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Preparing for the 2017 US Proxy and Annual Reporting Season

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With autumn just beginning, the proxy and annual reporting season may seem a long way off. However, in light of the amount of work and planning that goes into the proxy statement, annual report and annual meeting of shareholders, this is the ideal time to begin preparations. This post provides an overview of key issues that companies should consider as they get ready for the upcoming 2017 proxy and annual reporting season.

Say-on-Pay and Related Compensation Matters

Say-on-Pay

As a result of six years of say-on-pay voting, executive compensation has become a prominent part of the proxy season landscape. Companies have expanded shareholder engagement to encompass executive compensation issues. Many companies are devoting resources to the enhancement of design and style elements in proxy statements—employing color, graphics and plain English—in an effort to more clearly present the link between pay and performance and otherwise make the proxy statement more reader-friendly.

Since the say-on-pay vote became mandatory, shareholders generally have approved executive compensation, often by large margins. Semler Brossy, an executive compensation consultant, reports that, as of July 25, 2016, only 31 Russell 3000 companies (1.7 percent) experienced a failed say-on-pay vote in 2016. The average vote in favor of say-on-pay proposals during that time period was 91 percent. Of the 1,388 Russell 3000 companies that conducted say-on-pay votes in each year between 2011 and 2016, only 10 percent have ever had a failed say-on-pay vote (in some cases more than once); however, 28 percent have received favorable votes at a level below 70 percent at least once.

Although say-on-pay votes are usually favorable, that fact is of little comfort to companies facing the prospect of a negative, or relatively low favorable, say-on-pay vote. While negative recommendations do not always result in failed say-on-pay votes, proxy advisory firms, such as Institutional Shareholder Services (ISS) and Glass Lewis, can be very influential. Many, but not all, companies that receive a negative say-on-pay recommendation from a proxy advisory firm choose to file additional proxy materials with the Securities and Exchange Commission (SEC) that they can present to shareholders to counter the arguments made by the proxy advisory firms. Sometimes a company will make, and publicly disclose, changes to its executive compensation program in an effort to receive a favorable recommendation or obtain a favorable vote. Companies often seek to increase their shareholder engagement in the face of a negative proxy advisory recommendation, although it is more difficult to gain an audience with busy institutional investors during the height of proxy season than it is during the "off season."

A company's compensation discussion and analysis must describe whether and, if so, how it has considered the results of the most recent say-on-pay vote in determining compensation policies and decisions and how that consideration affected such policies and decisions. If a company's say-on-pay vote ultimately fails or is otherwise below 70 percent in favor, it will be especially important for the company to establish that its compensation committee has taken the results of the vote into account when making subsequent decisions. Companies in this situation should consider engaging with shareholders following the meeting to identify what concerns investors have, including the specific elements of its executive compensation program that were viewed as problematic, if any, and ways in which they might address valid concerns.

While the say-on-pay vote is an advisory vote, it can be perilous to ignore a vote against, or a low vote in favor of, executive compensation. Generally, companies whose say-on-pay votes fail make some changes to their executive compensation programs to avoid another failed say-on-pay vote. Failure to do so can result in votes against members of the compensation committee or other directors. Once a company files a Form 8-K following the meeting to report voting results pursuant to Item 5.07, it will be a matter of easily accessible public record if any director's support has diminished vis-à-vis other directors or prior year votes. Even if such opposition does not result in directors failing to win reelection, the targeted directors may suffer reputational harm.

Compensation Litigation

In recent years executive compensation programs sometimes have given rise to litigation against companies and their directors, with lawsuits alleging breach of fiduciary obligations, alleging insufficient compensation-related proxy disclosures, seeking to enjoin annual meetings and/or challenging specific compensation actions. Accordingly, compensation decisions should be made, and compensation disclosures should be prepared, with care, especially for companies that anticipate resistance to their executive compensation policies. In addition, compensation committee members should be able to demonstrate that they exercised due care in applying their business judgment to executive compensation by reviewing adequate information, asking questions and understanding the pros and cons of various alternatives, any or all of which can involve the assistance of company or outside experts, as appropriate.

Director compensation, which can raise issues of self-dealing requiring a heightened "entire fairness" standard rather than the business judgment rule, has also been the subject of litigation. To minimize this risk, companies and boards should carefully review existing director compensation arrangements (perhaps on a separate cycle from executive compensation) and consider adding shareholder approved annual limits or annual formula-based awards to current (or new) plans. Alternatively, companies and boards may choose to develop a factual record of these arrangements with a view to withstanding an "entire fairness" scrutiny, including by reviewing director compensation paid at a carefully selected group of comparable companies, possibly with the assistance of an outside expert.

Say-When-On-Pay

Rule 14a-21(b) first required public companies to conduct an advisory vote on the frequency of the say-on-pay vote at the first annual or other meeting of shareholders on or after January 21, 2011, with subsequent frequency votes no more than every six years thereafter. As a result, many public companies will be required to include an agenda item for their 2017 annual meetings asking shareholders if the say-on-pay vote should occur every one, two or three years. This will need to be done even if the company is already conducting its say-on-pay vote annually and intends to continue this practice. In addition, the Form 8-K reporting voting results will need to disclose not only the results of the say-when-on-pay vote, but also the frequency with which the company intends to conduct the say-on-pay vote in light of the results of the advisory frequency vote. (The intended frequency may be disclosed by amendment to that Form 8-K filed within 150 calendar days after the shareholders' meeting, as long as the disclosure is made within 60 days prior to the deadline for shareholder proposals.)

Shareholder Proposals

General Considerations

Rule 14a-8 under the Securities Exchange Act of 1934 (Exchange Act) permits shareholders who have either owned at least $2,000 in market value or one percent of the voting stock for one year to submit a proposal that a company must include in its proxy statement, unless the proposal has specified procedural deficiencies or can be excluded based on one of the 13 substantive grounds that are set forth in the rule. Shareholder proposals are often one of the first topics that companies address at the start of any proxy season as a result of deadlines specified by Rule 14a-8 for submission of proposals and for notifying the SEC if companies plan to exclude any shareholder proposals. Less frequently, a company may initiate a lawsuit seeking a declaratory judgment that a proposal may be excluded.

To determine whether there is a reasonable basis to exclude a shareholder proposal from a proxy statement, a company should review precedent no-action letters pursuant to Rule 14a-8 as well as the series of Staff Legal Bulletins addressing Rule 14a-8. If a company believes that Rule 14a-8 provides grounds to exclude the shareholder proposal from its proxy statement, it must notify the SEC, generally by submitting a no-action request to the staff of the SEC's Division of Corporation Finance (Staff), describing each basis upon which the company believes it may omit the shareholder proposal and seeking its concurrence, and the company must provide the proponent with a copy of its submission. Alternatively, or in addition to submitting a no-action request, companies often attempt to negotiate with the proponent to see if an agreement can be reached resulting in the withdrawal of the proposal.

When available, procedural deficiencies (such as failing to provide the requisite proof of ownership) offer clear bases supporting a no-action request to omit a shareholder proposal from the proxy statement but only if the company complies with the Rule 14a-8 requirements and notifies the proponent in writing about the defect within 14 days of its receipt of the proposal. The company does not have to notify the proponent of a defect that cannot be remedied, such as late submission of the proposal. After receiving a notice of a procedural defect, the proponent has 14 days to correct the deficiency. Because these deadlines require prompt action, it is important for companies to have procedures in place to promptly disseminate shareholder proposals internally and to quickly review and analyze shareholder proposals under Rule 14a-8 to identify potential defects in time to preserve an effective basis for exclusion.

If a company must include in its proxy statement a shareholder proposal that the company does not support, the company should carefully draft a persuasive statement of opposition. It must send this statement to the proponent of the proposal at least 30 days before the company files its definitive proxy statement.

Proxy Access

Proxy access initiatives made significant inroads during the last two proxy seasons. Much of the impetus for proxy access came from the Boardroom Accountability Project campaign launched by the Comptroller of New York City and the New York City Pension funds, which submitted proxy access proposals to 75 companies during the 2015 proxy season and to 72 companies for the 2016 proxy season. The proxy solicitation and corporate advisory firm, Alliance Advisors, reports that over 200 proxy access resolutions were submitted by shareholders during the 2016 US proxy season and that, as a result of negotiated withdrawals and voluntary adoptions, over 250 companies had established proxy access rights by the end of June 2016. According to Alliance Advisors, through July 1, 2016, shareholders voted on 79 shareholder-sponsored proxy access proposals, receiving on average 51.1 percent support from shareholders. Of these proxy access proposals, 41(representing 52 percent of the total) received majority votes in favor.

In October 2015, the Staff issued Staff Legal Bulletin No. 14H (SLB 14H) providing, among other matters, that a shareholder proposal would be excludible as directly conflicting with a management proposal only if a reasonable shareholder could not logically vote in favor of both proposals. SLB 14H expressly applied this principle to proxy access, specifying that a shareholder proposal requesting proxy access for a shareholder or group of shareholders holding at least three percent of the company's outstanding stock for at least three years to nominate up to 20 percent of the directors would not directly conflict with a management proposal that would allow shareholders holding at least five percent of the company's stock for at least five years to nominate for inclusion in the company's proxy statement 10 percent of the directors. As a result, no-action requests related to proxy access proposals largely shifted to substantially implemented arguments during the 2016 proxy season. For further information on SLB 14H, see our Legal Update, "US SEC Provides Guidance on Excluding Shareholder Proposals from Proxy Statements," dated November 3, 2015.

Early in the 2016 proxy season, the Staff granted a series of no-action requests to exclude from their proxy statements shareholder proposals requesting the adoption of proxy access where the companies had adopted proxy access provisions that they claimed "substantially implemented" such proposals before their annual shareholders meetings. The Staff agreed that the companies had substantially implemented the shareholder proposals where they had adopted provisions granting proxy access to shareholders who held three percent of the company's stock for three years, even though the provisions adopted did not completely mirror the other terms of the shareholder proposals. In these cases, the Staff was satisfied that the proposals that the companies adopted achieved the "essential objective" of the proxy access provision requested by the shareholder proposals.

On the other hand, the Staff denied the no-action requests of companies that argued that they had substantially implemented the requested proxy access proposal when their provisions used a five percent ownership threshold. In those situations the Staff concluded that the policies, practices and procedures adopted by those companies did not compare favorably with the guidelines of the shareholder proposals and that the companies had not, therefore, substantially implemented the proposals.

Most of the US proxy access provisions that have been adopted use a three percent ownership/three-year threshold, comparable to the threshold that the SEC adopted in its original proxy access rule, which was vacated by court action. Other typical terms include requiring shareholders to have full voting and economic ownership in order to use proxy access and allowing aggregation by groups of not more than 20 shareholders to reach the designated threshold. It is also common to limit the number of proxy access nominees to 20 percent of the board, but often with a minimum of two nominees. Although there are quite a few other details on which proxy access provisions vary, to a large degree there have been a sufficient number of US proxy access provisions adopted that there is a growing consensus as to which variations are viewed as “market.”

Companies that do not allow for proxy access may receive shareholder proposals requesting that proxy access be adopted. Such companies may want to consider adopting their own proxy access provisions in order to incorporate the detailed aspects in a manner that they think makes sense, while at the same time satisfying the essential objectives test necessary to persuade the Staff that the shareholder proposals have been substantially implemented. Other companies may choose to submit shareholder proxy access proposals to a vote of shareholders.

Companies that have already adopted proxy access provisions may nevertheless receive proxy access shareholder proposals during the 2017 proxy season that request amendments to specific features of their existing provisions that certain shareholders find objectionable. When a shareholder requests particular amendments to a proxy access provision, a company should expect that it will be more difficult to convince the Staff that a proposal has been substantially implemented by an existing proxy access provision that does not contain the revisions that are being specifically requested.

For example, in *H&R Block, Inc.* (available July 21, 2016), the Staff did not permit the company to exclude from its proxy statement a proxy access shareholder proposal as being substantially implemented by an existing three percent/three year proxy access bylaw. In that situation, the shareholder proposal requested that the following four substantive revisions be made to the proxy access bylaw:

- Increasing the number of proxy access nominees to the board of directors to the greater of 25 percent or two nominees
- Permitting loaned securities to be counted toward the ownership threshold in certain circumstances
- Eliminating the cap on the number of shareholders that can aggregate their shares to achieve the required three percent ownership threshold for proxy access nominations
- Eliminating renominations based on the number or percentage of votes received in any election

The Staff responded to H&R Block's no-action request by stating that it was unable to conclude that the existing proxy access bylaw compared favorably to the guidelines of the proposal. Comparing *H&R Block* and proxy access no-action relief granted earlier in 2016, it appears that the Staff draws a distinction between proposals requesting the adoption of proxy access provisions and proposals requesting specific amendments to existing proxy access provisions.

Accordingly, despite many voluntary adoptions of proxy access bylaw provisions during the past year, proxy access is likely to be a continuing subject of shareholder proposals during the 2017 proxy season.

Other Shareholder Proposals

In addition to proxy access, proposals submitted during the 2016 proxy season that companies might anticipate receiving for the 2017 proxy season include corporate governance proposals regarding independent board chairs, action by written consent of shareholders, special shareholder meetings, supermajority voting and board diversity, as well as political contribution and lobbying proposals, environmental and social proposals (such as proposals addressing climate change and greenhouse emissions), and compensation proposals (such as proposals relating to golden parachutes, stock retention, gender pay equality and adjustment of executive pay metrics to exclude the impact of stock buybacks). There are also rumblings of new sorts of proposals for 2017, such as proposals to preclude Internet-only virtual shareholder meetings. For a discussion of virtual shareholder meetings, see "Annual Meeting Mechanics—Virtual Meetings" below.

Dodd-Frank Compensation-Related Rulemaking

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) directed the SEC to adopt rules in several areas involving compensation-related matters, as discussed below.

Pay Ratio Disclosure

Pursuant to the SEC's final pay ratio disclosure rule, initial pay ratio disclosure will be required with respect to compensation for a company's first full fiscal year that begins on or after January 1, 2017. Therefore, companies generally will first be required to include pay ratio disclosure in their 2018 proxy statements or later in the case of companies that are new SEC registrants. Pay ratio disclosure will be required in all filings that require executive compensation disclosure pursuant to Item 402 of Regulation S-K, such as proxy statements.

Briefly, pay ratio disclosure will require public companies to disclose:

- The median of the annual total compensation of all employees other than the chief executive officer;
- The annual total compensation of the chief executive officer; and
- The ratio of these amounts.

Although pay ratio is not required for 2017 proxy statements, companies that will be required to provide pay ratio disclosure need to devote time and resources now to prepare for compliance with the rule. Companies should be determining the methodology they will use to calculate and report their pay ratio disclosure and, if necessary, coordinating their reporting systems in various jurisdictions. Companies should evaluate their payroll and other compensation recordkeeping systems for planning purposes, develop strategies for compliance and consider how they will update their disclosure controls and procedures for pay ratio disclosure. Employees responsible for assembling the information needed for the disclosure should be sure they understand what compensation programs the company has, including on a worldwide basis if the company has employees outside of the United States. In addition, it should be determined whether gathered information needs to be adjusted to reflect differences in internal compensation reporting systems in various jurisdictions. Companies should be developing adequate disclosure controls and procedures to ensure compliance. In addition, compensation committees may want to preview what the ratio is likely to be.

The pay ratio calculation must include full-time, part time, temporary and seasonal employees, including employees based outside the United States. The rule permits a company to annualize the compensation for all permanent employees, whether full-time or part-time, who were employed on the calculation date but did not work for the company for the full fiscal year, but the rule does not permit annualization for temporary or seasonal employees. In addition, the pay ratio disclosure rule does not permit the use of full-time-equivalent adjustments.

The pay ratio disclosure rule provides an exemption for employees in a foreign jurisdiction in which data privacy laws or regulations are such that, despite the company's reasonable efforts to obtain and process the information necessary to comply with the pay ratio disclosure rule, the company is unable to do so without violating those data privacy laws or regulations. It also provides a *de minimis*exemption for non-US employees representing five percent or less of a company's total employees.

The pay ratio disclosure rule gives companies flexibility to select a method for identifying the median employee that is appropriate to the size and structure of their businesses and compensation programs. Companies may determine the median employee based on any consistently used compensation measure, such as compensation amounts reported in its tax and/or payroll records. Companies will be permitted to identify the median employee based on total compensation regarding their full employee population. Alternatively, they may do so by using a statistical sample or another reasonable method.

The above description contains just a brief summary of the pay ratio disclosure rule. For more information on the SEC's pay ratio disclosure rule, see our Legal Update, "Understanding the SEC's Pay Ratio Disclosure Rule and its Implications," dated August 20, 2015.

Clawbacks

In 2015, the SEC proposed a new rule directing national securities exchanges and associations to establish listing standards that prohibit the listing of any security of a company that does not adopt and implement a written policy requiring the recovery, or "clawback," of certain incentive-based executive compensation payments. The recovery would be the amount of incentive compensation payments that are later shown to have been paid in error, based on an accounting restatement that is necessary to correct a material error of a financial reporting requirement.

If a current or former executive officer received erroneously awarded incentive-based compensation within the three fiscal years preceding the date of the determination that a restatement is required, the company would have to recover from the executive the excess incentive-based compensation on a "no-fault" basis. The proposal also specifies proxy statement disclosure requirements relating to clawback policies and recovery efforts.

The proposed rule defines incentive-based compensation as any compensation (including stock options and other equity awards) that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure. For this purpose, the term "financial reporting measures" are measures that are determined and presented in accordance with the accounting principles used in preparing the company's financial statements, any measures derived wholly or in part from such measures, such as non-GAAP financial measures, and stock price and total shareholder return (TSR).

Although the comment period on the SEC's clawback proposal has closed, the SEC has not issued a final clawback rule, and it is not clear when it will do so. Under the proposal, once the SEC's final rule is adopted, the stock exchanges would have to file their proposed listing standards within 90 days after the publication of the SEC's final rule in the *Federal Register*, and new listing standards would have to become effective no later than one year following such publication date. Thereafter, companies would have 60 days to adopt compliant clawback policies.

For more information on the SEC's clawback proposal, see our Legal Update, "US Securities and Exchange Commission Proposes Compensation Clawback Listing Standards Requirement," dated July 16, 2015.

Pay Versus Performance Disclosure

In 2015, the SEC proposed a "pay versus performance" rule to require companies to disclose in a clear manner the relationship between executive compensation actually paid and the financial performance of the company, with performance measured both by company TSR and peer group TSR. If adopted as proposed, companies would need to add a new pay versus performance table to their proxy statements that would separately provide annual compensation information for the chief executive officer for each of the past five fiscal years. In addition, the table would have to provide average annual compensation for the named executive officers (other than the chief executive officer) identified in the summary compensation table for those years.

As proposed, executive compensation actually paid would consist of total compensation as reported in the summary compensation table, modified to adjust the amounts included for pension benefits and equity awards. Equity awards would be considered actually paid on the date of vesting, whether or not exercised. They would be valued at fair value on the vesting date, rather than fair value on the date of grant as reported in the summary compensation table. Accordingly, the stock and option award amounts shown in the summary compensation table would be subtracted from total compensation, and the vesting date fair value amounts for these equity awards would be added back, to calculate compensation actually "paid." Vesting date valuation assumptions would have to be disclosed if they are materially different from those disclosed in the financial statements as of the grant date. A clear description of the relationship between pay and performance would have to accompany the proposed new table.

The comment period on this proposed rule has expired, but no final rule has been issued. As a result, it is not clear when pay versus performance disclosure will first be required in proxy statements. The proposed phase-in for this rule would require pay versus performance disclosure for three years in the first proxy statement in which such disclosure is required. In each of the two subsequent years, another year of disclosure would be added.

For more information on the SEC's pay versus performance proposal, see our Legal Update, "US Securities and Exchange Commission Proposes Pay Versus Performance Disclosure Rule," dated May 13, 2015.

Hedging Disclosure

The SEC also proposed a new disclosure requirement in 2015 addressing hedging by employees, officers and directors. The comment period on this proposed rule has expired, but the SEC has not issued a final rule. Therefore, it is not clear when companies will need to add the new hedging disclosure to their proxy statements.

The proposal would require companies to disclose in their proxy statements whether their employees (including officers) or directors are permitted to engage in transactions to hedge or offset any decrease in the market value of their companies' equity securities granted to them as compensation or held directly or indirectly by employees or directors.

The proposal covers all transactions that establish downside price protection in a company's equity securities, whether by purchasing or selling a security or derivative security or otherwise. The resulting disclosure would need to make clear which categories of price protection transactions a company permits and which it prohibits.

The proposed hedging disclosure requirement would extend beyond the existing requirement in the compensation discussion and analysis with respect to hedging. Currently, the compensation discussion and analysis only requires a discussion of hedging policies affecting the named executive officers, while the proposed rule would mandate disclosure of hedging policies with respect to all employees, officers and directors. In addition, the proposed hedging disclosure rule would apply to all companies that are required to comply with the SEC's proxy rules, even companies that are not required to include compensation discussion and analysis, such as smaller reporting companies, emerging growth companies, business development companies and registered closed-end investment companies.

For more information on the SEC's hedging disclosure proposal, see our Legal Update, "US Securities and Exchange Commission Proposes Hedging Disclosure Rules," dated February 20, 2015.

Other Key Disclosure Topics for the 2017 Proxy and Annual Reporting Season

Non-GAAP Financial Measures

Companies sometimes use non-GAAP financial measures in their annual reports on Form 10-K, as well as other SEC filings. In addition, it has become common for companies to highlight performance measures, including non-GAAP financial measures, in their proxy statements to demonstrate the connection between pay and performance. To the extent that non-GAAP performance measures are disclosed in documents filed with the SEC, companies must pay attention to the requirements of Regulation G and Item 10(e) of Regulation S-K.

There are special rules for non-GAAP financial measures in the proxy statement context. The disclosure of target levels for incentive compensation arrangements that are non-GAAP financial measures is not subject to Regulation G, although a company must disclose how the numbers are calculated from its audited financial statements. In compliance and disclosure interpretation (C&DI) number 118.09 relating to Regulation S-K, the Staff extended this principle to the disclosure of the actual result of the non-GAAP financial measure that is used as a target, provided that this disclosure is made in the context of a discussion about target levels.

When non-GAAP financial measures are included in a proxy statement for any purpose other than with respect to target levels, a company must comply with Regulation G and Item 10(e) of Regulation S-K. For pay-related circumstances only, the Staff stated in C&DI 118.08 that it will not object if a registrant includes the required GAAP reconciliation and other information in an annex to the proxy statement, provided that the registrant includes a prominent cross-reference to this annex. If the non-GAAP financial measures are the same as those included in the Form 10-K that is incorporating by reference the proxy statement's executive compensation disclosures, the Staff stated that it will not object if the company complies with these rules by providing a prominent cross-reference to the pages in the Form 10-K containing the required GAAP reconciliation and other information. When providing a non-GAAP performance measure in a proxy statement, including in a proxy statement summary, a company wishing to rely on these Staff interpretations should be careful to tie such disclosure to compensation.

In the past year the SEC has increased its focus on compliance with the requirements for use of non-GAAP financial measures, and the Staff issued new and updated C&DIs on the subject in May 2016. These C&DIs provide insight into what the Staff considers to be misleading use of non-GAAP financial measures and what is considered unacceptable prominence of a non-GAAP financial measure presentation in an SEC filing. Even before these C&DIs were issued, the Staff had been issuing comment letters with respect to filings in order to improve the level of company compliance with SEC rules on non-GAAP disclosures, and the Staff has already issued, and made public, comment letters in which it specifically references the new guidance.

By the time the 2017 proxy and annual reporting season gets into full swing, SEC reporting companies already will have had experience applying the new guidance to their presentations of non-GAAP financial measures. However, compliance with these interpretations is an ongoing process. As companies transition from disclosures that investors or analysts may have come to expect or are accustomed to seeing but that are now identified as potentially misleading or otherwise unacceptable, they may find it useful to further update their approaches to reflect refinements that their peers have developed in response to the SEC's guidance. Companies may also gain insights from comments given to other companies, especially as SEC comment letters become public. Companies should expect the SEC to focus on non-GAAP financial measures when reviewing proxy statements and annual reports for the 2017 proxy and annual reporting season. Therefore, companies should pay particular attention to such presentations as they draft such documents.

For more information on the SEC's new and updated guidance on non-GAAP financial measures, see our Legal Update, "SEC Provides Guidance on Non-GAAP Financial Measures," dated May 24, 2016.

Audit Committee Disclosure

On July 1, 2015, the SEC issued a concept release requesting comments on possible revisions to audit committee disclosures. The concept release focused on three main areas of disclosure:

- The audit committee's oversight of the auditor
- The audit committee's process for appointing or retaining the auditor
- The audit committee's consideration of the qualifications of the audit firm and certain members of the engagement team

The concept release also requested comments on the location of audit committee disclosures in SEC filings and comments relating to audit committee disclosure by smaller reporting companies and emerging growth companies, as well as other miscellaneous questions related to audit committee disclosures.

The comment period for the audit committee disclosure concept release has expired, but the SEC has not issued any specific proposals in response to the issues raised by the concept release. However, the conversation about whether there should be more audit committee disclosure already has begun. Some institutional investors have been advocating for additional audit committee disclosures even before the SEC issued its concept release. Some companies, in the interest of transparency, are already expanding audit committee disclosures beyond the mandatory requirements, for example, by providing greater detail about the audit committee's oversight of the independent auditor. As the 2017 proxy season approaches, those responsible for preparing the proxy statement may want to discuss with audit committees and auditors whether they consider it appropriate to voluntarily expand any audit committee disclosures at this time.

Form 10-K Summaries

In accordance with the Fixing America's Surface Transportation Act, the SEC issued an interim final rule amending the Form 10-K to expressly allow, but not require, companies to include a summary of information required by that form. New Item 16 of Form 10-K authorizes optional summary information that is presented fairly and accurately if there is a hyperlink to the material contained in the Form 10-K, including exhibits, to which the summary relates. The summary may only refer to information that is included in the Form 10-K at the time it is filed. Companies do not need to update the summary for information required by Part III of Form 10-K that is incorporated by reference to a proxy or information statement filed after the Form 10-K, but in that case, the summary must state that it does not include Part III information because that information will be incorporated from a later-filed proxy or information statement involving the election of the board of directors.

Risk Factors

Companies should review their risk factors in full as part of the process for preparing the annual report on Form 10-K to ensure that current risks are not only identified but described in relation to their businesses. For some companies, the potential impact of Brexit and related developments present a risk factor topic that may be particularly relevant. (To the extent that Brexit is, or could, materially affect a company's financial results, it may also be appropriate for that company to discuss it as part of management's discussion and analysis of financial condition and results of operation.) Issues regarding sustainability and climate change disclosure have been gaining increasing attention, so it may be useful to consider whether any additional risk factor disclosure is warranted in that area. Recognition has been growing that cybersecurity poses both economic and security threats. Therefore, companies should carefully analyze whether they need new, revised or expanded cybersecurity disclosure. These subjects represent just a few recent areas of concern. Each company should consider its own risk profile to be sure that the risk factor section of its Form 10-K adequately reflects the specific risks currently facing that company. In this regard, it can be helpful to review precedents of similarly situated companies, as long as the end result is tailored to be relevant to the particular company and does not reflect a boilerplate description of a general risk.

Other Disclosure Initiatives

The SEC has commenced a number of initiatives during 2016 as part of a program to review and enhance disclosure effectiveness. These efforts are in the beginning stages and, therefore, are not likely to directly impact the 2017 proxy and annual reporting season. However, it is useful to keep these issues in mind as annual disclosures are being prepared.

For example, in April 2016, the SEC issued a concept release examining many aspects of the business and financial disclosures required by Regulation S-K that companies provide in their periodic reports. This concept release not only focuses on what information should be disclosed, but also on whether information can be presented in a way that is more effective. It explores the extent to which technology may be able to improve disclosure, such as through hyperlinks and navigability tools, and whether such features can be harnessed to streamline disclosure. The concept release also considers whether there are new topics that should be added to disclosure requirements, such as in the sustainability and climate change area. For a further discussion of this concept release, see our Legal Update, "Modernization of US Business and Financial Disclosures: A 'Taste' of the SEC's Concept Release," dated April 26, 2016.

Another initiative was introduced in July 2016, when the SEC proposed amendments to eliminate redundant, overlapping, outdated or superseded regulations in light of subsequent changes to SEC disclosure requirements, US GAAP, International Financial Reporting Standards and technology. The proposing release for those amendments also solicited comments on certain disclosure requirements that overlap with US GAAP to determine whether to retain, modify, eliminate or refer them to the Financial Accounting Standards Board for potential incorporation into US GAAP.

In August 2016, the SEC requested comments on subpart 400 of Regulation S-K, which contains disclosure requirements with respect to directors, executive officers, promoters and control persons, including compensation, security ownership and related person transaction information, as well as corporate governance matters, code of ethics information and late filings of insider trading reports. The request for comments does not propose any amendments or raise specific questions for comments. Rather, the release states that comments can be directed at existing requirements or potential disclosure issues that commenters believe the rules should address. (With respect to executive compensation, the SEC is requesting comments on the disclosure requirements of Item 402 generally, as opposed to comments on the outstanding clawback, pay versus performance disclosure and hedging disclosure proposals discussed in "Dodd-Frank Compensation-Related Rulemaking" above.) Comments on this proposal are due by October 31, 2016. It is unlikely that amendments to subpart 400 of Regulation S-K will be made in time to affect the 2017 proxy and annual reporting season.

Also in August 2016, the SEC proposed amendments to require companies that file registration statements and periodic and current reports that are subject to the exhibit requirements of Item 601 of Regulation S-K, or that file on Forms F-10 or 20-F, to include a hyperlink to each electronically filed exhibit (other than the XBRL exhibit) listed in the exhibit index to these filings. Companies would be required to file the forms affected by the proposal in HTML format (as opposed to ASCII format). Comments on this proposal are due later this fall. It is not clear whether a final amendment implementing this hyperlinked exhibit requirement will be in place prior to the filing deadlines for 2016 annual reports on Form 10-K or 20-F. However, if the SEC adopts these amendments, the hyperlink requirement would apply to nearly all of the forms that are required to include exhibits under Item 601, including periodic and current reports, so companies should monitor this rulemaking throughout the year.

Finally, companies involved in mining should be aware that in June 2016, the SEC proposed revisions to property disclosure requirements for mining registrants and related guidance that are currently contained in Item 102 of Regulation S-K and Industry Guide 7. This proposal is intended to modernize disclosure requirements for mining properties in order to align the SEC's rules with current industry and global regulatory practices and standards. The proposal would rescind Guide 7 and create new Regulation S-K subpart 1300, which would govern disclosure for registrants with mining operations.

Specialized Disclosure

Form SD, although not part of the annual report on Form 10-K, represents an annual filing requirement for issuers that are subject to reporting under both the conflict minerals and resource extraction issuer disclosure rules.

Conflict Minerals

The SEC adopted conflict minerals disclosure rules in accordance with the directive of Dodd-Frank. These rules require SEC reporting companies to file a Form SD with respect to conflict minerals for any year in which they used conflict minerals that were necessary to the functionality or production of a product they manufactured or contracted to be manufactured. The first such reports were required in 2014, so there are now three years of precedent.

Litigation over required conflict minerals disclosure has resulted in a judicial opinion holding that the conflict minerals statute and rule violated the First Amendment to the extent that it required companies to report to the SEC and to state on their web sites that any of their products have "not been found to be 'DRC conflict free.'" However, the other portions of the conflict minerals disclosure requirements have been upheld. Affected companies must file their reports on Form SD, complying with the portions of the conflicts mineral rules that the court upheld. Keith Higgins, Director of the SEC's Division of Corporation Finance, issued a statement in April 2014 specifying that as a result of the court opinion, companies are not required to describe their products as "DRC conflict free," as having "not been found to be 'DRC conflict free'" or as "DRC conflict undeterminable." The statement also provided that no independent private sector audit (IPSA) would be required unless a company voluntarily elects to describe any of its products as "DRC conflict free" in its conflict minerals report. Therefore, unless the SEC provides guidance to the contrary, there is still no IPSA requirement for any Form SD being filed in spring 2017 with respect to usage of conflict minerals in 2016 unless a company chooses to affirmatively describe any product as "DRC conflict free."

Resource Extraction Issuer Payment Disclosure

On June 27, 2016, the SEC adopted final resource extraction issuer payment disclosure rules pursuant to a Dodd-Frank mandate, replacing an earlier version that had been vacated by the US District Court for the District of Columbia in 2013. The final rules require resource extraction issuers to disclose payments made to US federal or foreign governments for the commercial development of oil, natural gas or minerals. New Rule 13q-1 under the Exchange Act requires resource extraction issuers to file their payment information reports on Form SD.

A resource extraction issuer will have to file a Form SD containing payment disclosure annually, not later than 150 days after the end of the issuer's fiscal year, but the SEC has provided a transition period for compliance. Resource extraction issuers will first need to comply with the final rules for fiscal years ending on or after September 30, 2018. This means that calendar-year companies impacted by the new rules will first need to comply by May 30, 2019.

Although there is a transition period before reporting is required, and no resource extraction issuer payment disclosure will be required during the 2017 proxy and annual reporting season, companies affected by the rules should realize that there may be considerable start-up time and expense required in order to be ready to comply by the required deadline. These could require IT consulting, establishing new reporting systems, training local personnel on tracking and reporting, and developing guidance to ensure consistency across reporting units. In addition, some companies may need their accounting groups to develop new information systems, processes and controls.

Companies that fall within the definition of resource extraction issuer should also begin reviewing their systems and controls for financial accounting and financial reporting to determine what additional procedures and processes they may need in order to report the payments required to be disclosed. Additional disclosure controls and procedures may also need to be implemented in order to track payments by subsidiaries and controlled joint ventures to governments and government-controlled entities, as well as to comply with the XBRL (interactive data) reporting requirements.

For more information on the resource extraction issuer payment disclosure rules, see our Legal Update, “US SEC Adopts Final Rules for Payments by Resource Extraction Issuers,” dated July 13, 2016.

Annual Meeting Mechanics

Proxy Cards

In March 2016, the Staff issued an interpretation of the requirement in Rule 14a-4(a)(3) that the form of proxy “identify clearly and impartially each separate matter intended to be acted upon.” C&DI 301.01 emphasized that a proxy card must describe the specific action on which shareholders will be asked to vote, whether the proposal is one submitted by management or one submitted by a shareholder. The proxy card must contain sufficient detail to explain the proposal. For example, if management proposes an amendment to the company’s articles of incorporation to increase the number of authorized shares of common stock, it is not appropriate for the proxy card to describe the proposal as “a proposal to amend our articles of incorporation.” Similarly, it would be insufficient for a proxy card to describe a shareholder proposal calling for a bylaw amendment to allow shareholders holding 10 percent of the company’s common stock to call a special meeting as “a shareholder proposal on special meetings.”

C&DI 301.01 also provided the following examples of proxy card descriptions of shareholder proposals that are too general to satisfy Rule 14a-4(a)(3):

- A shareholder proposal on executive compensation
- A shareholder proposal on the environment
- A shareholder proposal, if properly presented
- Shareholder proposal #3

Because C&DI 301.01 was issued fairly late in the 2016 proxy and annual reporting season, some companies may have already released the proxy cards for their 2016 annual meetings before this guidance became available. In preparing for their 2017 annual meetings, companies should make sure that the descriptions of proposals on their proxy cards contain sufficient detail to comply with the Staff’s guidance.

Director and Officer Questionnaires

The Nasdaq Stock Market adopted a “golden leash” rule, effective August 1, 2016, that requires its listed companies to disclose on their web sites and/or in their proxy or information statements compensation paid by third parties to directors or nominees for directors. Therefore, Nasdaq companies should either add questions to their director and officer questionnaires to elicit the information necessary to determine if any such disclosure is needed or to confirm that their existing questionnaire template already covers this topic. For more information on this Nasdaq requirement, see our Legal Update, “US SEC Approves Nasdaq Rule Amendments Requiring Disclosure of ‘Golden Leash’ Arrangements,” dated July 18, 2016.

In addition, Auditing Standard 18 regarding related parties became effective for audits for fiscal years beginning on or after December 15, 2014, thereby impacting 2015 and later audits for calendar year companies. Among other things, this new standard requires auditors to perform procedures to obtain an understanding of a company's relationships and transactions with its related parties and to evaluate whether the company has properly identified its related parties and relationships and transactions with its related parties. In preparing questionnaires with respect to the 2017 proxy and annual reporting season, companies should either confirm that their questionnaires contain questions that will elicit the identification of parties related to their directors and executive officers so that they can appropriately monitor related person transactions or otherwise satisfy themselves that alternative information gathering procedures are in place for this purpose. Some companies already added such questions to their 2016 questionnaires. Companies should confirm that their auditors are satisfied with their procedures to identify reportable relationships, including the wording of questions in director and officer questionnaires involving related party matters if they are the vehicles used to elicit such information.

There are no recent rule changes under the federal securities laws that would require changes to existing director and officer questionnaires for the 2017 proxy and annual reporting season. However, public companies should review their existing forms of questionnaires to determine whether developments from the past few years are adequately addressed. Companies should also consider whether there are regulatory developments outside of the federal securities laws, or any new or amended state or foreign laws, requiring additions or modifications to director and officer questionnaires for the 2017 proxy and annual reporting season.

Virtual Meetings

The number of companies conducting virtual annual meetings has increased over the past few years. Online shareholder meetings can take a variety of forms. Some are hybrids, with in-person meetings supplemented by audio and/or video options. Other companies conduct fully virtual meetings. For example, HP Inc. (formerly Hewlett-Packard Company) conducted completely virtual annual meetings in both 2015 and 2016, providing shareholders with the opportunity to submit questions online but not the opportunity to be physically present with management or directors of the company. Similarly, Intel held a completely virtual annual meeting in 2016.

Companies hosting virtual meetings often emphasize shareholder engagement as well as cost savings. Intel explained in its proxy statement that virtual meeting technology saves time and money, both for the company and its investors, while also observing that web participation has grown significantly and has proven to be substantially more popular than physical attendance. HP noted that the virtual meeting format allows shareholders to participate from any location around the world.

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The complete publication, including footnotes, is available here.