10-K and 20-F, as well as registration statements and Exchange Act reports that are required to include exhibits under Item 601 of Regulation S-K. If an exhibit is incorporated by reference, then an active hyperlink to the exhibit separately filed on the EDGAR system is required.

The filings must be supported in HTML format instead of ASCII format, as ASCII does not support hyperlinking. As a result, while the affected registration statements and Exchange Act reports will be required to be filed in HTML, companies may continue to file in ASCII any schedules or forms that are not subject to the exhibit filing requirements under Item 601 of Regulation S-K, such as proxy statements, Form 6-K or the multijurisdictional forms used by Canadian issuers. Smaller reporting companies and non-accelerated filers that submit filings in ASCII format do not have to comply with the new rules until September 1, 2018.

Importantly, the rules instruct companies on how to address inaccurate or nonfunctioning hyperlinks in their filings. In the case of a registration statement that is not yet effective, registrants must correct the error by filing a pre-effective amendment to such registration

[19] https://www.sec.gov/rules/final/2017/33-10332.pdf.

[20] https://www.sec.gov/rules/final/2017/33-10322.pdf.

statement, and, in the case of an effective registration statement or an Exchange Act report, the registrant must correct the error in the next Exchange Act report that requires or includes an exhibit pursuant to Item 601 of Regulation S-K (or in the case of a foreign private issuer, pursuant to Forms 20-F and F-10). Note that the rules provide that an inaccurate hyperlink by itself will not render a filing materially deficient or affect a registrant's eligibility to use short-form registration statements, such as Forms S-3 and F-3.

Finally, with respect to the placement of the exhibit index, whereas Item 601(a)(2) of Regulation S-K and Rule 102(d) of Regulation S-T previously required the exhibit index to precede immediately the exhibits filed with such registration statement or document, the amended rules now require the exhibit index to appear before the required signatures in the registration statement, report or document. Accordingly, companies are not required to provide a separate exhibit index with hyperlinks following the signature page.

Given that the list of exhibits included in annual reports on Forms 10-K and 20-F are typically more extensive than those contained in registration statements and other Exchange Act reports, companies should begin to review the exhibits that will be filed with and incorporated by reference into their annual reports in advance of their respective 2018 filing deadlines to ensure that hyperlinks are appropriately included in the list of exhibits. In addition to reviewing last year's annual report exhibit index, updating for new exhibits and confirming that all exhibits incorporated by reference from registration statements and Exchange Act reports include accurate hyperlinks, companies should consider contacting their financial printer, EDGAR filing agent or EDGAR filing software provider, to the extent not already done so in connection with Forms 10-Q for their most recent periodic or current report, to confirm that their annual report exhibit indexes are appropriately included with the annual report filing.[21]

[21] For additional guidance, the EDGAR Filer Manual, Volume II, Version 43, Section 5.4.2 Exhibits (September 2017) is available at https://www.sec.gov/info/edgar/edgarfm-vol2-v43.pdf.

Consider Recent Trends in Virtual Shareholder Meetings

In recent years, an increasing number of companies have embraced the use of virtual annual shareholder meetings. Virtual meetings generally take on two forms: a virtual-only meeting or a hybrid approach, which involves both an in-person and a virtual participation component.

Broadridge Financial Solutions, an investor communications firm and a provider of a virtual meeting platform, reported that, during 2016, 187 companies held virtual meetings, of which 155, or 83 percent, were virtual-only meetings, as compared to 67 percent virtual-only meetings in 2015.[22] It has been reported that 234 companies included a virtual component to their 2017 annual meetings. According to ISS' 2017-18 Global Policy Survey, the increasing prevalence of virtual meetings has generally been viewed favorably by its investor respondents, with a slight preference for a hybrid approach rather than virtual-only meetings. A majority of ISS investor respondents, approximately 87 percent, generally approve of the hybrid approach as an acceptable practice, whereas 32 percent indicate they would be comfortable with a virtual-only meeting if such meetings provided the same shareholder rights as physical meetings.

Potential Advantages

Virtual meetings present certain potential advantages to both companies and shareholders, including the ability to enhance shareholder participation through improved access without the added costs of planning or attending an in-person meeting. In addition to promoting shareholder engagement by fostering participation in a greater number of meetings throughout the typical annual meeting season, virtual meetings offer companies greater flexibility and reduced time constraints, as compared to in-person meetings, thereby encouraging companies to prepare comprehensive answers to shareholder questions and accommodate a greater number of participating shareholders during the question-and-answer segment. Finally, a company may further promote engagement among its shareholders by making available on its website a webcast or audio recording of the meeting.

State and Federal Law Considerations

A company's ability to hold a virtual meeting is a matter of state law. In particular, Section 211 of the Delaware General Corporation Law (DGCL) enables a Delaware corporation to hold its annual meeting virtually solely by means of "remote communication," although the company must "implement reasonable measures" to confirm that each person permitted to vote at the meeting is a shareholder or proxyholder and to provide such persons "a reasonable opportunity to participate in the meeting and to vote," including the ability to read or hear the proceedings on a "substantially concurrent" basis with such proceedings.[23] In addition to applicable state law, if a company's governing documents specify a physical location of the annual meeting, the company must amend its governing documents to provide for the ability to conduct the annual meeting virtually.

U.S. federal securities laws and SEC rules do not impose any requirements in connection with a virtual annual meeting, except for the solicitation of proxies. Interestingly, although not authority on the substance of virtual meetings, the SEC staff granted HP Inc. no-action relief last year to exclude from its annual meeting proxy statement a shareholder proposal requesting that the board adopt a corporate governance policy to initiate or restore in-person annual meetings on the basis that the "determination of whether to hold annual meetings in person" is related to the company's ordinary business operations.[24] Both the New York

[22] http://media.broadridge.com/documents/mkt-1956-17-vsm-article4.pdf.

[23] http://delcode.delaware.gov/title8/c001/sc07.

[24] https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2016/cheveddennaylor122816-14a8.pdf.

Stock Exchange and Nasdaq require listed issuers to hold annual shareholder meetings, but neither impose restrictions on virtual meetings. Nasdaq has stated informally that webcasts are permitted instead of, or in addition to, an in-person meeting, provided that shareholders have an opportunity to ask questions of management.

Potential Challenges

Notwithstanding some potential advantages, virtual meetings also present potential challenges in facilitating shareholder engagement. Shareholder activists and certain institutional investors, including the Council of Institutional Investors (CII), have expressed concerns that virtual meetings reduce the ability of shareholders to participate meaningfully by eliminating shareholders' ability to express concerns face-to-face with senior management and directors and engage in constructive "back and forth" dialogues on controversial issues. For these reasons, CII and CalPERS do not support virtual-only meetings, and provide in their corporate governance policies that a virtual meeting component should only supplement a traditional in-person shareholder meeting, not serve as a substitute, to "facilitate the opportunity for remote attendees to participate in the meeting to the same degree as in-person attendees."[25]

The Office of the New York City Comptroller, however, has taken a more aggressive position against virtual-only meetings by adopting a change to its proxy voting guidelines to vote against all incumbent directors of a governance committee subject to election at a virtual-only meeting because in-person meetings, according to the comptroller, provide shareholders the opportunity to engage with senior management and directors face-to-face at least once per year.[26] Similarly, Glass Lewis recently announced that beginning in 2019, it will generally recommend voting against all incumbent directors of the governance committee at companies planning to hold virtual-only meetings unless companies provide assurances through proxy statement disclosure that shareholders will be afforded the same rights and opportunities to participate as they would be at an in-person meeting.[27]

Furthermore, although proxy advisory firms such as ISS and Glass Lewis have not published policies against virtual meetings in their guidelines, ISS has indicated it may make adverse recommendations if companies use virtual meetings to frustrate meaningful shareholder participation and engagement directly with senior management and directors. Finally, in addition to shareholder engagement challenges relating to communication concerns, a virtual-only meeting may create greater uncertainty in shareholder voting because shareholders are provided greater flexibility to delay or change votes electronically. This type of shareholder engagement issue is an important consideration for companies engaged in a contested solicitation because it may impact a company's solicitation strategy depending upon preliminary voting results.

Matters to Consider

Companies considering whether to add virtual components to their annual shareholder meetings should consider the points noted above. They also may want to review the "Guidelines for Protecting and Enhancing Online Shareholder Participation in Annual Meetings" published by a group of institutional investors and public company representatives, as well as proxy and legal service providers.[28] The guidelines suggest, among other things, that companies:

- adopt safeguards and mechanisms to protect shareholder interests and ensure online participation and interaction that would otherwise be available at in-person meetings;
- establish procedures to verify meeting participants as shareholders and proxyholders and enable online voting; and
- confirm, from a logistical perspective, that the technology platform is functioning properly and technical support operations are prepared in advance.

[25] https://www.calpers.ca.gov/docs/forms-publications/global-principles-corporate-governance.pdf; http://www.cii.org/corp_gov_policies.

[26] https://comptroller.nyc.gov/newsroom/comptroller-stringer-virtual-only-meetings-deprive-shareowners-of-important-rights-stifle-criticism.

[27] http://www.glasslewis.com/wp-content/uploads/2017/11/US_Guidelines_2018.pdf.

[28] http://www.calstrs.com/sites/main/files/file-attachments/shareholder_participation_annual_meetings.pdf.

Comply With New IFRS XBRL Tagging Requirement

In March 2017, the SEC published the long-delayed IFRS Taxonomy.[29] As a result of the availability of the taxonomy, foreign private issuers that prepare their financial statements under IFRS as issued by the International Accounting Standards Board (IASB) must file their financial statements in eXtensible Business Reporting Language (XBRL) for fiscal years ending on or after December 15, 2017.

XBRL is a technology for tagging data to identify and describe information in a company's financial statements. The interactive data format makes a company's financial statements machine-readable so they can be downloaded, analyzed and compared using certain software applications. The SEC had long been delayed in its efforts to develop a standard list of data tags — the "taxonomy" — for IFRS as issued by IASB.

Under the SEC rules, issuers must prepare an XBRL exhibit that contains tagged data for the face of the financial statements, the footnotes to the financial statements and the related financial statement schedules. The XBRL exhibit must be submitted with the following filings:

- Annual reports and transition reports on Form 20-F or Form 40-F.
- Reports on Form 6-K, but only to the extent the Form 6-K contains interim financial statements included pursuant to the nine-month updating requirement of Item 8.A.5 of Form 20-F or a revised version of financial statements that were previously filed with the SEC.

A company conducting an initial public offering (IPO) is not required to include XBRL data in its IPO registration statement. For subsequent registered offerings, XBRL data is only required in the registration statement if it includes (rather than incorporates by reference) financial statements and contains a price or a price range, and at any later time when the financial statements are changed (rather than in each filing or amendment). In the context of a business combination, XBRL financial information will be required for the registrant (the acquiring company) but not for the target company being acquired.

A company that maintains a public website also is required to post the XBRL data to its public website by the end of the day on which the registration statement or periodic report was filed with the SEC or was required to be filed (whichever is earlier). The XBRL data must remain on the company's website for 12 months. Companies should accomplish this by posting the relevant SEC filing to their website — merely providing a hyperlink to the SEC's website will not be sufficient for this purpose.

[29] https://www.sec.gov/rules/other/2017/33-10320.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 rule-making mandates continues to be mired in delay. It is increasingly unclear when or whether these remaining mandates — hedging disclosures, pay-versus-performance and clawback provisions — will be finalized. In fact, perhaps because of the change in leadership at the SEC and the vote by the House of Representatives to approve the Financial CHOICE Act of 2016 to repeal provisions of the Dodd-Frank Act, the SEC downgraded the status of these rule proposals to "long-term actions" from "proposed rule stage," informally indicating that the SEC does not intend to take action on the proposals in the next 12 months.

Although the SEC is not expected to advance the expected Dodd-Frank Act required rule-making provisions, in October 2017, the SEC proposed changes that would modernize and simplify the disclosure items in Regulation S-K and related rules and forms. The proposed amendments included changes to Regulation S-K Item 102 to provide that a description of a company's physical properties only will be required if the properties are material to the company and to Regulation S-K Item 303(a) to reduce the period-to-period comparison required in MD&A from three to the two most recent fiscal years. In addition, the proposed amendments would fundamentally change the existing, burdensome process companies are required to follow to redact and request confidential treatment for certain information included in SEC filings. The proposed changes reflect a push by the SEC to reduce costs and burdens on public companies while continuing to ensure all material information is provided to investors. It is unclear whether these changes will be adopted, but changes are not expected until any earlier than late 2018.

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. If the business criteria for performance goals under a plan were last approved in 2013, such criteria will require shareholder approval in 2018. Companies should also 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. Companies also should review the status of the members of the compensation committee to ensure they are independent and qualify under Section 162(m). Moreover, any proxy disclosures relating to Section 162(m) should be carefully reviewed to implement executive compensation programs, including the ability to award nondeductible compensation.

The 2017 Tax Cuts and Jobs Act contains proposed amendments to Section 162(m) which, if enacted, may significantly affect executive compensation practices and required disclosures in subsequent years. Proposed changes include eliminating the exclusion of performance-based compensation and commissions from the $1 million compensation deduction limitation under Section 162(m). In addition, the covered employees subject to Section 162(m) would be expanded to include the CFO, the three other most highly compensated officers who are named executive officers for the taxable year, and each individual who was a covered employee for any taxable year beginning after December 31, 2017.

For more information about the potential impact of the Tax Cuts and Jobs Act on Section 162(m), please see our November 20, 2017, memorandum titled "Preparing for Tax Reform: The Current State of Play on Proposed Changes to Executive Compensation and Employee Benefits."

Note Recent Developments in Insider Trading Laws and Policies

There have been a number of interesting developments recently in federal insider trading laws. These developments were accompanied by a continued media interest in insider trading claims and allegations — from the Second Circuit Court of Appeals upholding the conviction of a high-profile hedge fund portfolio manager, to the demand for an investigation into the possible sale of company securities by certain executives following the disclosure of a material cyber data breach. Although these developments do not generally require specific changes to company insider trading policies and practices, we recommend that companies evaluate their policies and practices to reduce potential risks from insider trading matters.

Recent Court and Regulatory Actions

In December 2016, the United States Supreme Court held[30] that a gift of confidential information to a "trading relative or friend" is sufficient to establish a personal benefit required to hold the recipient of the tip liable under Exchange Act Section 10(b), siding with the Ninth Circuit Court of Appeals' ruling on appeal to resolve a split with the Second Circuit concerning that issue.[31] The Supreme Court ruling did not address another element of the Second Circuit ruling, though, which presumably still controls — namely that the government must prove that the trading defendant knew that the information came from an insider or that the insider received a personal benefit in exchange for the tip.

A related development on that point that arose earlier in 2016 was the successful prosecution of insider trading claims based in part on the view that an insider's failure to disclose his relationship with a trader included on a routine post-deal announcement trading investigation by the Financial Industry Regulatory Authority (FINRA) demonstrated the insider's benefit in tipping the trader.[32] Such post-announcement investigations by FINRA have become routine, and law enforcement authorities seem to have also increased the aggressiveness of their own enforcement methods. These methods have included making use of search warrants rather than subpoenas, using technological aids both new and old, such as wire-tapping and data analytics, and applying prosecutorial pressure to owners of accounts used in connection with insider trading even when the accounts owners themselves were not necessarily culpable.

While most companies' confidential information policies already will prohibit such tipping, SEC and FINRA proceedings remind employers that merely having such policies isn't enough, and that they must be observed and enforced, as well. Both the SEC and FINRA have conducted recent enforcement procedures concerning financial institutions' failures to enforce policies and procedures intended to prevent disclosure of material nonpublic information. One lesson to draw from all of these developments is that companies should be explicit with their insiders in acknowledging that *any* misuse of confidential company information can potentially give rise to insider trading violations (alongside other damaging effects), such that management must be devoted to enforcing the related policies; that substantial resources are devoted to detecting and prosecuting insider trading violations; and that the potential consequences (to both the company and the individuals involved in any scheme to violate the law) can be enormous.

[30] *Salman v. United States*, 137 S. Ct. 420 (2016). See Skadden's related December 7, 2016, memorandum titled "*Salman* Rejects Heightened Personal-Benefit Requirement in Insider Trading Prosecutions."

[31] See *United States v. Newman*, 773 F. 3d 438, 452 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015).

[32] See *How FINRA's Surveillance Helped Score a Hole in One in "Golf Lingo" Insider Trading Case* at https://www.finra.org/investors/how-finras-surveillance-helped-score-hole-one-golf-lingo-insider-trading-case.

Suggested Matters to Consider

Following on that high-level reminder, companies also should periodically review the details of insider trading policies to consider whether they continue to serve the company's needs and give due consideration to the evolution of applicable "best practices," the company's past experience with the existing policy, and other relevant considerations, such as public stances by members of the company's peer group.

Although the appropriate scope and form of any such review will be dictated by the company's particular circumstances, many companies should consider:

- whether changes in the geographic scope of the company's business or the exchanges on which its securities are traded merit reference to any specific legal framework;
- if the company's categorization of employees and other persons into groups remains appropriate (*e.g.*, whether heightened restrictions, such as compliance with a preclearance policy, are targeted at the right people);
- if the company's policy is sufficiently clear in addressing gifts and estate planning transactions in contexts where they may raise concern;
- the continuing appropriateness of the timing of recurring closed- or open-trading windows;
- whether the policy establishes when news may be considered to have become public;
- if the company should mandate trading only through Exchange Act Rule 10b5-1 trading plans for any subset of persons subject to the policy;
- whether the company should permit trading plans to be adopted (or terminated or modified) only with the advance approval of the company, or permit the use of only a company-approved form of trading plan;
- if the company should announce the adoption (or termination or modification) of trading plans by certain persons (a practice that while not widespread may nonetheless be relatively common among certain peer groups);
- whether the company should reserve the right to restrict transactions that may otherwise be permitted under the policy, such as suspending the customary exception permitting insiders to engage in transactions directly with the company during periods in which they are not otherwise allowed to trade;
- how the policy addresses pledging, hedging and derivatives securities transactions, in light of governance advocates' interest in both disclosure of such policies and their willingness to consider significant hedging and pledging to be a board oversight failure; and
- whether the company has adequate training in place to best insure compliance with the policy.

Regarding the penultimate bullet, note that ISS recently codified its position with respect to whether companies allow securities to be pledged, which is evaluated on a case-by-case basis with consideration of the magnitude and rationale, as well as efforts to wind down pledging. Since 2013, ISS has recommended votes against committee members with oversight over instances where executives or directors have raised concerns by pledging significant amounts of company stock. The new update formalizes this policy for 2018.

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