

Preparing for the 2015 US Proxy and Annual Reporting Season

It is time for calendar year-end public companies to focus on the upcoming 2015 proxy and annual reporting season. This Legal Update discusses the following key issues for companies to consider in their preparations:

- Pending Dodd-Frank Regulation
- Say-on-Pay and Compensation Disclosure Considerations
- Shareholder Proposals
- Proxy Access
- Compensation Committee Independence Determinations
- Compensation Adviser Independence Assessment
- Compensation Consultant Conflict of Interest Disclosure
- NYSE Quorum Requirement Change
- Director and Officer Questionnaires
- Proxy Advisory Firm and Investment Adviser Matters
- Conflict Minerals
- Cybersecurity
- Management's Discussion and Analysis
- XBRL
- Proxy Bundling
- Foreign Issuer Preliminary Proxy Statement Relief
- Technology and the Proxy Season

Pending Dodd-Frank Regulation

Of interest to many people this proxy season is when the US Securities and Exchange Commission (SEC) will take action on four executive compensation/governance regulatory initiatives mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and what impact, if any, SEC action on these initiatives will have on proxy statements for 2015 annual meetings.

As of the date of this Legal Update, the SEC still needs to finalize (or re-propose) its pay ratio disclosure rules and to propose its clawback, hedging and pay-for-performance rules. The unified regulatory agenda published by the Office of Management and Budget of the Executive Office of the President¹ targets each of these four matters for SEC action by October 2014, but it is not clear if that timetable will be met.

Proposed Pay Ratio Disclosure Rules. On September 18, 2013, the SEC proposed pay ratio disclosure rules pursuant to a Dodd-Frank mandate.² Assuming no change is made to the transition period set forth in the proposed rules, pay ratio disclosure will not be required for the 2015 proxy season, even if the SEC adopts final rules in 2014. Should the SEC adopt final rules in 2014, the earliest that pay ratio disclosure is likely to be required for calendar-year companies would be the 2016 proxy season (with respect to 2015 compensation).

Under the pay ratio proposal, public companies would have 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 those amounts. As proposed, smaller reporting companies, emerging growth companies and foreign private issuers would not be subject to the pay ratio disclosure requirement.

The proposed pay ratio disclosure would cover all employees of the company and its subsidiaries as of the last day of the prior fiscal year, including employees based outside of the United States, part-time employees, temporary employees and seasonal employees. Companies would be permitted to annualize the compensation of a permanent employee who did not work the entire year. However, under the proposed rules, the compensation of temporary or seasonal workers may not be annualized, part-time employee compensation may not be measured on a full-time equivalent basis and cost-of-living adjustments may not be made for non-US employees.

The proposed rules would allow companies to select a method for identifying the median employee that is appropriate to the size and structure of their businesses and compensation program. Under the proposal, companies could use reasonable estimates to calculate annual total compensation or any element of such compensation. The only required narrative disclosure would be a brief, non-technical overview of the methodology used to identify the median, and any material assumptions, adjustments or estimates used to identify the median or to determine total compensation or elements of total compensation.

For additional information about the SEC's proposed pay ratio rules, see our Legal Update dated October 2, 2013, titled "Securities and Exchange Commission Proposes Pay Ratio Disclosure Rules."³

Clawbacks. Under Dodd-Frank, the SEC must direct stock exchanges to prohibit the listing of securities if a company does not develop a policy with respect to recovery of incentive-based compensation in certain circumstances. Unlike the comparable Sarbanes-Oxley Act provision, the clawback policy under Dodd-Frank will need to cover both current and former executive officers, not just the chief executive officer and the chief financial officer. The Dodd-Frank clawback provision applies to any accounting restatement resulting from material non-compliance, whether or not the executive officer is responsible for the misconduct that led to the restatement.

Companies are permitted to wait for the final rules before adopting or amending a clawback policy for the purposes of complying with this Dodd-Frank requirement, although some companies have already adopted clawback policies pending the completion of the rulemaking process. Whether or not a company has disclosed that it has a clawback policy is something that corporate governance rating firms and investors might consider when evaluating a public company's corporate governance structure.

Implementation of the Dodd-Frank clawback provision is an important area to follow closely, as it involves rulemakings by both the SEC and the stock exchanges. However, because the SEC has not yet taken the step of proposing a clawback policy listing requirement for the stock exchanges, it is unlikely that clawback rulemaking will directly affect the 2015 proxy season.

Hedging. The SEC still needs to propose regulations to implement the Dodd-Frank requirement for companies to disclose whether employees and directors are permitted, directly or indirectly, to hedge the market value of securities granted as compensation. Item 402(b)(2)(xiii) of Regulation S-K already requires companies to disclose any policies regarding hedging the economic risk of owning company securities. Given that the SEC has not

proposed a hedging rule pursuant to Dodd-Frank, it is not likely that hedging policy disclosure requirements will change for the 2015 proxy season.

Companies may wait until the SEC adopts final rules before adopting or amending a hedging policy in response to the Dodd-Frank hedging requirement. However, anti-hedging positions of proxy advisory and corporate governance rating firms, such as Institutional Shareholder Services, Inc. (ISS), have prompted some companies to prohibit directors and executive officers (and sometimes employees in general) from engaging in hedging transactions with respect to their company's stock.

Pay-for-Performance. Dodd-Frank requires the SEC to adopt rules regarding pay-for-performance. Under these rules, companies would have to disclose material information that shows the relationship between executive compensation actually paid and the financial performance of the company, taking into account any change in the value of the company's stock and the dividends paid by the company. The SEC has not yet proposed rules for implementing this disclosure requirement. It is unlikely that a rule on this subject could be proposed and finalized in time to impact the 2015 proxy season. However, it is important to monitor this rulemaking process, particularly since it is possible that the final disclosure requirements might influence upcoming decisions to be made by compensation committees.

Say-on-Pay and Compensation Disclosure Considerations

Say-on-Pay. Shareholders, for the most part, approved their companies' say-on-pay proposals in 2014, often by wide margins. Of the Russell 3000 companies that held say-on-pay votes between January 1, 2014 and September 5, 2014, the average vote result was 91 percent in favor; only 2.4 percent had their say-on-pay proposal fail. Since say-on-pay first became required in

2011, 92.2 percent of the Russell 3000 have had their say-on-pay votes pass in all four years.⁴ Average support for say-on-pay for large-cap companies rose in 2014; however, the percentage of small-cap and mid-cap companies failing to secure at least 50 percent support for say-on-pay increased in 2014.⁵

Although say-on-pay is a non-binding, advisory vote, it can be a sensitive agenda item for executive officers and directors. Therefore, public companies often devote considerable attention to how compensation is presented in the proxy statement, especially in the compensation discussion and analysis (CD&A) section. Plain English is very important to a clear presentation. Executive summaries have become a very common (although not required) component of the CD&A. Many companies include charts and graphs, often in color, to enhance the readability of their CD&A. Some companies include a proxy statement summary at the beginning of the proxy statement that, among other matters, highlights key aspects of the executive compensation program and rationales supporting compensation decisions.

In the CD&A, companies are specifically required to discuss the extent to which compensation decisions were impacted by the results of the prior year's say-on-pay vote. This is required whether or not the proposal received the support of a majority of the shares voting. Compensation committees should be reminded of this reporting obligation so that their deliberations can specifically address the results of the say-on-pay advisory vote.

Non-GAAP Financial Measures. It has become common for companies to highlight performance measures in order to explain that compensation is performance based. To the extent that non-GAAP performance measures are disclosed, companies must pay attention to the requirements of Regulation G.

Disclosure of target levels that are non-GAAP financial measures is not subject to

Regulation G, although the company must disclose how the number is calculated from its audited financial statements. In Regulation S-K compliance and disclosure interpretation number 118.09, the staff of the SEC's Division of Corporation Finance (Staff) extended this principle to the disclosure of the actual results 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 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 such 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.⁶ When providing a non-GAAP performance measure in a proxy statement, for example in a proxy statement summary, a company wishing to rely on these Staff interpretations should be careful to tie such disclosure to compensation.

Negative Proxy Advisory Firm Recommendations and Responses. Proxy advisory firms, such as ISS and Glass Lewis & Co., LLC (Glass Lewis), recommend to their institutional clients how to vote on the various matters put to a vote at an annual meeting, including say-on-pay. A negative recommendation on executive pay from a proxy advisory firm will not necessarily result in a failed say-on-pay vote. There are precedents for companies receiving majority approval for their

say-on-pay proposals even when a proxy advisory firm recommends votes against them, but it is likely that a negative recommendation will at least result in a lower percentage of approval.

Some companies increase their solicitation efforts if they receive a negative recommendation on say-on-pay from a proxy advisory firm. For example, they may prepare slides, a letter to shareholders, a proxy statement supplement, a script or talking points to counter assertions made in the proxy advisory firm's report or to emphasize why they believe executive compensation should be approved. However, before a company may use any additional solicitation material, the material must first be filed with the SEC.

Compensation Litigation. There have been several types of litigation instituted or threatened with respect to say-on-pay votes and proxy compensation disclosure. For example, some lawsuits alleged breach of fiduciary duty, some alleged insufficient compensation disclosures and sought to enjoin the shareholder vote and some challenged specific compensation actions. While many of these actions have failed, there have been some victories for the plaintiffs, so public companies need to be aware of the potential for compensation-related lawsuits to be brought in connection with the 2015 proxy season. Compensation disclosures should be prepared, and compensation decisions should be made, with care, especially for companies that anticipate resistance to their say-on-pay proposals.

Shareholder Engagement. While say-on-pay is advisory and non-binding in nature, it nevertheless has a practical impact. A vote against executive compensation will generate adverse publicity. It may also generate corporate governance consequences, such as poorer corporate governance ratings or increased votes against election of directors. As a result, say-on-pay has given rise to increased shareholder engagement throughout the year, because

outreach to key investors has been recognized as an important element of a successful say-on-pay vote.

To the extent that a company seeks input on particular aspects of pay practices, it should contact shareholders in time to consider their responses when making compensation decisions that will be disclosed in proxy statements. Many companies include shareholder engagement as part of their proxy process, especially in the say-on-pay area, and they are often trying to reach the same large shareholders. For a more effective discussion, companies should prepare in advance to focus the scope of their calls on particular issues.

In conversations with shareholders regarding pay practices (or any other topic), companies should be careful not to selectively disclose material, non-public information. If such information is disclosed in such discussions, the company will need to disseminate such information in a Regulation FD compliant manner.

Shareholder Proposals

Rule 14a-8 under the Securities Exchange Act of 1934, as amended, (Exchange Act) permits shareholders who, for one year, either own \$2,000 in market value or 1 percent of the voting stock, 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 13 substantive grounds that are set forth in the rule.

Popular shareholder proposal topics during the 2014 proxy season included social and environmental proposals, such as proposals relating to political contributions, lobbying, climate change and sustainability. While there were numerous social and environmental shareholder proposals, they generally did not garner majority support of the shareholders voting. For example, The Conference Board, in collaboration with FactSet, reports that of the

194 social/environmental policy shareholder proposals, including 86 political issue proposals and 58 environmental/sustainability issue proposals, that were voted on by the Russell 3000 companies holding annual meetings between January 1 and June 30, 2014, only one (an animal welfare proposal) won a majority of the votes cast.⁷

Regardless of their voting success, social and environmental proposals can have an impact, even when they do not receive majority approval. Proponents of shareholder proposals use the company's proxy statement and annual meeting as a platform to publicize issues. Rule 14a-8 permits failed shareholder proposals to be resubmitted in subsequent years when certain minimum approval thresholds have been achieved, enabling the subject of the losing shareholder vote to be discussed in proxy statements and at the annual meetings in future years. In addition, companies sometimes modify their practices to reflect concerns raised by shareholder proposals that did not pass (such as providing additional political contribution disclosure).

Governance-related proposals also represented a significant category of shareholder proposals in the 2014 proxy season. Certain governance proposals, such as board declassification, elimination of super-majority shareholder votes and majority voting for directors, were frequently successful in achieving majority approval in 2014. According to The Conference Board, at annual meetings of the Russell 3000 companies held between January 1 and June 30, 2014, votes in favor of proposals to declassify the board *averaged 80.6 percent* of the votes cast, votes in favor of proposals to eliminate supermajority vote requirements *averaged 66.2 percent* of the votes cast and votes in favor of proposals to change from plurality to majority voting *averaged 56.5 percent* of the votes cast. Shareholder proposals requesting that the board of directors have an independent chair, separate from the chief executive officer, while generally

not receiving majority support, often received relatively significant levels of support. The Conference Board report shows that at meetings of the Russell 3000 companies held between January 1 and June 30, 2014 votes in favor of such proposals averaged 31 percent. (Proxy access proposals are discussed separately below.)

Shareholders also submitted compensation proposals in 2014, many of which related to equity compensation issues, such as acceleration of vesting upon a change of control or stock ownership thresholds and equity retention periods. These compensation-based shareholder proposals were in addition to the management say-on-pay proposal, giving shareholders multiple opportunities to express views on executive compensation at the same meeting.

Many of the common shareholder proposal topics from 2014 are likely to be raised again during the 2015 proxy season. In addition, there may be new proposals and proposals with increased prevalence for the 2015 proxy season, such as proposals addressing board tenure and its impact on director independence.

If a company wants to exclude a shareholder proposal (and the shareholder's associated statement of support), the company will need one or more procedural or substantive grounds to omit the proposal under Rule 14a-8. If a company believes that Rule 14a-8 specifically provides grounds to exclude the shareholder proposal from its proxy statement, it should submit a no-action request to the Staff, describing each alternative reason. In recent years, some companies have turned to the courts to seek exclusion of shareholder proposals, but such litigation has had mixed results. Most public companies rely on the Staff's no-action process when seeking to omit shareholder proposals.

When available, procedural deficiencies (such as failing to provide the requisite proof of ownership) can present a clear-cut argument

supporting a no-action request to omit a shareholder proposal from the proxy statement, but only if the company 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 defect, the proponent has 14 days to correct the procedural defects. Because of these deadlines, it is important for companies to have a procedure in place so that shareholder proposals are quickly reviewed by someone familiar with 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 it does not support, it should carefully draft a persuasive statement of opposition. The company must send this statement to the proponent of the proposal 30 days before the company files its definitive proxy statement. Depending on the nature of the proposal, in addition to the statement of opposition, the company might consider enhancing other sections of the proxy statement. For example, if a compensation proposal is included in a proxy statement, the company may want to emphasize its rationale on related issues in its CD&A. Similarly, if a shareholder submits a proposal involving board tenure (or otherwise raises board tenure as an issue), a company might wish to expand its description of the attributes that each director contributes to the board and the company.

There have been a number of suggestions for reform of the shareholder proposal process. SEC Commissioner Gallagher has advocated increasing the number of shares that an investor must own in order to submit a proposal for the proxy statement, as well as increasing the length of the holding period.⁸ Commissioner Gallagher also suggested that the SEC increase the percentage of favorable votes needed for a proposal to be re-submitted year after year. Business groups, including the US Chamber of

Commerce, have submitted a rulemaking petition to the SEC asking for such change,⁹ but the SEC has also received opposition to the request to raise the resubmission threshold.¹⁰ Commissioner Gallagher also urged the Staff to provide additional guidance as to what constitutes a significant social policy that prevents a company from excluding a shareholder proposal as relating to the ordinary course of business. The proposed changes to the rule are very controversial, and it does not seem likely that the SEC will change Rule 14a-8 for the 2015 proxy season, although the Staff has the flexibility to issue guidance on the process based on the existing rule.

Proxy Access

In 2011, the US Court of Appeals for the District of Columbia vacated Rule 14a-11 under the Exchange Act (a rule that would have required public companies to include shareholder nominees for director in company proxy materials in certain circumstances). As a result, proxy access is now addressed, if at all, on a company-by-company basis through the shareholder proposal mechanism described above.

Shareholders submitted two different types of proxy access proposals during the 2014 proxy season. The relatively more successful proposal requested proxy access for shareholders owning 3 percent or more of the voting shares for at least 3 continuous years, a standard that was similar to the one contained in the SEC rule that the court struck down. However, the 3 percent/3-year proxy access proposal was put to a vote at only a small number of companies. According to The Conference Board, of the Russell 3000 companies holding annual meetings between January 1 and June 30, 2014, 13 such proxy access proposals were voted upon. Five won majority support and four others received support of more than 40 percent of the votes cast.

The other type of proxy access proposal voted upon in 2014 provided for two alternative

standards for nominating directors that would be easier for shareholders to achieve. These proposals requested proxy access for shareholders owning between 1 percent and 5 percent of the company's stock for two continuous years. They also would have granted proxy access to groups of 25 or more holders, each holding stock, generally for one year, that at some point in the prior 60 days was worth at least \$2,000, with such group collectively owning between 1 percent and 5 percent of the company's stock. We are not aware of this form of proxy access proposal receiving majority support at any company during the 2014 proxy season, or of its receiving levels of shareholder support comparable to the more than 40 percent support achieved by some 3 percent/3-year proposals that failed to achieve majority support.

If a company receives a proxy access shareholder proposal, it should promptly evaluate the proposal for procedural or substantive deficiencies, as it should for any other shareholder proposal. If no other grounds for excluding the proxy access proposal exists, the company may want to consider adding to its proxy statement a management proxy access proposal containing terms that the company finds more acceptable. This action could provide a basis for excluding the shareholder proposal on the grounds that it would conflict with a company proposal on the same subject.

Companies can prepare in advance for the possibility of a proxy access shareholder proposal by considering (without adopting) whether there are any alternative proxy access provisions (perhaps one with a 5 percent ownership requirement) that they might put forward in the event they receive such a proposal. However, before taking the step of proposing its own proxy access proposal in response to a proxy access shareholder proposal, a company may want to assess with a proxy solicitor and/or its investor relations department what the likelihood would be for the

shareholder proposal to be approved. Also, such companies should realize that even if they are able to exclude a proxy access shareholder proposal in this manner, shareholders in future years could submit proposals to amend the proxy access provisions so adopted.

Compensation Committee Independence Determinations

The New York Stock Exchange (NYSE) and the NASDAQ Stock Market (NASDAQ) have listing rules governing compensation committee member independence, which were required pursuant to Dodd-Frank and SEC Rule 10C-1, adopted thereunder. These rules became effective with respect to the earlier of a company's first annual meeting after January 15, 2014, or October 31, 2014. Therefore, the board of directors should be sure to consider all factors specifically relevant to determining whether any compensation committee member has a relationship to the company which is material to that director's ability to be independent from management in connection with the duties of a compensation committee member. This is in addition to the board of directors' general determination of independent director status.

Among other things, the board of directors must consider the source of compensation of each compensation committee member, including any consulting, advisory or other compensatory fee paid by the company to such director; and whether a compensation committee member is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company. NYSE and NASDAQ rules do not expressly require consideration of indirect compensation, such as compensation paid to a family member or to a related entity, but such compensation may need to be considered to the extent that it is relevant to determining whether a director has a relationship that is material to his or her ability to be independent from management. Assuming a director otherwise satisfies the general criteria for independence,

neither the NYSE rule nor the NASDAQ rule makes receipt of any type of compensation or affiliation with the company a bar to serving on the compensation committee.

Compensation Adviser Independence Assessment

NYSE and NASDAQ listing rules require compensation committees to assess the independence of compensation consultants, legal counsel or other advisers by considering the following factors before selecting or receiving advice from them:

- The provision of other services to the company by the compensation adviser's employer;
- The amount of fees received from the company by the compensation adviser's employer, as a percentage of the total revenue of such employer;
- The policies and procedures of the compensation adviser's employer that are designed to prevent conflicts of interest;
- Any business or personal relationship of the compensation adviser with a member of the compensation committee;
- Any stock of the company owned by the compensation adviser; and
- Any business or personal relationship of the compensation adviser or the compensation adviser's employer with an executive officer of the company.

In addition, compensation committees of NYSE-listed companies must consider any other relevant to a compensation adviser's factors independence from management. Compensation adviser assessments are not needed with respect to in-house legal counsel or compensation advisers solely consulting on non-discriminatory, broad-based plans or providing non-customized data.

When adopting Rule 10C-1, which also established the framework for review of

compensation adviser independence, the SEC emphasized that compensation committees are required to conduct a conflict of interest assessment regardless of whether the compensation committee or management retained the adviser. However, the applicable rules do not require compensation advisers to be independent. After considering these independence factors, the compensation committee may select or receive advice from any compensation adviser it prefers, including ones that are not independent.

In its adopting release for Rule 10C-1, the SEC expressed an expectation that compensation committees would conduct assessments of compensation advisers at least annually. Therefore, listed companies should include the assessment procedure to their compensation committee's annual calendar. In addition, compensation committees should perform an independent assessment before retaining, or obtaining advice from, a new compensation consultant.

Compensation Consultant Conflict of Interest Disclosure

If a compensation consultant that has a role in determining or recommending the amount or form of executive or director compensation has a conflict of interest, the proxy statement must disclose the nature of such conflict and how the conflict is being addressed, regardless of whether the compensation committee, management or any other board committee retained the consultant. In determining whether a conflict of interest exists for disclosure purposes, companies should consider the same factors that compensation committees are required to use when making the adviser independence assessment described above.

Companies are not required to disclose a *potential* conflict of interest or an *appearance* of a conflict of interest in their proxy statements. Disclosure is only required if a compensation consultant has an *actual* conflict of interest.

Consulting on broad-based plans and providing non-customized benchmark data does not require conflict of interest disclosure under this rule. This conflict of interest disclosure is limited to compensation consultants; no disclosure is required with respect to other compensation advisers (such as outside legal counsel).

NYSE Quorum Requirement Change

Section 312.07 of the NYSE-listed company manual establishes voting requirements for shareholder proposals where shareholder approval is a prerequisite to the listing of any additional or new securities, such as approval of certain issuances of stock or equity compensation plans. In 2013, the SEC approved a rule change to remove a previously mandated quorum requirement.¹¹ Accordingly, Section 312.07 of the NYSE-listed company manual, as amended, now reads:

Where shareholder approval is a prerequisite to the listing of any additional or new securities of a listed company, or where any matter requires shareholder approval, the minimum vote which will constitute shareholder approval for such purposes is defined as approval by a majority of votes cast on a proposal in a proxy bearing on the particular matter.¹²

As a result of this change, companies including proposals in their proxy statements that are subject to the NYSE shareholder approval policy no longer have to disclose and calculate a separate quorum requirement for those agenda items. They can instead rely on the general requirements of their by-laws and governing law to determine the quorum.

Notwithstanding the quorum change, the NYSE made clear in its annual memorandum to listed company executives dated March 7, 2014, that:

Section 312.07 of the Listed Company Manual continues to provide that, where shareholder approval is required under

NYSE rules, the minimum vote that constitutes approval for such purposes is approval by a majority of votes cast (i.e., the number of votes cast in favor of the proposal exceeds the aggregate of votes cast against the proposal plus abstentions).¹³

In other words, when calculating the votes required to approve an NYSE-mandated agenda item, such as approval of an equity compensation plan, abstentions have the same effect as a vote against, even if governing laws or the company's by-laws specify otherwise. When a company submits an equity compensation plan to shareholders for approval, the proxy statement must disclose this treatment of abstentions.

Director and Officer Questionnaires

There are no recent rule changes under the federal securities laws or NYSE or NASDAQ listing rules that would require changes to director and officer questionnaires for the 2015 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 reflected. For example, with respect to the recent changes to compensation committee listing standards, companies should check to see if their questionnaires elicit information regarding any business or personal relationships that an executive officer or a director (at least a compensation committee member) may have with a compensation adviser retained, or proposed to be retained, by management or the compensation committee. In addition, companies may want to include a question concerning the source of compensation committee members' compensation and whether a compensation committee member is affiliated with the company, any subsidiaries of the company or any affiliate of a subsidiary of the company.

The Iran Threat Reduction and Syria Human Rights Act of 2012 (ITRA) requires any reporting company to disclose in its annual and quarterly reports whether, during the period covered by the subject report, it or any affiliate has knowingly engaged in certain sanctionable activities relating to Iran—ITRA requires disclosure even when the actions did not violate any provision of US law and does not provide any materiality threshold. As a disclosure control, companies may want to include questions on their director and officer questionnaires addressing the sanctionable activities identified by ITRA. Because the directors and officers may be regarded as affiliates, the questions should ask about their activities with respect to Iran, as well as what they know about company activities.

Companies should also consider whether there are regulatory developments outside of the federal securities laws or any new state or foreign law requirements for which inquiries should be added to the director and officer questionnaires for the 2015 proxy and annual reporting season.

Proxy Advisory Firm and Investment Adviser Matters

The influence and methods of proxy advisory firms on the proxy process of public companies have received an increasing amount of scrutiny and debate. In 2010, the SEC issued its "Concept Release on the U.S. Proxy System,"¹⁴ soliciting comment on various aspects of the US proxy system, including issues related to proxy advisory firms. In December 2013, the SEC held a roundtable to discuss the current use of proxy advisory firm services by institutional investors and investment advisers.

On June 30, 2014, the SEC's Division of Investment Management and the Division of Corporation Finance issued a staff legal bulletin on proxy voting responsibilities of investment advisers and the availability of exemptions from the proxy rules for proxy advisory firms (Proxy

Voting Legal Bulletin).¹⁵ While investment advisers and proxy advisory firms may need to make internal changes to their policies and procedures based on the Proxy Voting Legal Bulletin in time for the 2015 proxy season, this staff guidance is not likely to have any direct impact on public company interaction with proxy advisory firms such as ISS and Glass Lewis.

The Proxy Voting Legal Bulletin provides examples of steps that an investment adviser could take to demonstrate that proxy votes are cast in accordance with the client's best interests, as well as the adviser's proxy voting procedures. The guidance clarifies that investment advisers do not have to cast votes on every item being voted on at shareholders meetings, recognizing that an investment adviser and its clients have the flexibility to determine the scope of the adviser's obligation to exercise voting authority.

The Proxy Voting Legal Bulletin addresses the issue of errors in proxy advisory firm reports by emphasizing that when an investment adviser retains a proxy advisory firm, the investment adviser should ascertain whether the proxy advisory firm has the capacity and competence to adequately analyze proxy issues. According to the Proxy Voting Legal Bulletin, an investment adviser should have policies and procedures reasonably designed to provide ongoing oversight of any proxy advisory firm it retains, including measures to address conflicts that may arise. Investment advisers retaining proxy advisory firms have a duty to ascertain that the proxy advisory firm has the ability to make voting recommendations based on materially accurate information, including investigating errors and seeking to determine whether the proxy advisory firm is taking reasonable steps to reduce similar errors.

While a proxy advisory firm is subject to the proxy rules if it provides recommendations reasonably calculated to result in the procurement, withholding or revocation of a

proxy, the firm may rely on exemptions contained in Rule 14a-2(b) under the Exchange Act to the extent it satisfies the conditions of the applicable exemption. The exemption contained in Rule 14a-2(b)(1) does not allow a proxy advisory firm to offer a service permitting a client to establish policies, in advance of receiving proxy materials, that such advisory firm would apply in its discretion to the vote. However, to the extent that the proxy advisory firm limits its activities to distributing reports containing recommendations (and does not solicit the power to act as proxy for the clients receiving such reports), this exemption from the proxy rules would be available as long as the proxy advisory firm otherwise satisfies the requirements of the exemption.

If Rule 14a-2(b)(1) is not available, proxy advisory firms may nevertheless be exempt under Rule 14a-2(b)(3) if they are providing advice to a person with whom a business relationship already exists, subject to certain conditions. If a proxy advisory firm seeks to rely on this existing business relationship exemption while providing consulting services to a company on a matter that is the subject of its voting recommendation, the firm will need to assess whether its relationship with the company is significant or if the firm has any material interest in the matter upon which it is providing a voting recommendation. According to the Proxy Voting Legal Bulletin "[w]hether a relationship would be 'significant' or what constitutes a 'material interest' will depend on the facts and circumstances." If a proxy advisory firm has a significant relationship or material interest, it must provide specific, non-boilerplate disclosure to the recipient of its advice describing the existence of the significant relationship or material interest. Offering to provide such disclosure upon request would not be sufficient. While the exemption does not specify where the required disclosure should be placed, it should be provided in a manner that lets the client assess the advice and the nature

and scope of the relationship or interest at about the same time that it receives the advice.

The Proxy Voting Legal Bulletin only provides guidance on specific voting issues and exemption issues relevant to proxy advisory firms and investment advisers. While the SEC and Staff have not yet proposed any rules or issued general guidance on other proxy advisory firm procedures, interest in this topic continues. In August 2014, SEC Commissioner Gallagher issued a paper entitled “Outsized Power & Influence: The Role of Proxy Advisers”¹⁶ in which he advocated that the SEC fundamentally review the role and regulation of proxy advisory firms to explore whether there are possible reforms that could promote transparency and best practice. However, it is unlikely that any such regulatory reforms would be made in time for the 2015 proxy season.

Proxy advisory firms may initiate steps on their own to improve practices that have generated controversy. For example, one criticism that has been leveled at proxy advisory firms is that they sometimes base proxy recommendations on inaccurate facts. ISS recently launched a portal through which any US company submitting an equity-based compensation plan for shareholder approval can verify key data points underlying ISS’s evaluation of the plan.¹⁷

Conflict Minerals

On April 14, 2014, shortly before the first year of conflict minerals filings were due, a three-judge panel of the US Court of Appeals for the District of Columbia Circuit issued an opinion in litigation challenging the SEC’s conflict minerals rule brought by the National Association of Manufacturers, et al.¹⁸ Although the court upheld many elements of the rule, it held that the conflict mineral statute and rule violated the First Amendment to the Constitution to the extent that it required companies to report to the SEC and to state on their website that any of their products have “not been found to be ‘DRC conflict free.’”

Despite the court ruling, the SEC required affected companies to file their reports on Form SD with respect to conflict minerals disclosure on or before the scheduled due date of June 2, 2014. However, companies only needed to comply with and address those portions of Rule 13p-1 and Form SD that the appellate court upheld. In accordance with the court decision, the Staff did not require companies to describe their products as “DRC conflict free,” as having “not been found to be ‘DRC conflict free’” or as “DRC conflict undeterminable.”

Conflict minerals disclosure is provided on an annual basis. Because a significant portion of the 2014 calendar year is complete, many of the facts of conflict minerals usage are, to a large degree, established for 2014, even if companies are in the process of making and implementing changes in their sourcing of materials.

Companies will need to gather the relevant information to prepare the Form SD and, if required, the associated Conflict Minerals Report, both from inside and outside their organizations, including from suppliers. While the experience from the first year of reporting should facilitate determinations for upcoming conflict minerals reporting, and while suppliers may be more accustomed to responding to the inquiries that public companies need to make, the process to comply with the conflict minerals rule is time consuming.

Public companies affected by the conflict minerals rule should continue to compile and analyze information about their use and source of conflict minerals between now and next spring to be in a position to make any required filing on or before June 1, 2015. The initial Form SD filings that were due by June 2, 2014 provide a varied precedent base for filings due in the spring of 2015.

The conflict minerals litigation is not necessarily resolved. On August 1, 2014, the full US Court of Appeals for the District of Columbia Circuit issued an opinion in the appeal of *American Meat Institute v. US Department of*

*Agriculture*¹⁹ that is relevant to the conflict minerals litigation. The *American Meat Institute* opinion upheld a Department of Agriculture “country-of-origin” labeling requirement that had been challenged on First Amendment grounds. It is possible that the SEC may now appeal the portion of the *National Association of Manufacturers* opinion that invalidated a portion of its conflict minerals rules. If the SEC were to successfully appeal, the conflict minerals requirements would be more stringent for filings in subsequent years. Therefore, companies required to file Form SD should monitor developments to determine if any disclosure changes are needed.

Cybersecurity

Cybersecurity has been a growing concern, garnering significant public and governmental awareness, as well as attention at the board of directors level of many public companies. The Staff has identified cybersecurity as an important matter and includes cybersecurity as an area upon which it issues comments when reviewing company filings. When preparing upcoming annual reports (or other periodic reports), public companies should consider whether they need to address this topic initially or expand or update prior year disclosures.

According to CF Disclosure Guidance: Topic No. 2, titled “Cybersecurity,”²⁰ public companies must disclose cybersecurity risks and cyber incidents to the extent relevant. For example, if the risk of cyber incidents is among the most significant factors that make an investment in the company’s securities risky, cybersecurity should be disclosed as part of risk factors. Cybersecurity risks and cyber incidents would need to be described in the management’s discussion and analysis (MD&A) if the costs or other consequences are reasonably likely to have a material effect on results of operations, liquidity or financial condition, or cause reported financial information to be not indicative of future results or financial conditions.

Similarly, the business section may need cybersecurity disclosure to the extent a company’s products, services, customers or supply relationships, or competitive conditions, are materially affected by cyber incidents. If litigation is commenced regarding a cyber incident, that may also need to be disclosed.

On March 26, 2014, the SEC held a public roundtable to discuss cybersecurity and the issues and challenges it raises for market participants and public companies. In the roundtable panel devoted to public disclosure issues, participants noted that boilerplate disclosure is not helpful to investors but also acknowledged that in some situations specific disclosures could increase a company’s vulnerability to cyber attack. The question of whether any further SEC guidance would be helpful was discussed at the roundtable, but as of the date of this Legal Update there is no additional SEC or Staff rule or guidance on cybersecurity.

Management’s Discussion and Analysis

The MD&A has long been recognized as a very significant part of a public company’s annual report. It is intended to enhance the reader’s understanding of the company’s financial condition, changes in financial condition and results of operations. It is a topic upon which the SEC has provided guidance over many years.²¹ MD&A is a recurring subject of comment letters during the Staff’s review of company filings. Therefore, public companies should pay particular attention to drafting this section of their annual reports.

The SEC does sometimes bring actions for alleged violations of the MD&A requirements, though this is less frequently a subject of SEC enforcement than of SEC guidance or Staff comment. This potential avenue of risk from defective MD&A disclosure was emphasized in the SEC’s press release regarding a recent mortgage loan settlement.²² This press release focused on the admission of disclosure failures

that were made to settle SEC charges, with the press release observing that “Regulation S-K requires public companies ... to disclose in the Management’s Discussion & Analysis (MD&A) section of its periodic financial reports any known uncertainties that it reasonably expects will have a material impact on income from continuing operations.”

XBRL

SEC staff have published several observations from reviews of interactive financial data.²³ These reports provide useful guidance regarding practices for implementing its XBRL interactive data requirement. In addition, both the Division of Corporation Finance and the Office of Interactive Disclosure have published FAQs, providing an ongoing resource.²⁴

The XBRL rules require that issuers include calculation relationships for certain contributing line item elements for their financial statements and related footnotes. In July 2014, the staff of the Division of Corporation Finance sent a comment letter to a number of chief financial officers asserting that their companies’ filings do not include all required calculation relationships and requesting that they take the necessary steps to ensure that they are including all required calculation relationships. The staff posted a sample comment letter so that all filers would be aware of this issue.²⁵

In July 2014, the staff of the Commission’s Division of Economic and Risk Analysis issued observations relating to custom tag rates in which it reported a steady decline in custom tag use by large accelerated filers.²⁶ The staff felt that this reduction was “consistent with both improvements in the taxonomy over this period and filers’ selections of financial elements.” The staff expressed concern that there was not a similar trend away from custom tag usage among smaller filers. The staff attributed this to three third-party filer and service software providers used by the smaller filers with high custom tag rates. The staff wrote:

This suggests that in many instances the high custom tag rate may not be determined by the unique reporting requirements of a filer or available taxonomy, but an artifact of the reporting tool or service used.

This observation makes clear that the staff is closely monitoring the use of custom tags in XBRL filings, which, by their nature, make it harder for users to compare data uniformly among various public companies. Public companies using custom tags should be prepared to justify why such treatment is necessary for their specific situations.

Proxy Bundling

When preparing proxy statements, public companies must not “bundle” separate matters together for the purposes for shareholder voting. In accordance with Rule 14a-4(a)(3) under the Exchange Act, when distinct matters are submitted to shareholders for approval pursuant to the solicitation of proxy authority, they must be “unbundled” so that shareholders are given the opportunity to vote on each material item individually. Rule 14a-4(a)(3) requires that a proxy card must “identify clearly and impartially each separate matter intended to be acted upon, whether or not related to or conditioned on the approval of other matters.”

When the proposals being presented for approval at a shareholders meeting involve topics that are clearly different from each other, it is relatively straightforward to divide the proposals into distinct voting items. However, when a proposal involves multiple components that bear relationships to each other, it can be more difficult to determine whether such proposal must be “unbundled” to give shareholders the option to vote on each separate part.

On January 24, 2014, the Staff issued three compliance and disclosure interpretations providing guidance on when unbundling is

necessary.²⁷ These interpretations addressed multi-faceted charter amendments and omnibus equity incentive plan amendments. This new guidance supplements the guidance on unbundling that the SEC provided in the context of mergers and acquisitions, which appears in the SEC's September 2004 Interim Supplement to the Publicly Available Telephone Interpretations,²⁸ which still remains in effect.

For more information on the Staff's bundling guidance, see our Legal Update dated February 3, 2014, titled "US Securities and Exchange Commission Clarifies its Position on 'Unbundling' Proxy Proposals."²⁹

Foreign Issuer Preliminary Proxy Statement Relief

In 2014 the Staff granted no-action relief to certain foreign issuers that are subject to the SEC's proxy rules. The relief allows these issuers to avoid filing preliminary proxy statements with the SEC where the only proposals being acted upon at the shareholders meetings are matters required by applicable foreign law or matters specifically exempted from preliminary proxy filing requirements by Rule 14a-6 under the Exchange Act. These no-action letters are limited to foreign issuers organized under the laws of the jurisdictions examined in the applicable no-action requests with respect to the proposals specifically discussed in such letters.

For more information on this no-action position, see our Legal Update dated April 9, 2014, titled "No-Action Relief Granted With Regard To Certain Foreign Issuer Preliminary Proxy Filing Requirements."³⁰

Technology and the Proxy Season

Technological developments continue to impact the mechanics of proxy season. E-proxy has gained a stronghold and become a relatively commonplace practice, although it is often used in hybrid form, with some investors receiving electronic delivery of proxy materials while other

investors receive traditional, full set delivery of printed proxy materials. Electronic platforms (e.g., Internet and telephone, including mobile applications) are typically used for voting shares, both by individuals and institutions. Although the number is still small, some companies conduct virtual annual meetings. This can be in the form of an in-person meeting supplemented by an audio and/or video option or a fully virtual meeting. According to Broadridge data, 88 companies allowed shareholders to participate in shareholders meetings electronically during the past fiscal year.³¹ Of the virtual meetings conducted between January 1, 2014 and May 22, 2014, 90 percent provided for only an audio link, while 10 percent provided video streaming.³² In addition some companies use social media tools during the annual meeting to highlight key points.

If you have any questions regarding the 2015 proxy and annual reporting season, please contact the author of this Legal Update, Laura D. Richman, at +1 312 701 7304, any of the co-authors listed below or any other member of our Corporate & Securities group.

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Endnotes

- ¹ See http://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST¤tPub=true&agencyCode=&showStage=active&agencyCd=3235&Image58.x=23&Image58.y=10.
- ² Available at <http://www.sec.gov/rules/proposed/2013/33-9452.pdf>.
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- ⁴ See Semler Brossy, “2014 Say on Pay Results,” September 10, 2014, <http://www.semlebrossy.com/wp-content/uploads/SBCG-2014-Say-on-Pay-Report-2014-09-10.pdf>.
- ⁵ See Broadridge Financial Solutions, Inc. and PwC Center for Board Governance, Proxy Pulse Second Edition 2014, available at http://www.pwc.com/en_US/us/corporate-governance/publications/assets/proxypulse-2nd-edition-june-2014.pdf.
- ⁶ See <http://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm>.
- ⁷ All references in this Legal Update to The Conference Board’s statistics on shareholder proposals are from The Conference Board, in collaboration with FactSet, “Proxy Voting Fact Sheet,” July 2014, available at <https://www.conference-board.org/publications/publicationdetail.cfm?publicationid=2804>.
- ⁸ Commissioner Gallagher’s speech is available at <http://www.sec.gov/News/Speech/Detail/Speech/1370541315952>.
- ⁹ See <http://www.sec.gov/rules/petitions/2014/petn4-675.pdf>.
- ¹⁰ See, for example, <http://www.sec.gov/comments/4-675/4675-2.pdf>.
- ¹¹ See <http://www.sec.gov/rules/sro/nyse/2013/34-69970.pdf>.
- ¹² See <http://nysemanual.nyse.com/LCMTTools/PlatformViewer.asp?selectednode=chp%5F1%5F4&manual=%2Fflcm%2Fsections%2Fflcm%2Dsections%2F>.
- ¹³ Available at http://usequities.nyx.com/sites/usequities.nyx.com/files/final_2014_nyse_domestic_listed_company_compliance_guidance_memo_3_7_14.pdf.
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- ¹⁵ Available at <http://www.sec.gov/interps/legal/cfs1b20.htm>.
- ¹⁶ Available at <http://www.wlf.org/upload/legalstudies/workingpaper/GallagherWP8-14.pdf>.
- ¹⁷ For further information on ISS’s equity plan data verification portal see <http://www.issgovernance.com/equity-plan-data-verification>.
- ¹⁸ Available at [http://www.cadc.uscourts.gov/internet/opinions.nsf/D3B5DAF947A03F2785257CBA0053AEF8/\\$file/13-5252-1488184.pdf](http://www.cadc.uscourts.gov/internet/opinions.nsf/D3B5DAF947A03F2785257CBA0053AEF8/$file/13-5252-1488184.pdf).
- ¹⁹ Available at [http://www.cadc.uscourts.gov/internet/opinions.nsf/A064A3175BC6DEEE85257D24004FA93B/\\$file/13-5281-1504951.pdf](http://www.cadc.uscourts.gov/internet/opinions.nsf/A064A3175BC6DEEE85257D24004FA93B/$file/13-5281-1504951.pdf).
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- ²¹ See *Commission Statement About Management’s Discussion and Analysis of Financial Condition and Results of Operations*, Release No. 33-8056 (Jan. 22, 2002), available at <http://www.sec.gov/rules/other/33-8056.htm>; *Disclosure in Management’s Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations*, Release No. 33-8182 (Jan. 28, 2003), available at <http://www.sec.gov/rules/final/33-8182.htm>; *Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations*, Release No. 33-8350 (Dec. 19, 2003), available at <http://www.sec.gov/rules/interp/33-8350.htm>; and *Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management’s Discussion and Analysis*, Release Nos. 33-9144 (Sept 17, 2010), available at <http://www.sec.gov/rules/interp/2010/33-9144.pdf>.
- ²² Available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542719632>.
- ²³ Available at <http://www.sec.gov/spotlight/xbrl/staff-review-observations.shtml>.
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- ²⁵ Available at <http://www.sec.gov/divisions/corpfin/guidance/xbrl-calculation-0714.htm>.
- ²⁶ Available at <http://www.sec.gov/dera/reportspubs/assessment-custom-tag-rates-xbrl.html>.
- ²⁷ See <http://www.sec.gov/divisions/corpfin/guidance/14a-interps.htm>.
- ²⁸ See <http://www.sec.gov/interps/telephone/phonesupplement5.htm>.
- ²⁹ Available at <http://www.mayerbrown.com/US-Securities-and-Exchange-Commission-Clarifies-its-Position-on-Unbundling-Proxy-Proposals-02-03-2014/>.

³⁰ Available at <http://www.mayerbrown.com/No-Action-Relief-Granted-With-Regard-To-Certain-Foreign-Issuer-Preliminary-Proxy-Filing-Requirements-04-09-2014/>.

³¹ See *Broadridge Financial Solutions, Inc., 2014 Proxy Season Key Statistics & Performance Rating*, available at <http://media.broadridge.com/documents/Broadridge-Proxy-Stats-2014-Report.pdf>.

³² See *Broadridge Financial Solutions, Inc. and PwC Center for Board Governance, Proxy Pulse Second Edition 2014*, available at http://www.pwc.com/en_US/us/corporate-governance/publications/assets/proxypulse-2nd-edition-june-2014.pdf.

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