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The 2018 Proxy Season
Mayer Brown experts analyze what lies ahead

Four Mayer Brown lawyers presented the following comprehensive guide to preparing for the 2018 annual proxy and reporting season on November 1, 2017.

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Laura Richman

Say-on-pay has had a dramatic impact on proxy statement disclosure and design —and shareholder engagement— both in the executive compensation area and more generally. Say-on-pay was approved at most companies in 2017 and often the votes were overwhelmingly in favor. This is a typical say-on-pay voting pattern. But not all companies achieve a positive result and when companies don't achieve adequate support—and that generally means less than seventy percent approval, not just a failed say-on-pay vote—they generally feel pressured to make changes to their compensation programs even though the vote is advisory in nature. If they don't, they likely face repeated unsuccessful pay votes and their compensation committee members may find an increase in votes against their re-election. Proxy advisory firms, particularly ISS, are influential, so companies worry about receiving a negative recommendation because that generally lowers support for pay. But a negative recommendation does not necessarily result in a failed say-on-pay vote.

As to why shareholders vote the way they do, there is an interesting study on say-on-pay by professors from Penn, Rutgers and Berkeley that is about to be published in the Harvard Business Law Review. It concluded that to a large degree say-on-pay votes reflect dissatisfaction with performance, not solely pay. What's more, the study also found that support for pay is highly correlated to short-term stock performance.

As for other opportunities to vote on

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Laura Richman
Mayer Brown

compensation matters, last year many companies had to conduct a frequency vote, also on an advisory basis, to see if shareholders wanted the say-on-pay vote conducted every one, two or three years. By far, the frequency most often chosen by shareholders was an annual vote on pay. In fact, many boards of directors recommended the annual frequency. It has become the norm.

There have been initiatives to limit mandatory say-on-pay. For example, the Financial Choice Bill passed by the House earlier this year would limit it to when a company materially changed its executive compensation since the previous year. But I'm not convinced that such initiatives are going anywhere. One reason for that is that an annual advisory say-on-pay vote can be a safety valve of sorts. Without say-on-pay, investors might be more likely to express displeasure on executive compensation through binding votes against compensation committee members or other shareholders.

Shareholders also get the opportunity to vote on equity compensation plans and while only a very small number of companies failed to receive approval for such plans in 2017, a binding vote against an equity plan or amendment is another tool that can reflect dissatisfaction with a company's compensation program.

Because companies want to achieve a high level of support for say-on-pay, executive compensation has become a regular focus of shareholder engagement throughout the year. There are many reasons for the year-round schedule. Institutional investors just can't make time for everyone during the proxy season, so meetings have to be spread across the calendar. Also, shareholder engagement on compensation after a meeting can provide substance that enhances the following year's proxy disclosure. And a robust shareholder engagement process on executive compensation is often viewed as a sign of good governance.

It's a wise strategy for companies to prepare a few key issues to present during their compensation engagement sessions to focus the presentation. They should also decide who can most effectively make the company's presentation.

Companies may also want to reach out to proxy advisory firms for a number of reasons. In that regard, be aware that a recent survey conducted by NASDAQ and the Chamber of Commerce found that although engagement with proxy advisers has been increasing, it appears to make little difference in outcomes for voting recommendations. But it may be worth a try. In any event, it is important to monitor these recommendations and if possible to determine whether ISS or other advisers have accurately used current information.

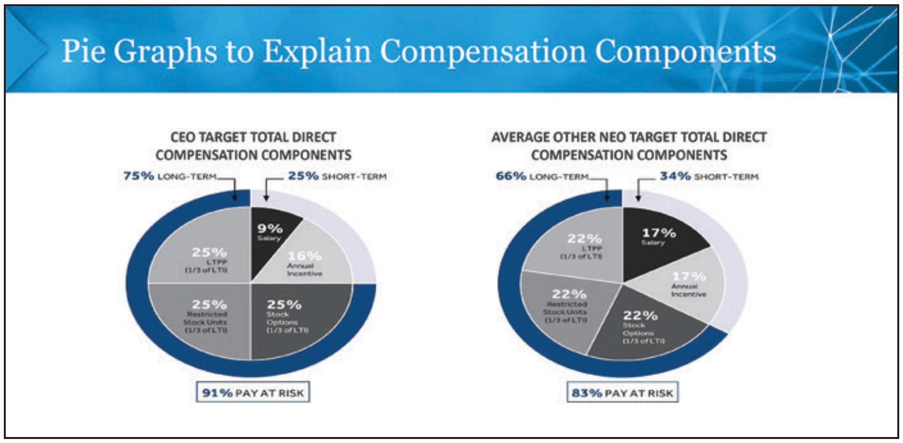
As a result of mandatory say-on-pay, proxy statements are now viewed as advocacy documents supporting approval of executive compensation, rather than just required disclosure documents. So proxy statements get more attention, with design and readability becoming integral parts of the proxy statement process. Summaries, graphics, color, design, plain English, and hyperlinked tables of contents are now common proxy statement features.

Many companies like to file a courtesy PDF of their proxy statement with the SEC when they file the required EDGAR one, because the PDF may more reliably present the design features in the way they are intended to look. Some companies have also developed interactive on-line versions of the proxy statement that present the same content as the EDGAR copy but with a format that uses a landing page with graphics and other links that you can click through. Target is a good example of this. You can easily find it with a Google search for "Target interactive proxy."

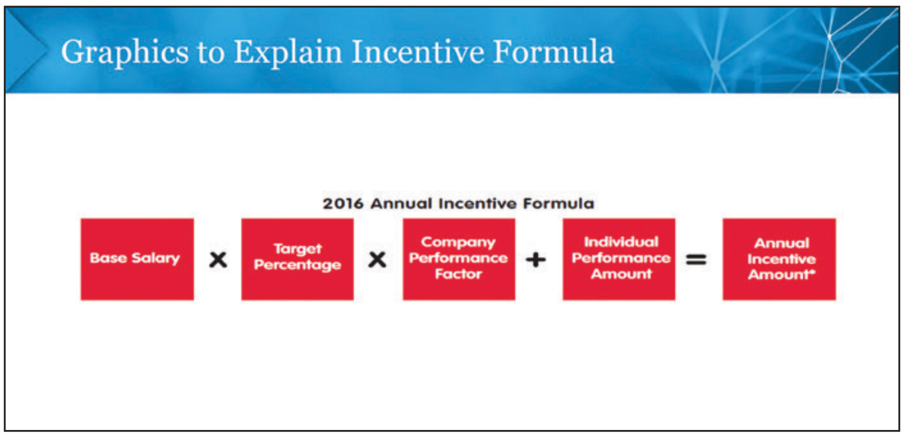
Many companies like to enhance proxy statements with optional features such as a letter signed by the full board of directors or a message from the lead director. Another feature I've seen is an alphabetical index of frequently requested information, which may make it easier to find what you're looking for in the proxy statement than the traditional table of contents, which also would be included. Some companies will include question and answer sections on various subjects, which can then be addressed by the chairman or lead director in the proxy statement. Other special elements can be a values statement or a goal description. ExxonMobil supplements its proxy statements with separate documents including both an executive compensation overview and an energy and carbon summary.

Compensation Disclosure & Analysis is key to presenting the executive compensation program. The CD&A of course must be responsive to all relevant Regulation S-K items. But today the CD&A serves as much more than line item disclosure. With respect to the two slides immediately above ("Proxy Access" and "Environmental & Social Proposals"), the authors note, "Since those two slides relate to shareholder proposals and are not examples of graphics, consider moving them to

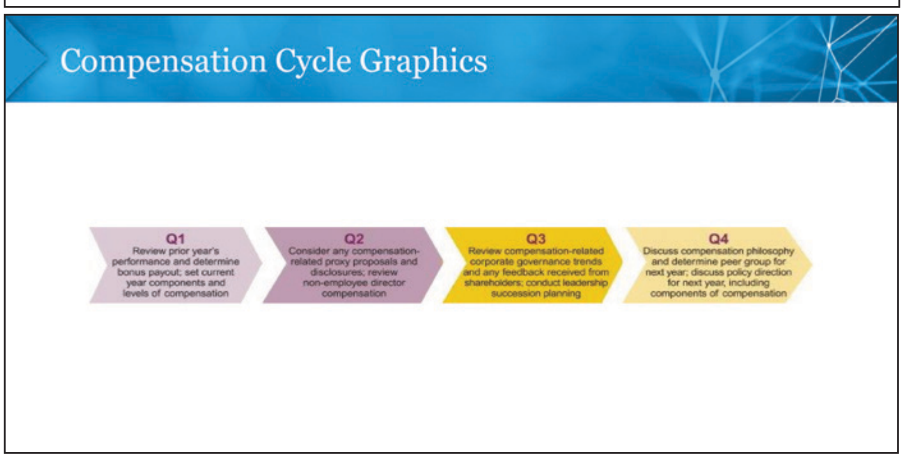
EXAMPLES OF GRAPHICS USED IN 2017 PROXY STATEMENTS



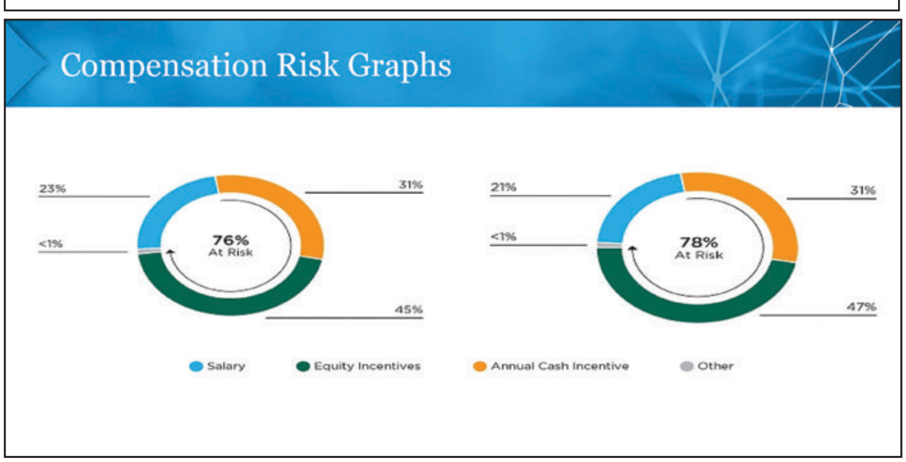
Pie graphs explaining the components of compensation



Graphics making it easier to understand what goes into an incentive formula



Graphics illustrating the compensation cycle



Graphics showing how much compensation is at risk

Proxy Season →

Proxy Season

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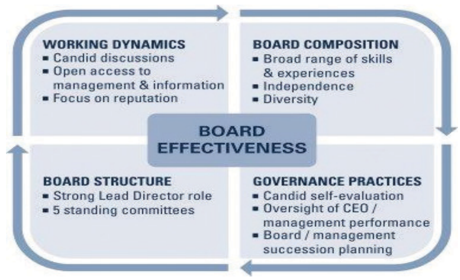
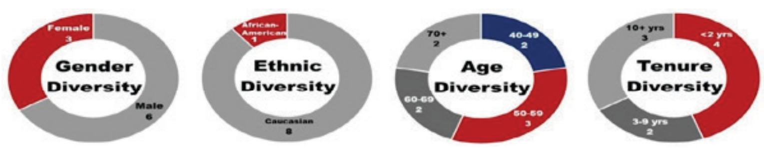
Board Effectiveness Graphics

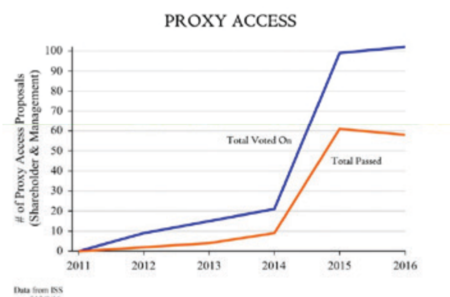


Board Diversity Graphics



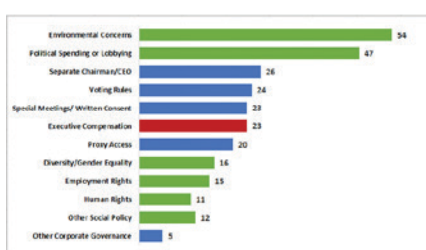
Proxy Access

- Adopted by 425+ companies (60% of S&P 500)
- Over 170 proposals submitted in 2017
- Only 30% voted on, due to negotiated withdrawals and omissions
- 58.2% average support



Environmental & Social Proposals

*2017 Shareholder Proposals by Subtype**



the proxy access / shareholder proposal section." So a lot of thought goes into the look and feel and content of the CD&A. Executive summaries or overviews are very popular CD&A tools to highlight the goals of the program and recent changes. The CD&A frequently uses graphics and design to present compensation information in an easy-to-understand manner, emphasizing the link between pay and performance.

Many companies have added "realized pay" or "realizable pay" in the CD&A, or elsewhere in the compensation disclosure, as a means of demonstrating a commitment to pay for performance. In that regard, be aware that ISS recently indicated that it is considering potential changes to its quantitative pay-for-performance methodology to take into account outcomes of performance-based pay using the realizable pay measure.

The CD&A must disclose how the compensation committee took the prior year say-on-pay vote into account. But even if say-on-pay passed with an overwhelming majority and no changes are made, this disclosure is now often expanded by discussing why the existing program is still deemed appropriate, as opposed to simply stating that no changes have been made because the shareholders approved pay at the last meeting. When changes have been made in response to the vote, they are typically emphasized in this section.

So what do you if ISS or Glass Lewis issues a negative voting recommendation on pay or anything else? The company doesn't have to respond, but it can if it wants to. Companies may prepare additional soliciting materials to rebut a negative recommendation, or for any other reason. But those materials must be filed with the SEC not later than the date the company first distributes or uses them. Additional soliciting materials can take many forms. Even materials underlying oral presentations such as scripts or talking points must be filed with the SEC.

As for compensation litigation, there always seems to be someone willing to bring lawsuit, so companies should keep litigation risk in mind as part of the process for making compensation decisions and drafting disclosure.

These next few slides [See pages 3 and 4] are examples of graphics that were used in 2017 proxy statements. This one illustrates how a pie graph can be used to explain the components of compensation, and here is a graphic to make it easier to understand what goes into an incentive formula. Graphics have been used to illustrate the compensation cycle or to show how much compensation is at risk. "What we do and what we don't do" presentations about compensation are common. Graphics and design may highlight governance practice as well as compensation. For example, here's a graphic illustrating board effectiveness and one for board diversity. Some companies have found graphics effective on other topical issues such as environmental and social governance matters.

Before my time is up, I'd like to address the growing reach of investor stewardship. In a moment, Kristen is going to be discussing shareholder proposals, but they are not the only way investors make their positions known, and executive compensation is not the only topic on which investors seek shareholder engagement. For example, State Street identified board diversity and, in particular, gender diversity, as a key issue for its 2017 proxy voting. They carried through on this policy, voting against directors up for re-election at companies where, in State Street's opinion, sufficient efforts were not being made in this area. BlackRock identified improving gender balance on the board as an engagement focus for the coming year, as well as issues of climate risk and human capital management. In August, Vanguard sent an open letter to directors of public companies describing its increased focus on climate risk and gender diversity, making clear that these are on-going priorities.

It's not just a few big players raising these points. Many of the investors responding to a recent ISS survey consider it problematic for there to be no female directors on a public company board. This week, ISS announced methodology changes to its QualityScore governance rating scale, which, among other things, will reward companies for meeting higher standards for women on the board.

The point is that companies should take note of the topics which their shareholders consider important because even when those areas are not the subject of proposals being voted on, companies may want to add or expand disclosures that highlight their efforts and progress in those matters.

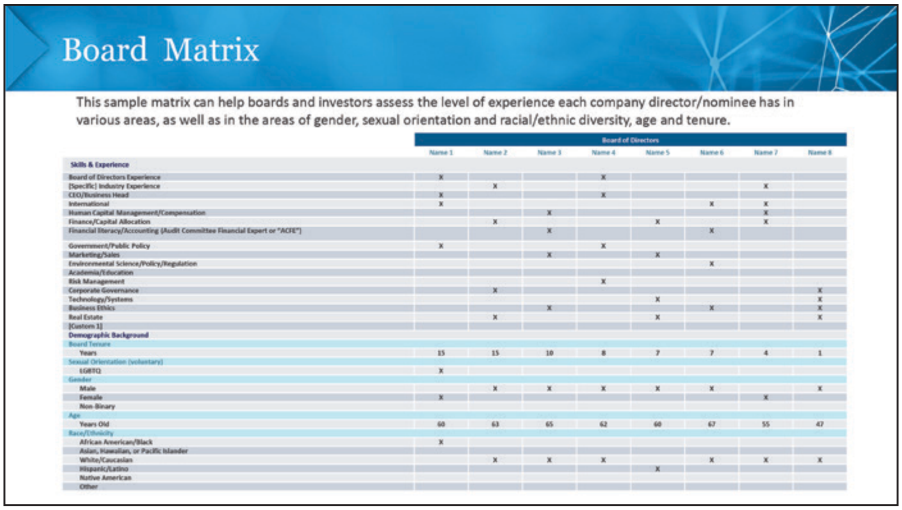
Also, this year the New York City Comptroller and Pension Funds are asking companies to disclose the demographics and skills of their board members in a standardized matrix format and to enter into a dialogue on their board refreshment process. Here's what the proposed matrix looks like. It remains to be seen how much traction it will gain. Requesting a different format for disclosure may be viewed as qualitatively different than requesting a right that doesn't otherwise exist. So some companies might not view

Proxy Season ➔

Proxy Season

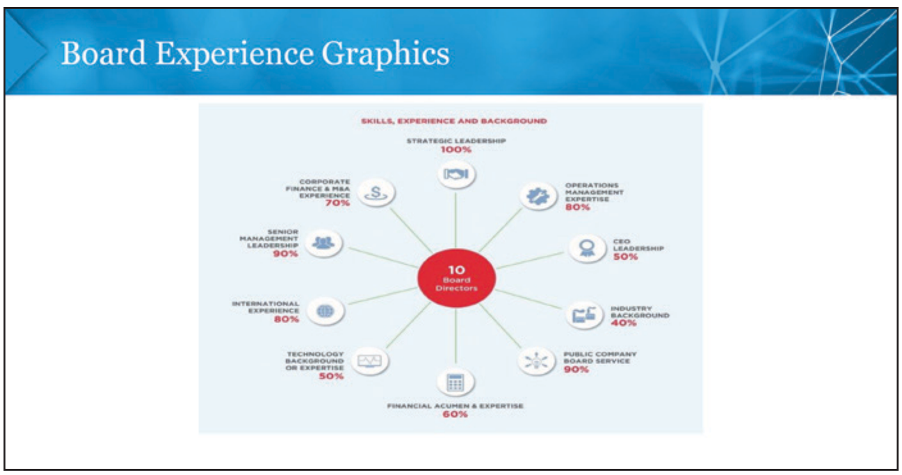
continued

This year, the New York City Comptroller and New York City Pension Funds are asking companies to disclose demographics and skills of their board members in a standardized matric format and to enter into a dialogue on their board "refreshment process." This proposed matrix appears on this slide.

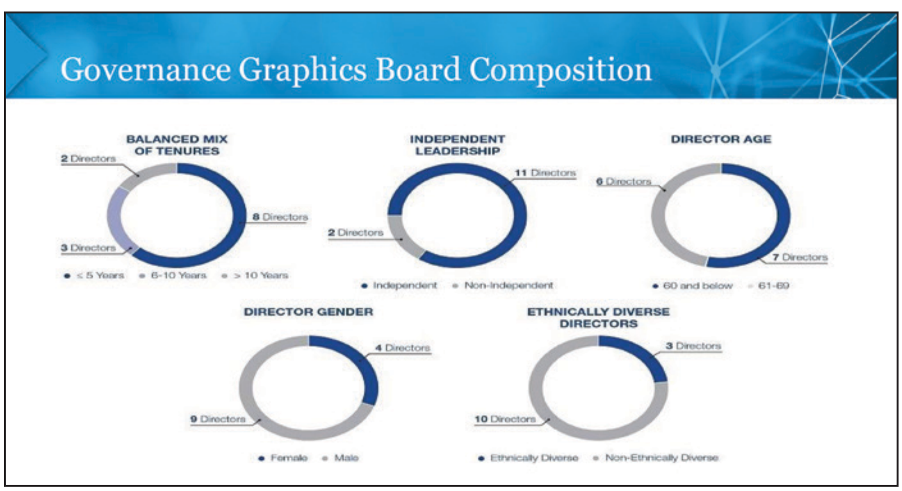


	Board of Directors							
	Name 1	Name 2	Name 3	Name 4	Name 5	Name 6	Name 7	Name 8
Skills & Experience								
Board of Directors Experience	X			X				
[Specific] Industry Experience		X					X	
CEO/Business Head	X			X				
International	X					X	X	
Human Capital Management/Compensation			X				X	
Finance/Capital Allocation		X			X		X	
Financial literacy/Accounting (Audit Committee Financial Expert or "ACFE")			X			X		
Government/Public Policy	X			X				
Marketing/Sales			X		X			
Environmental Science/Policy/Regulation						X		
Academia/Education								
Risk Management				X				
Corporate Governance		X						X
Technology/Systems					X			X
Business Ethics			X			X		X
Real Estate		X			X			X
[Custom 1]								
Demographic Background								
Board Tenure								
Years	15	15	10	8	7	7	4	1
Sexual Orientation (voluntary)								
LGBTQ	X							
Gender								
Male		X	X	X	X	X		X
Female	X						X	
Non-Binary								
Age								
Years Old	60	63	65	62	60	67	55	47
Race/Ethnicity								
African American/Black	X							
Asian, Hawaiian, or Pacific Islander								
White/Caucasian		X	X	X		X	X	X
Hispanic/Latino					X			
Native American								
Other								

It remains to be seen how much traction the suggested matrix will gain. Some companies may believe a customized, narrative approach is better. Many companies have already developed informative graphics to display skills and experience such as this experience graphic and this series of graphics illustrating various aspects of board composition. Also, while it is not a perfect tool, a photograph can illustrate some key demographic points.



Requesting a different format for disclosure may be viewed as qualitatively different from requesting a right that does not otherwise exist. Therefore it is possible that some companies may not view this matrix a compelling request. However, other companies may feel the matrix is a relatively easy request to comply with.



the matrix as a compelling request. Some may believe that a customized narrative approach is better than trying to fit qualifications into pre-determined boxes. Many companies have already developed informative graphics to display skills and experience, such as a bar graph for board skills or an experience graphic illustrating aspects of board composition. Also, while it's not a perfect tool, a photograph can also illustrate some key demographic points. However, some companies may feel the matrix is a relatively easy request to comply with.

So with that, I'm going to turn the program over to Kristen.

Kristen Ford

I'm a partner in the corporate and securities group here in the Houston office of Mayer Brown. Today, I'll be speaking about shareholder proposals, particularly where we are with proxy access following this 2017 season. We'll begin our discussion on proxy access by highlighting market standard proxy access provisions as well as proposals to modify existing provisions, or so-called fix-it proposals. We'll also discuss other shareholder proposals that have gained traction through institutional investor initiatives, as Laura just spoke about, including with respect to climate change and board diversity. And finally, we'll wrap up with some trends in shareholder proposals that we expect to see for the 2018 season.

Before we get started on proxy access, let's briefly walk through the procedural requirements of the shareholder proposal process as these proposals may potentially be excluded due to technical deficiencies. Rule 14a-8 provides that a shareholder will only be eligible to submit a proposal for inclusion in proxy materials if the shareholder has continuously held at least $2,000 in market value or one percent of the outstanding voting securities entitled to vote on the proposal for at least one year as of the date the proposal is submitted. If the shareholder holds their shares in street name, the shareholder must also provide the company with proof of ownership and eligibility from the record holder of the shares, which is typically the shareholder's broker or bank. The written statement must also confirm that the shareholder intends to continue to hold the securities through the date of the meeting. The deadline for shareholders to submit proposals for the annual meeting is typically found in the company's proxy statement from the prior year. Each shareholder may only submit one proposal per meeting, and the proposal, including any accompanying support statement, may not exceed 500 words.

As previously mentioned, technical deficiencies should be focused on early in the process as this is the company's first line of defense in excluding a proposal. The company may exclude the proposal for technical deficiencies but only after it has notified the shareholder within 14 calendar days of receiving the proposal and the shareholder then fails to adequately correct the issue in a timely manner. The company is not required to provide this notice if the deficiency cannot be remedied, such as a proposal that was not submitted prior to the deadline.

So even if the shareholder meets the procedural and eligibility requirements under Rule 14a-8, the company may still be able to exclude the proposal on substantive grounds if the proposal meets one of the 13 substantive bases for exclusion. For purposes of proxy access and the fix-it proposals that we will discuss in a few minutes, "substantial implementation" is the most relevant basis for exclusion. In order to exclude a shareholder proposal under one of these substantive bases, the company must first notify the SEC, which is typically done through a no-action letter request. This request must be filed with the SEC no later than 80 calendar days before it files the definitive proxy statement. The shareholder proponent of the proposal may submit a response to the SEC with counter arguments to the company's basis for exclusion. Both the incoming no-action request and any responses relating to shareholder proposals are made publicly available in the Rule 14a-8 section of the no-action letter database on the SEC's website.

There have been some recent efforts to amend the shareholder proposal process from the current requirements set out in Rule 14a-8. For instance, the Financial Choice Act, which the U.S. House of Representatives passed in June 2017, would make it more difficult for shareholders to submit proposals by increasing the share ownership threshold to one percent for a period of three years, thereby removing the $2,000 market value option, and prohibiting proposals by proxy, where shareholders authorize other persons to submit a shareholder proposal on their behalf.

It's not yet clear when this bill will be considered by the full Senate or, if it's approved by the Senate, whether the Senate will make changes to the version of the Financial Choice Act that was passed by the House. Further to the proposed legislation, Jay Clayton, the relatively new SEC chair, in July 2017 questioned "how much cost should the quiet shareholder, the ordinary share-

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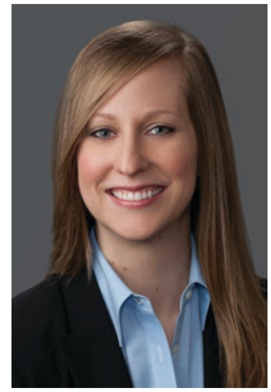

Kristen Ford
Mayer Brown

Proxy Season

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holder, bear for the idiosyncratic interests of others," suggesting that reform of the shareholder proposal process may be a priority. Additionally, the U.S. Chamber of Commerce offered recommendations to the SEC on shareholder proposal reform and tightening the eligibility requirements in a paper submitted in July 2017.

On the other hand, investor advocacy groups, such as the Council of Institutional Investors, believe that the concerns of the SEC and the Chamber of Commerce with respect to overload of shareholder proposals are exaggerated, pointing to data that most companies can expect to receive a proposal once every 7.7 years. So for now, Rule 14a-8 continues to govern the shareholder proposal process as this debate continues. Changes could be on the horizon, although given the timing, these changes would be unlikely for the 2018 proxy season.

So, despite the lack of clarity on the potential reform to the shareholder proposal process, a topic that has stabilized over the course of the last year is proxy access. Currently, more than 425 companies, including over 60 percent of the S&P 500, have adopted proxy access bylaw or charter provisions and that percentage is expected to increase by the end of 2017.

Just to back up for the moment—what is proxy access? It's shorthand for the ability of a long-term shareholder or a group of them to nominate a limited number of board candidates for election at a company's annual shareholders meeting. Many companies have enacted proxy access bylaw provisions in response to shareholder proposals, and there was an uptick in these proposals as a result of the 2014 Board Accountability Project that was launched by the New York City Comptroller and the New York City Pension Funds. To date, although proxy access bylaw provisions are quite prevalent, proxy access has only actually been used once in the U.S. in November 2016. In that case, the nomination was withdrawn when the shareholders that invoked the use of proxy access did not meet the eligibility requirements.

Following the launch of the Board Accountability Project in 2014, proxy access was quite a hot topic in 2015 and 2016. For 2017, proxy access was almost a non-event. Although over 170 resolutions were filed, only 30 percent ever reached ballots due to negotiated withdrawals and omissions. Although fewer proposals reached ballots, those that did generally had a higher success rate than in 2016, receiving 58.2 percent average support. Changes to investor voting policies have also added pressure on companies to adopt proxy access in response to proposals. For example, Fidelity Investments reversed its historical position of opposing proxy access and began supporting market-standard provisions. Therefore, companies could no longer rely on opposition votes from large investors such as Fidelity to defeat proxy access proposals and many have opted instead to adopt market-standard provisions that we will discuss in a few minutes. The number of proxy access proposals has leveled out following the surge in 2014 and 2015 now that proxy access has become more mainstream.

Given the sheer number of companies that have adopted proxy access bylaw provisions, market-standard provisions have emerged, known in shorthand as 3/3/20/20. This translates to a required ownership threshold of three percent, for three years, allowing aggregation of up to 20 shareholders to reach this ownership threshold, and limiting the number of proxy access nominees to 20 percent of the board, often with a minimum of two nominees. These provisions also frequently specify a minimum number of support for re-nominations in future years.

Given that many large U.S. companies have adopted proxy access, there has been a new wave of shareholder proposals seeking to amend previously adopted provisions in order to broaden the rights provided thereunder. These so-called fix-it proposals typically seek to amend one or more features of existing proxy access provisions such as by raising the maximum number of directors eligible for election or increasing or eliminating aggregation limits. Where a company's proxy access provision is in line with the 3/3/20/20 market standard, the SEC is likely to allow the fix-it proposal to be excluded on the substantive basis of being substantially implemented.

For example, in November 2016, the SEC permitted Oshkosh Corporation to exclude a proposal as substantially implemented where in response to the proposal, Oshkosh had implemented some but not all of the proxy access enhancement package that had been proposed, including reducing the eligibility threshold from five percent down to the market-standard three percent. For a single-issue fix-it proposal seeking to increase the aggregation limit to 50 shareholders, the SEC has permitted the exclusion as substantially implemented where the company includes information in its no-action request about its institutional investor base to demonstrate that a higher aggregation limit would not impact proxy access in a meaningful way. On the other hand, despite the exclusion of many fix-it proposals on the basis of substantial implementation, the SEC rejected the no-action request of H&R Block in July 2017 to exclude a fix-it proposal to completely eliminate the cap on shareholder aggregation in order to reach the market-standard three percent ownership threshold that is set out in their bylaws currently.

So for 2018, we're likely to continue to see fix-it proposals such as the one eliminating the aggregation caps that survived H&R Block's no-action request. For instance, Franklin Resources has already received a proxy access enhancement package proposal that seeks to eliminate the aggregation cap on its existing provision, among other requested amendments to its existing proxy access provision.

Despite the high frequency of these fix-it proposals, support was consistently low in 2017 and we expect the same level of support in 2018.

In addition to proxy access, environmental and social-related proposals made significant headway in 2017, in part due to institutional investors shifting their voting policies in favor of these proposals and putting pressure on companies to increase disclosure for issues that they deem material to shareholder value. Particularly interesting for the energy clients that we work with in Houston are the climate-change proposals that we saw in 2017. Proposals relating to environmental concerns were the most prevalent proposals introduced, out-pacing political spending and lobbying proposals which are always high on the list.

Although the sheer number of environmental and climate-change proposals was impressive, three of the proposals received majority support for the first time. These three proposals were predicated on the November 2016 implementation of the Paris Agreement and proposed that each of ExxonMobil, Occidental and PPL publish an annual assessment of the long-term portfolio impacts of technological advances and global climate change policies consistent with government policies to limit average global temperature rise to well below two degrees Celsius. These are known then as Two Degree Celsius Proposals. The New York State Common Retirement Fund was the lead sponsor at ExxonMobil and PPL, while the California Public Employees Retirement System was the lead sponsor of the proposal at Occidental. In 2016, ExxonMobil and Oxy received similar proposals but the proposals did not receive majority support. However, in 2017, many large institutional investors shifted their vote, such as BlackRock and Vanguard, thereby resulting in the proposals obtaining majority support. Notably, Chevron received a similar Two Degree Celsius Proposals in 2017, which was withdrawn once Chevron published its 2017 Climate Risk Management Report.

Given the shift in voting policies of institutional investors with respect to environmental matters, the U.S. decision in June 2017 to withdraw from the Paris Agreement and the general rolling back of environmental regulations, we're likely to continue seeing these proposals in 2018 and perhaps even more of them will receive majority support as investors look to private ordering in order to address issues relating to climate change on a company-by-company basis.

In the no-action requests for the 2018 season posted on the SEC's website, we've already seen a couple of environmental-related proposals submitted to Apple and Deere & Company, each requesting that the company prepare a report on its potential to achieve net zero greenhouse gas emissions by a certain target date.

In addition to environmental-related approvals, another hot topic from 2017 relates to gender equality and diversity, which Laura alluded to earlier, with respect to the launch of the Boardroom Accountability Project 2.0 and the related initiatives at State Street and BlackRock. A record number of proposals relating to board and workplace diversity and gender pay equality were introduced. With respect to board diversity, the majority of proposals were withdrawn following the targeted company's agreement to improve board diversity through recruitment. Voting momentum for these proposals increased incrementally with average support of 27.7 percent up from 24.8 percent in 2016, and two proposals receiving majority approval at Cognex and Hudson Pacific. Big players like BlackRock are supporting these proposals as part of their initiatives that Laura spoke about. For instance, BlackRock supported eight out of nine board diversity proposals in 2017.

With respect to workplace diversity, the number of proposals doubled in 2017 versus 2016. Many of these proposals were withdrawn when companies agreed to publish workplace diversity data. No proposals obtained majority approval but support marginally increased as compared to 2016.

With respect to gender pay gap proposals, Aruna Capital and Pax World joined with the New York City Pension Funds to request that companies report on whether they had a gender

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Proxy Season

continued

Michael L. Hermsen
Mayer Brown

pay gap, the size of that gap, and policies and goals for reducing the gap. About half of these proposals were withdrawn following companies' agreement to comply with the request. Support for these proposals was generally low despite ISS recommendations to vote in favor of them. Nevertheless, Aruna Capital plans to re-file the proposals for 2018.

So in addition to these environmental and social proposals, the following types of proposals were also introduced in 2017. Proposals relating to political spending and lobbying are always high on the list of political proposals and 2017 was no exception. Proposals of this sort that went to vote in 2017 received average support of 25.8 percent, up slightly from 24 percent in 2016, but no proposal received majority support. Given the current political climate, these proposals will likely continue to be popular in 2018.

Requests that the chairman of the board be an independent director remained relatively common but none received majority support. Other proposals relating to traditional governance reform as well as executive compensation proposals continued to decline in frequency. Twelve proposals related to Holy Land Principles went to vote in 2017, up from eight proposals in 2016. Support for these proposals remains low. For 2018, Apple has already received a Holy Land Principles proposal and has submitted a no-action request on substantial implementation grounds. Monsanto and Apple have both received proposals for the 2018 season, requesting that their boards form human rights committees. We may see more of these types of proposals in 2018. Lastly, we continued to see proposals in 2017 requesting that companies prepare sustainability reports, disclosing short-term and long-term effects related to environmental, social and governance issues. While the number of these proposals was down as compared to 2016, average support was up versus 2016. One such proposal passed at Pioneer Natural Resources. Given the increased level of support, we're likely to continue to see sustainability proposals in 2018 as well.

So to wrap up this portion of the presentation, what will be some of the trends in this area for 2018? There could be potential revisions to the shareholder proposal process if the Financial Choice Act is enacted, or through SEC regulations, making it more difficult for shareholders to introduce proposals, although given timing, such reform will likely not impact the 2018 season.

The frequency of proxy access proposals will likely continue to decline, although we may see a surge of fix-it proposals, particularly those modeled after the proposal that survived H&R Block's no-action request earlier this year. Climate change proposals will also likely be on the rise. We expect to see an increase in the number of proposals introduced as well as an increase in support. Board gender diversity will continue to be a headliner topic with support levels likely propped up by institutional investors, given recent initiatives. We're also likely to continue to see a steady stream of political spending and lobbying proposals consistent with previous years. And with that, I will hand it over to Mike.

Michael L. Hermsen

Thanks Kristen. I'm now going to turn our attention to the four SEC compensation-related rules that were mandated by Dodd Frank: pay ratio, clawbacks, pay-for-performance, and hedging disclosure. I'm going to begin with the one compensation-related rule that has been adopted by the SEC, pay ratio disclosure, and I'll be spending most of my time on this topic.

Although there was some discussion earlier this year of either Congress eliminating this obligation as part of the Financial Choice Act, or the SEC delaying, revising or rescinding the rule, that has not happened. If you're hoping that something will happen, that is probably wishful thinking on your part. So at this point, companies should be well into their planning for this requirement.

The initial pay ratio disclosures will be required for a company's first fiscal year that begins on or after January 1, 2017. Pay ratio disclosure will have to be included in all filings that require executive compensation disclosure, such as annual meeting proxy statements. Therefore, the first required pay ratio disclosures will likely be in the 2018 annual meeting proxy statement. Some companies are exempt from having to comply with the requirement, including emerging growth companies, smaller reporting companies, foreign private issuers, Canadian companies subject to MJDS, and registered investment companies.

Briefly, what the pay ratio rules require is for public companies to disclose the median of the annual total compensation of all employees other than the CEO, the annual total compensation of the CEO, and the ratio of these amounts.

If a company chooses to express the ratio numerically, it needs to do so in relation to one, as in fifty to one. Alternatively, the company may express the pay ratio narratively, as in the total annual compensation of the CEO is fifty times that of the median of the annual total compensation of all other employees. In addition, the rule requires a brief non-technical overview of the methodology used to identify the median employee and any material assumptions, adjustments or estimates used to identify the median employee or to determine total compensation or elements of total compensation.

For purposes of the pay ratio rule, the term "employee" means an individual employed by the company or its consolidated subsidiaries, including full time employees, whether based in the U.S. or outside the U.S., part-time employees, temporary employees, and seasonal employees. However, a worker employed by, and whose compensation is determined by, an unaffiliated third party such as an independent contractor or leased worker is not considered an employee for purposes of the rule. The determination of the median employee can be made as of any date determined by the company within the last three months of the company's last completed fiscal year.

There are two limited exemptions from the definition of employee for certain non-U.S. employees. One exemption is for employees in a foreign jurisdiction if compliance with the pay ratio disclosure rule would violate that jurisdiction's data privacy laws or regulations. If the company relies on this privacy exemption, it must exclude all employees from that jurisdiction from its pay ratio calculation.

There are some hoops that have to be jumped through in order to rely on this exemption, including exercising reasonable efforts to obtain a waiver from any applicable data privacy requirements, obtaining a legal opinion that the data privacy provisions apply, and providing certain disclosure regarding reliance on the exemption.

The SEC also provided a de minimis exemption for non-U.S. employees. A company may be able to exclude up to five percent of its non-U.S. employees from its pay ratio calculation. However, if a company excludes any employees in a particular non-U.S. jurisdiction, it must exclude all employees in that jurisdiction. As a result, if more than five percent of a company's employees are in one non-U.S. jurisdiction then no employees in that jurisdiction may be excluded in reliance on this exemption. In addition, employees excluded pursuant to the privacy exemption will count toward the five percent limit for the de minimis exemption. Finally, as with the other exemption, if this exemption is being relied upon, certain disclosure must be provided regarding reliance on the exemption.

The pay ratio disclosure rule gives companies the 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 applied compensation measure, or CACM, such as compensation amounts reported in its tax and/or payroll records, total compensation regarding their full employee population, statistical sampling, or any other reasonable method.

The rule permits companies to identify the median employee only once every three years as long as there has been no change in employee population or employee compensation arrangements that would significantly change the pay ratio disclosure.

Once the median employee has been identified, the total compensation for that employee will have to be calculated consistent with the requirements for calculating the CEO's total compensation for purposes of summary compensation table. In determining the median employee and calculating his or her compensation, a company is permitted to use a cost-of-living adjustment for employees living in jurisdictions other than the jurisdiction in which the CEO resides. If the company does this, it will have to present the employee's information with and without the cost-of-living adjustment.

There are a couple of other exemptions that I want to mention. One is that pay ratio disclosure is not required to be included in a prospectus for an IPO. Another is that individuals who become employees as a result of a business combination or the acquisition of a business can be omitted from the company's identification of the median employee for the fiscal year in which the transaction became effective.

In September of this year, the SEC issued an interpretive release to assist companies in their efforts to comply with the new requirements. The Division of Corporation Finance provided additional guidance to assist companies in determining how to use statistical sampling and other reasonable methods, and the Division also updated its Compliance and Disclosure Interpretations, or CDIs, related to guidance on the methodology for applying compensation measures and determining the employee population to identify the median employee.

In the interpretive release, the SEC provided

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guidance in three areas to assist companies in their compliance efforts. The first area was in the use of reasonable estimates, assumptions and methodologies in statistical sampling. In the interpretive release, the SEC makes clear that the required disclosure may be based on:

- a company's reasonable belief,
- use of reasonable estimates, assumptions and methodologies and
- reasonable efforts to prepare the disclosures.

Further, the SEC stated that, in its view, if a company "uses reasonable estimates, assumptions or methodologies, the pay ratio and related disclosure that results from such use would not provide the basis for SEC enforcement action, unless the disclosure was made or reaffirmed without a reasonable basis or was provided other than in good faith."

The second area relates to how existing internal records can be used. The SEC gave a couple of examples, but the important takeaway is that the company may use internal records in determining the median employee.

The third area relates to whether independent contractors should be considered employees for purposes of the rule. The SEC makes clear that the exception from the definition of employee for independent contractors included in the rule was not intended to serve as the exclusive basis for determining whether a worker is an employee. The SEC said that a company could apply a widely recognized test under another area of law that it otherwise uses, such as employment or tax law, for this purpose.

At the same time the SEC issued the release, the staff of the Division of Corporation Finance issued guidance providing four examples of sampling and other reasonable methodologies that may be used to identify the median employee and to calculate the total compensation or any element of total compensation for employees.

- First, the Division noted that companies may combine the use of reasonable estimates with the use of statistical sampling, or other reasonable methodologies, in preparing their disclosures. Mixing and matching will work. A company doesn't need to use just one methodology.
- Second, the Division gave examples of sampling methods that companies may use, alone or in combination, all of which are too technical for us to discuss here.
- Third, the Division gave examples of situations where companies may use reasonable estimates, including in analyzing the composition of the company's workforce, evaluating the likelihood of significant changes in employee compensation from year to year, and identifying the median employee.
- Fourth, the Division identified several examples of common statistical techniques and methodologies that companies may consider reasonable, including using reasonable methods of imputing or correcting values and using reasonable methods of addressing extreme observations and outliers.

Finally, the Division provided three hypothetical examples of how their guidance could be applied in situations involving a company with employees located in various geographical regions, inside and outside the U.S.

As of today, the Division of Corporation Finance has published five CDIs relating to selecting a methodology for applying compensation measures and determining the employee population to identify the median employee.

- One CDI makes clear that a company may not use exclusively hourly or annual rates of pay as its CACM.
- Another CDI discusses time period issues involved in identifying the median employee through a CACM. This CDI observes that when a company uses its CACM to identify its median employee, it does not have to use a period that includes the employee population determination date or a full annual period. A CACM may consist of annual total compensation from a prior fiscal year, so long as there has not been a change in the company's employee population or compensation arrangements that would result in a significant change of its pay distribution to its workforce. So a company won't necessarily have to redo all of the work each year.
- A third CDI deals with furloughed employees and specifies that a company must first determine whether its furloughed workers will be treated as employees, which is a matter of facts and circumstances.
- A fourth CDI makes clear that any appropriate method that reasonably reflects the annual compensation of employees can serve as a CACM. For example, a company may use internal records that reasonably reflect annual compensation to identify the median employee even if those records do not include every element of compensation such as equity awards widely distributed to employees.
- The final CDI makes clear that the staff will

not object if a company discloses the pay ratio as a reasonable estimate calculated in a manner consistent with requirements. This position recognizes that the use of estimates, assumptions, adjustments, and statistical sampling permitted by the rule may cause a degree of imprecision.

The upshot of all this guidance from the SEC is to try to ease the compliance burden on issuers and help to provide insight into how the SEC is thinking about the disclosures that will be filed next year.

I want to leave you with a few practical considerations to keep in mind.

- One, which actually isn't on the list, but it's that we expect there to be a great variety in what the disclosures will look like this year. The SEC has provided some guidance. They also have given issuers a lot of flexibility and we expect them to use this flexibility and to see, as I said, a wide variety of types of presentations when these proxy statements come out.
- Another consideration to keep in mind is that the pay ratio disclosures will be filed not furnished. Therefore, they will be subject to certifications by the CEO and the CFO and subject to potential securities law liabilities.
- The first compliance date is fast approaching. Companies should already be determining the methodology they will use to select the median employee and calculate and report their pay ratio disclosure and, if necessary, coordinating their reporting systems in various jurisdictions. Companies should be developing adequate disclosure controls and procedures to ensure compliance.
- Additional interpretations may come out of the SEC before the first disclosures are required, so stay tuned.
- Companies should also consider the practical impact of pay ratio disclosure on employee population and whether it will create any employee morale issues. While employees as a group may share a general interest in the ratio of the CEO's pay to the median employee, many employees may react to the pay ratio disclosure more personally, wanting to know why their compensation is in the bottom half or why their compensation is only in the middle of the compensation spectrum. Therefore, in addition to planning for public pay ratio disclosure, companies should be planning on how they will handle internal employee communication on this subject.
- Consider where you will put the pay ratio disclosure in the proxy statement. Although there is a relationship between pay ratio and some of the other disclosures in the proxy statement, such as CD&A (Compensation Discussion & Analysis), it should be its own stand-alone section that doesn't necessarily repeat other information being disclosed.
- Also consider whether, in addition to the required disclosures, you will provide additional narrative disclosures. Optional disclosures to consider include explanations, rationale or context for any of the required disclosure such as referencing the CD&A for how the amounts of CEO pay are determined and describing how geographical, regional and skill differences impact the pay ratio.
- The narrative portion of the pay ratio disclosure may be sensitive. Therefore, it's important to prepare a draft of the disclosure early and circulate it to senior management, the compensation committee and any compensation consultants.
- Recognize that pay equality is a political issue. Therefore the disclosure may be of interest to stakeholders who aren't necessarily shareholders.
- And the final practical consideration: some states and municipalities are considering new taxes on companies with pay ratios exceeding specified levels. For example, Portland, Oregon approved a variable sliding surcharge on a company's business tax if the CEO earns more than 100 times the median pay of the other officers. As part of getting ready for the pay ratio disclosure, companies should determine, based on where they do business, whether their pay ratios will trigger additional taxation by any state or municipality.

There are three Dodd Frank compensation rules – clawbacks, pay-for-performance and hedging disclosure – that have not been adopted by the SEC. All three rules were proposed by the SEC in 2015. I won't go over them in detail since based on the SEC's most recent rule-writing agenda, we don't expect to see any action on these proposals in the near future.

With respect to clawbacks and the hedging disclosure, similar to some of the issues that Kristen mentioned before, we are seeing some private ordering at work. Many public companies already have a clawback requirement, either as a governance matter or to address concerns of a proxy advisory firm. There are many variations

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Jennifer Carlson
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of the policy currently fully in effect but few if any of them go as far as what would be required by the proposed rule.

Many of the companies already discuss having hedging policies in their CD&A either to address concerns of proxy advisory firms or in response to Item 402(b) of Regulation S-K, which requires disclosure of material information necessary to understand compensation policies, and include hedging policies as examples of information that should be provided, if material.

And with that, I am going to turn it over to Jen.

Jennifer Carlson

Thanks Mike.

For the last part of our program, I'll discuss some additional disclosure issues and annual meeting logistics. First, on October 23 of this year, the SEC approved the PCAOB (the Public Company Accounting Oversight Board) proposal to adopt AS 3101. The new standard will require auditors to disclose significantly more to investors about what they learn during a company's audit. Beginning with audit periods ending on or after December 15, 2017, the auditor's report must be reformatted and include new information to help clarify the auditor's role and responsibilities related to the audit.

Next, and the more significant change, the standard will require audit reports to disclose any CAMs, or critical accounting matters, arising during the audit, or state that there were no CAMs. A CAM is any matter arising from the audit or the financial statements that was communicated or required to be communicated to the audit committee, and that (1) relates to accounts or disclosures that are material to the financial statements and (2) involve especially challenging, subjective, or complex auditor judgment.

To determine whether a matter involves challenging, subjective, or complex judgment, auditors should look at a number of factors. For all identified CAMs, the audit report must identify the CAM, describe the principal considerations that led the auditor to determine that it was a CAM, and describe how it was addressed in the audit. The auditor also must refer to the relevant financial statement accounts or disclosures. This portion of the new standard will be effective for the annual periods ending on or after June 30, 2019 for large accelerated filers and on or after December 15, 2020 for all other filers.

So as you see, the new audit reports are designed to provide specific information about the auditor and the audit to make the report more useful for investors. Although implementation of CAMs is still a ways off, companies need to start thinking about, and discussing with their accountants and audit committee, how they will identify and disclose CAMs. And remember that the general content and formatting changes will be effective for the 2018 proxy season. With all this new information, companies may want to think about voluntarily expanding disclosure in their proxy statements about their auditors.

Along these lines, in recent years, we've seen an increased interest by regulators in enhanced audit committee disclosures to shareholders. In July 2015, the SEC's concept release solicited comment on whether there should be greater disclosure by audit committees about their work. The release focused on the three areas of disclosure: oversight of auditors; process for appointing/retaining auditors; consideration of audit firms and engagement team qualifications. Although the comment period expired, the SEC has not yet released proposals but has encouraged voluntary disclosures. In 2016, the PCAOB re-proposed an auditing standard that would require increased disclosure as well. And amidst all this background, we continue to see increasing amounts of voluntary disclosure by companies. This generally relates to three different categories, including factors considered by the committee when reviewing qualifications, statements that the choice of auditor was in the best interests of the company, and explanations for increases in fees paid to the auditor compared to the prior year.

Extracts from Coca-Cola's proxy statement show several voluntary disclosures: a statement that the audit committee annually evaluates the performance of the auditors and determines whether to re-engage them, the qualifications of the auditor that are considered, and a statement that the auditor is in the best interest of the company and its shareowners. Similar disclosures can be found in GE's proxy statement and in Apple's proxy statement.

Moving along to other disclosure issues, the new revenue recognition standard goes into effect starting with fiscal years beginning after December 15, 2017. Calendar year companies will apply the standard in their first quarterly report for 2018 and not in the annual report for 2017, but should include transition disclosure in the annual report to aid their investors. Companies should already be discussing the effects of the new standard with their accountants and audit committee and preparing for the appropriate disclosure.

Although we don't have time today for a full discussion, companies have two choices for the transition to the standard: the full retrospective method or the modified retrospective method. Companies using the full retrospective method should understand that it will limit their ability to file a Form S-3 during 2018 without also revising annual financial statements included in the 10-K filed for 2017. Please consider and discuss the implications within your company.

Hyperlinks: the SEC now generally requires the items listed in the index of certain filings, including Form 10-K and 20-F, to be hyperlinked. The requirement covers both exhibits that are filed as part of the report and exhibits that are incorporated by reference to prior filings. Since annual reports typically have much longer lists of exhibits than other SEC filings, companies should identify hyperlinks early and make corrections as needed.

The staff continues to review compliance with disclosures to be used with non-GAAP financial measures since updating their new CDIs in May 2016. Many staff comments have been directed at the requirements for presenting the most directly comparable GAAP measure with equal or greater prominence and the company's justification for the use of non-GAAP measures outside the context of pay-related proxy statements.

In proxy statements, however, there are some special rules for non-GAAP financial measures. When a company discloses target levels for incentive comp, and the target is in non-GAAP measures, the disclosure is not subject to Regulation G but the company must disclose how the numbers are calculated from the audited financial statements. All other non-GAAP financial measures used in proxy statements must comply with Regulation G and Regulation S-K. There are a few instances where a company may provide the reconciliation in a separate document. For pay-related disclosures, the company may include the reconciliation in an annex to the proxy statement as long as there is a prominent cross-reference. For non-GAAP measures that are also included in the 10-K, the company must include the reconciliation in the 10-K but does not also need to include it in the proxy statement. The measure in the proxy statement may be accompanied by a prominent cross-reference to the reconciliation in the 10-K.

In connection with preparing the annual report, companies also need to review their risk factors to ensure they adequately reflect the current risks the company faces. In particular, the company should focus on any new risk factors that may be needed, or perhaps existing risk factors that should be expanded to match the company's risk profile in the current environment. Some key risk factors to consider at this time included cybersecurity, which is now recognized to be a major issue in all types of companies, political changes or changes in regulations and policies that could impact the profiles of certain companies, such as travel and immigration policy. These can either be stand-alone or in combination with other risk factors. Companies in the health care or insurance industries may face risks related to the proposed repeal and replacement of the Affordable Care Act. Brexit is still an issue to consider. Climate change has garnered increasing attention in the context of risk-factor disclosure as well. This coincides with more shareholder proposals as noted earlier by Kristen. Companies are also including specific risk factors for shareholder activism. You, your financial team, litigators, and other who monitor risk should be reviewing risk factors in considering whether updates or changes should be made.

Briefly, the SEC issued an interim rule in 2016 amending the Form 10-K to allow but not require companies to include a summary of information required by that form. The different factors to consider are listed here: the summary must be brief, it must be presented fairly and accurately, and it must include hyperlinks/cross-references for each item. But we have not seen broad adoption of this optional summary. Please also note that the 10-K cover page has been changed to include additional information for emerging growth companies to check.

Moving on to annual meeting logistics. More companies are moving to a virtual meeting either as a hybrid meeting or as a virtual podcast in addition to the in-person meeting, or as a completely virtual meeting with no in-person elements. Although the virtual meeting is still in the minority, we expect the numbers to grow. The rapid rise of virtual-only meetings has garnered much criticism. In particular, shareholders have voiced their concerns over their ability to engage with and confront boards and company management. We have seen proposals from individual shareholders asking virtual-only companies to reinstate the in-person meeting but these proposals continue to be excluded based on ordinary business grounds. Earlier in 2017, the New York City Comptroller asked more than a dozen companies to hold in-person meetings rather than continuing virtual meetings. And also this year,

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the New York City Pension Funds declared that they would vote against nominating committee members at virtual-only meetings. This new policy now applies to S&P companies and will apply to all other companies beginning in 2018.

If your company is considering moving away from physical meetings, you may want to consider a hybrid format first. In-person meetings can be supplemented by audio and/or video options and many investor groups support this format. In either case, companies should begin preparation for virtual meetings early. Confirm that your governing law permits such meetings and that your organizational documents allow the practice. Think particularly hard on how shareholder questions will be handled at a virtual meeting.

Just a few final thoughts on annual meeting matters. Begin planning and preparations early, especially if you're transitioning to a hybrid, virtual or virtual-only meeting. Many companies rely on a time-and responsibility check-list to help with the process. For D&O questionnaires, take the time to review and update the questionnaire, particularly if this hasn't been done for a few years. Although some changes have been made in recent years, we aren't expecting any major changes to D&O questionnaires for the 2018 proxy season. Remember that logistics matter. Make sure you have enough space for an in-person meeting and definitely consider a dry run for any type of the virtual meeting. It's also important to plan for security and the safety of your attendees, ranging from traffic control, parking, bag inspections, and the presence of company or hotel security or even police. Increased security may be necessary if there are contentious shareholder proposals.

Finally, proxy statements should note any admission requirements, including who will be allowed into the meeting and what identification may be required.

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