Updates
December 12, 2017
Preparing for the 2018 Public Company Reporting Season

In anticipation of the upcoming annual report and proxy season, we are highlighting new requirements and trends for public companies in 2018.

Proxy Statement and Annual Meeting Matters

CEO Pay Ratio Disclosure. With no relief in sight, it now appears that the CEO pay ratio disclosure mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act will be effective for the 2018 proxy season. Under the final rules adopted by the SEC, companies must disclose (1) the median of the annual total compensation of all employees, excluding the CEO; (2) the annual total compensation of the CEO; and (3) the ratio of these two totals. In September 2017, the SEC issued guidance to help companies comply with the new requirement.

Changes in Shareholder Proposal No Action Letter Process. On November 1, 2017, the SEC Division of Corporation Finance (Division) issued Staff Legal Bulletin No. 14I, providing additional guidance on the scope and application of two of the substantive bases for excluding shareholder proposals under Exchange Act Rule 14a-8, and on certain other matters. Companies seeking to exclude shareholder proposals under the "ordinary business" and/or "economic relevance" exceptions will need to consider these new requirements and may need to adjust their no action letter preparation timelines to provide for an appropriate level of board involvement.

"Ordinary Business" Exception—Rule 14a-8(i)(7). Rule 14a-8(i)(7) permits a company to exclude from its proxy statement any shareholder proposal that "deals with a matter relating to the company's ordinary business operations." The Division will not, however, permit exclusion of a shareholder proposal under the "ordinary business" exception if the proposal transcends the company's day-to-day business matters by raising a policy issue so significant that it would be appropriate for a shareholder vote. In the Division's view, such determinations raise difficult judgment calls, which the company's board is generally in the best position to make. Accordingly, the new guidance advises that, going forward, a company submitting a no-action request to exclude a shareholder proposal under the "ordinary business" exception is expected to include a discussion (1) reflecting the board's analysis of the particular policy issue raised and its significance and (2) detailing the specific processes employed by the board to ensure that its conclusions are well-informed and well-reasoned. Questions remain regarding how the guidance will be applied in practice, but the first example of a no-action request was made by Apple Inc. on November 20, 2017, arguing that the company should be able to exclude a shareholder proposal because its board has made a determination that the proposal is part of the company's ordinary business.

"Economic Relevance" Exception—Rule 14a-8(i)(5). The economic relevance exception, Rule 14a-8(i)(5), permits a company to exclude a shareholder proposal relating to company operations that account for less than five percent of a company's total assets, net assets and gross sales, and is not otherwise significantly related to the company's business. Companies historically have been unable to argue successfully for exclusion of a shareholder proposal under the economic relevance exception if the proposal relates to an issue of "broad social or ethical concern" and the company conducts *any* business related to the issue in the proposal. In the new guidance, the Division acknowledges that its historical application of Rule 14a-8(i)(5) unduly limited the exclusion's availability because it did not fully consider whether the proposal "deals with a matter that is not significantly related to the issuer's business" and is therefore excludable.

Going forward, the Division advises that it will focus on a proposal's significance to the company's business regardless of whether it raises broad issues of social or ethical significance. The Division's analysis will now be dependent on the particular circumstances of the company to which the proposal is submitted. For example, a proposal may be excludable under Rule 14a-8(i)(5) where a proponent fails to demonstrate that a proposal "may have a significant impact on other segments of the issuer's business or subject the issuer to significant contingent liabilities." As with the ordinary business exclusion, a company relying on the economic relevance exclusion must include a discussion in its no-action request that reflects the board's analysis of the proposal's significance to the company.

Other Matters Addressed. Staff Legal Bulletin No. 14I provides additional guidance on two other matters. First, for proposals that are submitted by a representative of the shareholder (known as "proposal by proxy"), the bulletin specifies documentation that should be provided by the shareholder describing the delegation of authority. This guidance is intended to alleviate concerns by some companies that proposals are being made without the knowledge of the actual shareholder, and to better allow companies and the Division to evaluate whether the proponent meets applicable eligibility requirements under Rule 14a-8. Second, the bulletin clarifies that Rule 14a-8(d), which limits shareholder proposals to 500 words, does not preclude the inclusion of graphs or images. The guidance does indicate, however, that words in a graphic are included in the 500-word limit, and that certain graphs or images may be excludable under other rules.

Institutional Investor and Proxy Advisor Areas of Focus

In November 2017, ISS and Glass Lewis released their 2018 proxy voting guidelines. The Glass Lewis 2018 Proxy Guidelines are available here. The ISS updates came in the form of an executive summary of its benchmark policy updates, a more detailed comparison chart showing changes to its policies, and preliminary FAQs announcing changes to its pay-for-performance quantitative analysis and equity plan scorecard. ISS plans to issue a complete set of updated policies and updated FAQs on certain policies in December, and may issue additional guidance on shareholder proposals in January 2018. Below we highlight areas of focus in these proxy advisors' guideline updates, as well as among institutional investors generally, for companies to consider as they draft their proxy statements and prepare for annual meetings.

Executive Compensation Matters. In connection with its pay-for-performance analysis, ISS is adding relative Financial Performance Assessment (FPA) as a secondary measure after the traditional three quantitative tests are calculated. Introduced in 2017 as part of the qualitative review, the FPA will compare a company's rankings to an ISS-selected peer group with respect to CEO pay and financial performance over three years. Companies should be aware that the results of the FPA may move a company between low and medium concern levels for pay-for-performance. In addition, ISS's preliminary FAQs make changes to the equity plan scorecard, including increasing the minimum points necessary to pass the model from 53 points to 55 points for all S&P 500 companies and changing several factors that previously awarded some points for partial achievement to award only full points or no points. Companies seeking shareholder approval of an equity plan in 2018 will need to consider these changes in preparing equity plan proposals.

Nonemployee Director Pay. ISS will generally recommend against members of the board committee responsible for setting nonemployee director compensation if there is a recurring pattern of awarding "excessive…compensation without disclosing a compelling rationale or other mitigating factors." ISS defines "recurring pattern" as two or more consecutive years, so the new policy will not have an impact on vote recommendations until 2019, but companies should review their ISS reports for 2018 to consider whether to make any changes to nonemployee director compensation in response to a negative ISS evaluation. Although ISS does not define excessive, it suggests that director pay will be evaluated on a basis relative to peers and the broader market.

Board Responsiveness. Both ISS and Glass Lewis made guideline changes related to board responsiveness to shareholder votes. ISS expanded its guidance on its approach to evaluating board responsiveness if a company's prior say-on-pay vote received less than 70% of the votes cast. In addition to its current policy of considering the board's response to investor concerns, ISS will now look for more detailed disclosure regarding the timing and frequency of engagements with major institutional investors, whether independent directors participated in the engagements, the specific concerns voiced by dissenting shareholders, and the specific and meaningful actions taken by the company to address the shareholders' concerns.

Currently, Glass Lewis is of the view that the board of directors generally is obligated to respond to shareholders any time 25% or more of the shareholder votes cast are contrary to the recommendation of management on a proposal at an annual meeting, particularly any proposal regarding compensation or director elections. In 2018, Glass Lewis is reducing this threshold to 20%. In light of this current focus on board responsiveness, companies receiving substantial shareholder votes opposing management's recommendations may want to consider not only increasing shareholder outreach to better understand shareholder concerns, but also supplementing proxy statement disclosures regarding this outreach process in future years.

Focus on Board Diversity. Board diversity remained a focus among major institutional investors in 2017, and these investors are beginning to back up their words with votes. In 2017, State Street Global Advisors voted against 400 nominating committee chairs at companies with no female directors and no female candidates in the company's 2017 proxy statement. Similarly, BlackRock reported that it supported eight out of nine shareholder proposals on board diversity in the second quarter of 2017, and voted against nominating committee members at five of these companies. With a broader view of diversity, the "Boardroom Accountability Project 2.0" launched by the New York City Comptroller and New York City Pension Funds sent letters to 151 U.S. companies in September 2017, calling for proxy statement disclosure of director skills and demographics (including board tenure, sexual orientation, gender, age and race/ethnicity) in a standardized disclosure matrix.

In line with this institutional investor focus, ISS revised its fundamental principles for determining votes for directors to include a statement in its principle on board composition that "boards should be sufficiently diverse to ensure consideration of a wide range of perspectives." ISS will also highlight in its voting analysis if a board has no female directors, but will not consider a lack of gender diversity in making voting recommendations.

Glass Lewis added a new section to its guidelines on board gender diversity pursuant to which, beginning in 2019, it will generally recommend voting against the nominating committee chair of a board that has no female members, and potentially against other nominating committee members, absent disclosure of a sufficient rationale or a plan to address the lack of diversity on the board. Glass Lewis may exempt companies outside the Russell 3000 Index from this policy.

Virtual-Only Annual Meetings. As we reported during the 2017 proxy season, virtual-only annual meetings have been on the rise among public companies, but some institutional investors object to the practice. In 2017, one of the most outspoken critics was New York City Comptroller Scott M. Stringer. Notably, Stringer sent letters to over a dozen S&P 500 companies in April, calling on them to cease their practice of virtual-only meetings (in contrast to "hybrid" meetings that include a live meeting with some kind of virtual access available to shareholders who do not attend in person). Glass Lewis also announced a policy, which will become effective for the 2019 proxy season, to generally recommend voting against board governance committee members of a company planning to hold a virtual-only meeting, unless the company has provided robust disclosure assuring shareholders that they will have the same rights and opportunities to participate as they would at an in-person meeting. As we noted last year, a company considering adopting a virtual-only meeting format should conduct outreach to gauge the responses of major shareholders and consider whether it has any shareholders that have publicly expressed concerns about virtual-only meetings, such as the New York City Pension Funds and CalPERS.

Climate Change Risk Disclosures. In June 2017, the Task Force on Climate-related Financial Disclosure (TCFD), created by the G20 Finance Ministers and headed by former New York City Mayor Michael Bloomberg, issued its recommendations for more effective climate-related disclosures. In the already-crowded sphere of climate-related voluntary disclosure schemes, one focus of these recommendations is that companies should provide disclosure regarding climate change-related risks and opportunities in their financial reports, rather than in separate sustainability reports. In light of the TCFD's recommendations, both ISS and Glass Lewis appear to be anticipating shareholder proposals requesting that companies report in accordance with these recommendations. ISS updated its policy on such proposals to better align with TCFD's recommendations, including transparency around the board and management's role in assessing and managing climate-related risks and opportunities. Glass Lewis codified its policy to generally recommend in favor of shareholder proposals requesting companies in extractive or energy-intensive industries to provide information concerning climate-change scenario analyses and related considerations. The policy also states that Glass Lewis is generally supportive of the TCFD recommendations, but it will review proposals requesting reporting in accordance with the recommendations on a case-by-case basis.

Other Updates. In other updates, ISS significantly revised and "simplified" its poison pill policy, including removing the grandfathered exception for poison pills with a term longer than one year adopted prior to 2009 and not approved by shareholders. ISS also added a policy regarding shareholder proposals on gender pay gap reports, providing that it will vote on a case-by-case basis on such proposals. Glass Lewis elaborated on its policy on "fix-it" proxy access proposals, providing that it will focus on whether the company's existing bylaw provisions reasonably conform with broad market practice.

Other 2018 Proxy and Annual Reporting Matters

Expanded Auditor Report Standard. In October 2017, the SEC approved a new PCAOB auditing standard, AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, intended to make public company auditor's reports more informative to investors and the public. The new auditor report standard includes certain formatting and disclosure changes that are effective for audits of fiscal years ending on or after December 15, 2017. These changes include provisions requiring statements in the auditor's report disclosing the auditors' tenure and independence, and form standardizations, including new section titles to guide readers. For a company with a long-standing auditor, management may want to consider including discussion in the proxy statement regarding the reasons that the company believes a long tenure does not impede the auditor's independence.

The most significant change in the new standard, which will not be applicable for the 2018 reporting season, is the requirement that the auditor's report disclose "critical audit matters" or CAMs.

CAMs are defined under AS 3101 as matters arising from the audit of the financial statements that have been communicated or were required to be communicated to the audit committee and that (1) relate to accounts or disclosures that are material to the financial statements and (2) involve especially challenging, subjective or complex auditor judgment. The disclosure requirements for CAMs will take effect for large accelerated filers for audits of financial statements for fiscal years ending on or after June 30, 2019. For all other applicable filers, CAMs disclosure will be effective for audits of financial statements for fiscal years ending on or after December 15, 2020. The disclosure of CAMs is not required for audits of emerging growth companies, brokers and dealers, investment companies other than business development companies, and employee stock purchase, savings and similar plans. In connection with preparing for CAMs reporting, companies should communicate with auditors in advance of the first audit for which the disclosures may be required. This preparation will help ensure that the auditor's report does not become a source for original information about the company and allow the external auditor, management and the audit committee to work through differences in opinion on CAM disclosures.

Disclosure for New Accounting Standards. Two key new accounting standards continue to loom on the horizon for most public companies: revenue recognition and lease accounting.

The new revenue recognition standard will be applicable for most companies for reporting periods beginning after December 15, 2017, and the lease accounting standard will be applicable for fiscal periods beginning after December 15, 2018. Throughout 2017, the SEC has asked companies to focus on transition disclosures in the notes to financial statements to describe the status of implementation efforts and anticipated impacts that new standards will have. This has been a common theme in several speeches by SEC Chief Accountant Wesley R. Bricker. Companies should continue to provide disclosure in their periodic reports updating investors on their preparations for both revenue recognition and lease accounting leading up to adoption of these standards.

Remember to Include New Checkboxes and Hyperlinked Exhibits in Form 10-K. The SEC implemented a few form changes over the past year that companies should keep in mind in preparing Form 10-K.

In March 2017, the SEC made cover page changes for registration statements under the Securities Act of 1933 and for current and periodic reports under the Securities Exchange Act of 1934, including Form 10-K. A company must now include two new check boxes to indicate whether, at the time of filing, the company is an "emerging growth company" (EGC) and, if it is an EGC, whether it elects not to use the extended transition period for compliance with new financial accounting standards.

The SEC also adopted amendments that became effective September 1, 2017, requiring most companies that file registration statements and reports subject to the exhibit requirements under Item 601 of Regulation S-K, including Form 10-K, to include a hyperlink to each exhibit listed in the exhibit index of the filings. Furthermore, Item 601(a)(2) of Regulation S-K was amended to require that the exhibit index be placed before the required signatures in the registration statement or report. Per the SEC's informal guidance, companies can combine the exhibit list (e.g., Item 15 of Form 10-K) with the exhibit index and place the latter, with hyperlinks, before the signature pages. A separate exhibit index (after the signature pages) is no longer required.

Congressional Review Act Eliminated Resource Extraction Payments Disclosure Rule but Conflict Minerals Report Continues. In February 2017, President Trump signed a joint resolution of Congress pursuant to the Congressional Review Act that eliminated the SEC rule adopted in 2016 that would have required resource extraction issuers to disclose payments over $100,000 made to the U.S. federal government or foreign governments for the commercial development of oil, natural gas or minerals for fiscal years ending on or after September 30, 2018.

Pursuant to the Congressional Review Act, this rule may not be reissued in substantially the same form as the nullified regulation. The Dodd-Frank Act rule requiring the SEC to issue regulations mandating resource extraction disclosure is still on the books, although there is no indication that the SEC is in a hurry to draft a replacement regulation.

In April 2017, the Division announced a no-action position with respect to all of the requirements under paragraph 1.01(c) of Form SD, including the detailed supply chain due diligence disclosure, Conflicts Mineral Report and independent private sector audit. Despite this announcement, many companies' 2016 reports filed on Form SD were similar to those they had filed in prior years, likely because the Division's guidance announced an enforcement position but did not make any change to the disclosure requirements. Unless legislative or regulatory action is taken to change the disclosure requirements, companies should continue to prepare for annual 2017 conflicts mineral disclosures, which are due May 31, 2018.

T+2 Settlement. Effective September 2017, the SEC adopted an amendment to shorten the standard settlement cycle for most broker-dealer securities transactions from three business days, or T+3, to two business days, or

T+2. For companies that issue dividends, the new settlement cycle means that ex-dividend dates are now one trading day prior to the record date rather than two trading days prior.

If you have any questions about these topics, including how they may apply to your particular situation, please contact experienced legal counsel.

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