

Preparing for the 2016 US Proxy and Annual Reporting Season

It is time for public companies to think about the upcoming 2016 proxy and annual reporting season. Preparation of proxy statements and annual reports requires a major commitment of corporate resources. Companies have to gather a great deal of information to produce the necessary disclosures. In addition, with increasing frequency, companies are choosing to implement the required elements of their proxy statements with a focus on shareholder engagement, seeking to clearly present, and effectively advocate for, their positions on annual meeting agenda items. As the process for the 2016 proxy and annual reporting season begins, there are a number of recent developments that public companies should be aware of that will impact current and future seasons.

This Legal Update is divided into five sections covering the following topics:

[Dodd-Frank Compensation-Related Rulemaking – page 2.](#) During 2015, the US Securities and Exchange Commission responded to mandates under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) involving compensation-related matters. Specifically, the SEC adopted a final pay ratio disclosure rule and proposed a clawback listing standards rule, a pay versus performance disclosure rule and a hedging disclosure rule. The pay ratio disclosure rule has a relatively long transition period, and the other three rulemaking projects currently remain in the proposal stage. As a result, at this point, none of

these initiatives is likely to require additional disclosures in proxy statements during the 2016 season, although it is possible that the SEC could finalize the pay versus performance and/or hedging disclosure rules in time to implement them for the upcoming season.

[Say-on-Pay and Related Compensation Disclosure and Litigation Considerations—](#)

[page 7.](#) Public companies now have five years of say-on-pay experience to draw on. Each year, most companies' executive compensation programs have achieved majority support, but some companies have faced the situation of a "failed" say-on-pay vote, while others, although securing majority support, have received percentages of disapproval that some proxy advisory firms and investors believe represents significant opposition to an executive compensation program. In many ways, say-on-pay has changed the proxy season landscape and has become a frequent topic of shareholder engagement. Some companies have even faced compensation-related litigation.

[Shareholder Proposals—page 9.](#) The SEC's rules permit shareholders meeting certain requirements to submit proposals to be included in a company's proxy statement for voting at a company's shareholder meeting. The 2015 proxy season saw an increase in the number of proxy access shareholder proposals submitted to companies and voted on at shareholder meetings, and many such shareholder proposals are likely to be submitted for the 2016 proxy season. There were also other popular

governance proposals, environmental and social policy proposals and executive compensation proposals submitted to companies for inclusion in their proxy statements. Companies typically use the SEC's no-action process to seek the concurrence of the staff of the SEC's Division of Corporation Finance (Staff) before omitting shareholder proposals from their proxy statements, although in recent years there have been examples of companies and shareholder proponents turning to the courts for decisions on the fate of particular shareholder proposals.

Other Proxy and Annual Reporting

Season Matters—page 13. There are a number of other topics of interest relevant to the 2016 proxy and annual reporting season and beyond. This section briefly discusses director and officer questionnaires, cybersecurity disclosures, audit committee disclosures, universal proxy developments, virtual meetings, design features, the SEC's interpretation of spouse and marriage, and delinquent filers.

Dodd-Frank Conflict Minerals and Resource Extraction Rulemaking—

page 17. The SEC faced court challenges both with respect to its conflict minerals rule and its resource extraction rule required by Dodd-Frank. There have been recent court actions with respect to both of these rulemakings. Although neither conflict minerals nor resource extraction disclosure is part of the Form 10-K annual reporting process, individuals involved in SEC reporting should monitor developments in these two areas.

Dodd-Frank Compensation-Related Rulemaking

Pay Ratio Disclosure. The SEC has adopted a pay ratio disclosure rule,¹ requiring public companies to disclose:

- The median of the annual total compensation of all employees other than the chief executive officer;

- The annual total compensation of the chief executive officer; and
- The ratio of these amounts.

The pay ratio disclosure rule is contained in new paragraph (u) of Item 402 of Regulation S-K.

The SEC has provided a transition period so that the initial pay ratio disclosure will be required with respect to compensation for a company's first full fiscal year that begins on or after January 1, 2017. Therefore, companies generally will first be required to include pay ratio disclosure in 2018, or later in the case of companies that are new SEC registrants.

For the purposes of the pay ratio rule, the term "employee" means an individual employed by the company, or its consolidated subsidiaries, as of any date (determined by the company) within the last three months of the company's last-completed fiscal year. In addition to full-time employees and employees based in the United States, the term includes:

- Employees based outside of the United States;
- Part-time employees;
- Temporary employees; and
- Seasonal employees.

Independent contractors and leased workers are not considered employees for the purposes of the pay ratio disclosure rule if they are employed by, and have their compensation determined by, an unaffiliated third party. Individuals who become employees as a result of a business combination or acquisition can be omitted from the company's identification of the median employee for the fiscal year in which the transaction became effective, provided that certain information is otherwise disclosed.

The SEC has provided two limited exemptions that permit companies to exclude certain employees located in non-US jurisdictions from the pay ratio calculation. First, the final rule provides an exemption for employees in a foreign jurisdiction in which data privacy laws or regulations are such that, despite the company's

reasonable efforts to obtain and process the information necessary to comply with the pay ratio disclosure rule, the company is unable to do so without violating those data privacy laws or regulations. According to Item 402(u), a company's reasonable efforts must, at a minimum, include "using or seeking an exemption or other relief under any governing data privacy laws or regulations." Second, the rule provides a *de minimis* exemption for non-US employees representing 5 percent or less of a company's total employees. Any employees excluded under the privacy law exemption will count toward the 5 percent limit. If any employees in a foreign jurisdiction are excluded from the pay ratio calculation, all employees in that jurisdiction (other than the chief executive officer) must be excluded from the calculation.

Generally, the pay ratio disclosure will be needed in filings that require executive compensation disclosure pursuant to Item 402 of Regulation S-K, such as proxy and information statements, annual reports on Form 10-K and registration statements under the Securities Act of 1933 and the Securities Exchange Act of 1934 (Exchange Act). Smaller reporting companies, emerging growth companies, foreign private issuers, MJDS filers (i.e., registrants filing under the US Canadian Multijurisdictional Disclosure System) and registered investment companies will not be subject to the pay ratio disclosure requirement.

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

so by using a statistical sample or another reasonable method.

Once the median employee has been identified pursuant to one of the methods described above, the total compensation for the median employee will have to be calculated for the last completed fiscal year in a manner consistent with the requirements for calculating the chief executive officer's total compensation for the same fiscal year for purposes of the summary compensation table.

The final rule permits a company to choose any date during the last three months of the fiscal year for the purpose of identifying the median employee. In addition, the final rule permits companies to identify the median employee only once every three years as long as there has been no change in the employee population or in employee compensation arrangements that would significantly change the pay ratio disclosure. If, during those three years, the median employee's compensation changes, or the median employee has left the company, the company may substitute another employee with compensation substantially similar to its median employee.

The new rule permits a company to annualize the compensation for all permanent employees, whether full-time or part-time, who were employed on the calculation date but did not work for the company for the full fiscal year. The rule does not permit annualization for temporary or seasonal employees. In addition, the pay ratio disclosure rule does not permit the use of full-time-equivalent adjustments for the required pay ratio disclosure. However, a company is permitted to derive and disclose an additional ratio using full-time equivalent adjustments.

In determining the median employee, a company is permitted to use a cost-of-living adjustment for employees living in jurisdictions other than the jurisdiction in which the chief executive officer resides. If a company uses a

cost-of-living adjustment in determining the median employee, and the median employee resides in a different jurisdiction than the chief executive officer, the company must use that same cost-of-living adjustment in calculating the median employee's annual total compensation; additionally, the pay ratio disclosure must be provided two ways—including the cost-of-living adjustment and excluding the cost-of-living adjustment.

The rule requires a brief, nontechnical 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. If a company uses a consistently applied compensation measure to determine the median employee, it will have to disclose the measure used. If statistical sampling is used, the size of the sample and the estimated whole population should be disclosed, as well as material assumptions used in determining sample size.

For more information on the SEC's pay ratio disclosure rule, see our Legal Update, "Understanding the SEC's Pay Ratio Disclosure Rule and its Implications," dated August 20, 2015.²

Clawback Proposal. The SEC proposed new Rule 10D-1, directing national securities exchanges and associations to establish listing standards that prohibit the listing of any security of a company that does not adopt and implement a written policy requiring the recovery, or "clawback," of certain incentive-based executive compensation.³ The recovery would be the amount of incentive compensation that is later shown to have been paid in error, based on an accounting restatement that is necessary to correct a material error of a financial reporting requirement.

If a current or former executive officer received erroneously awarded incentive-based

compensation within the three fiscal years preceding the date of determination that a restatement is required, the company would have to recover the excess incentive-based compensation on a "no-fault" basis. The proposal also specifies disclosure requirements relating to clawback policies and clawbacks.

Proposed Rule 10D-1 defines incentive-based compensation as any compensation (including stock options and other equity awards) that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure. For this purpose, the term "financial reporting measures" means measures that are determined and presented in accordance with the accounting principles used in preparing the company's financial statements, any measures derived wholly or in part from such financial information (such as non-GAAP financial measures), and stock price and total shareholder return (TSR).

With very few exceptions, the proposed clawback listing standards would apply to all listed companies. This means that foreign private issuers, smaller reporting companies, emerging growth companies and companies that list only debt or preferred securities would be subject to the clawback listing standards to the extent that they have securities listed on a national securities exchange or association.

The comment period for the clawback proposal expired on September 14, 2015. As of the date of this Legal Update, it is uncertain when the SEC will issue its final clawback rule. Under the proposal, once the SEC's final rule is adopted, securities exchanges and associations would have to file their proposed listing standards within 90 days after the publication of the final rule in the *Federal Register*, and new listing standards would have to become effective no later than one year following such publication date. Thereafter, listed companies would then have 60 days to adopt a compliant clawback policy.

Based on the proposed rulemaking schedule, it is unlikely that Dodd-Frank clawback listing standards would be in effect for the 2016 proxy season. Nevertheless, because clawbacks have gained attention from a governance perspective, if companies currently have clawback policies, it may be useful for them to consider enhancing their discussion of clawbacks in their 2016 proxy statements. In addition, companies may want to consider whether, prior to the finalization of the applicable listing standards, to adopt new clawback policies or amend their existing clawback policies, in order to reflect some or all of the provisions contained in proposed Rule 10D-1.

For more information on the SEC's clawback proposal, see our Legal Update, "US Securities and Exchange Commission Proposes Compensation Clawback Listing Standards Requirement," dated July 16, 2015.⁴

Pay Versus Performance Disclosure. The SEC proposed a "pay versus performance" rule to require companies to disclose in a clear manner the relationship between executive compensation actually paid and the financial performance of the company, with performance measured both by company TSR and, except in the case of smaller reporting companies, peer group TSR.⁵ The comment period on this rulemaking has expired.

If adopted as proposed, the rule would require pay versus performance disclosure in proxy or information statements in which executive compensation information is required to be included pursuant to Item 402 of Regulation S-K. The proposed rule would add new subsection (v) to Item 402 of Regulation S-K and would require a new compensation table be added to the existing disclosures.

As proposed, the pay versus performance rule would apply to all SEC reporting companies, *except*:

- Foreign private issuers;
- Registered investment companies; and
- Emerging growth companies.

Business development companies (a category of closed-end investment company that are not registered under the Investment Company Act) and smaller reporting companies would be subject to the rule, although the disclosure requirements for smaller reporting companies would be scaled down.

Under the proposed rule, the new pay versus performance table would separately provide compensation information for the principal executive officer, on an annual basis, for each of the past five fiscal years (three in the case of smaller reporting companies). If more than one person has served as principal executive officer in any year included in the new table, the compensation of all persons serving in that capacity would be aggregated. In addition, the table must provide average compensation, on an annual basis, for the named executive officers (other than the principal executive officer) identified in the summary compensation table for such years.

For the purposes of the new pay versus performance table, executive compensation actually paid would consist of total compensation as reported in the summary compensation table, modified to adjust the amounts included for pension benefits and equity awards. Equity awards would be considered actually paid on the date of vesting, whether or not exercised. They would be valued at fair value on the vesting date, rather than fair value on the date of grant as reported in the summary compensation table. Accordingly, the stock and option award amounts shown in the summary compensation table would be subtracted from total compensation, and the vesting date fair value amounts for these equity awards would be added back to calculate

compensation actually paid. Vesting date valuation assumptions would have to be disclosed if they are materially different from those disclosed in the financial statements as of the grant date.

A clear description of the relationship between pay and performance must accompany the proposed new table. This description may be presented in narrative or graphic form or in a combination of both. Companies may supplement the required disclosure by also showing pay versus performance using “realized pay,” “realizable pay” or another appropriate measure. However, any such supplemental disclosure may not be misleading and may not be presented more prominently than the required disclosure.

As proposed, the values in the pay versus performance table would have to be tagged in XBRL, and the related footnotes would have to be block text tagged, except in the case of smaller reporting companies.

The general phase-in for the rule will require pay versus performance disclosure for three years in the first proxy or information statement in which such disclosure is required. In each of the two subsequent years, another year of disclosure would be added. Smaller reporting companies would only need to provide information for two years initially, adding the additional year in their next annual proxy or information statement that requires executive compensation disclosure. Newly reporting companies would not need to include pay versus performance information for fiscal years prior to their last completed fiscal year.

For more information on the SEC’s pay versus performance proposal, see our Legal Update, “US Securities and Exchange Commission Proposes Pay Versus Performance Disclosure Rule,” dated May 13, 2015.⁶

Hedging Disclosure. The SEC has proposed a new disclosure requirement addressing hedging

by employees, officers and directors.⁷ The comment period on this rulemaking has expired.

As proposed, a new paragraph (i) would be added to Item 407 of Regulation S-K requiring companies to disclose whether employees (including officers) or members of the board of directors are permitted to engage in transactions to hedge or offset any decrease in the market value of a company’s equity securities granted to the employee or board member as compensation, or held directly or indirectly by the employee or board member.

The proposal is drafted to cover all transactions that establish downside price protection in a company’s equity securities, whether by purchasing or selling a security or derivative security or otherwise. It would cover hedging of any equity security issued by the company, by any parent or subsidiary of the company or by any subsidiary of any parent of the company that is registered under Section 12 of the Exchange Act. The resulting disclosure would need to make clear what categories of transactions a company permits and what categories it prohibits.

The proposed hedging disclosure would be required in any proxy statement or information statement relating to an election of directors. However, the proposal would not require hedging disclosure in registration statements or in annual reports on Form 10-K.

Many public company proxy statements already discuss hedging policies. The compensation discussion and analysis (CD&A) section of the proxy statement required by Item 402(b) of Regulation S-K must disclose all material elements of a company’s compensation policies and decisions for executive officers whose compensation is required to be disclosed in the proxy statement (NEOs). In that regard, Item 402(b)(2)(xiii) of Regulation S-K identifies policies regarding hedging the economic risk of owning company equity securities as an example of the kind of information that may be required.

The proposed hedging disclosure requirement would extend beyond the current requirement of the CD&A. For example, the CD&A only requires a discussion of hedging policies affecting the NEOs, while the proposal would mandate disclosure of hedging policies with respect to all employees, officers and directors. In addition, the proposed hedging disclosure requirement would apply to all companies that are required to comply with the SEC's proxy rules. Therefore, the hedging disclosure proposal would impact companies that are not required to provide CD&A disclosure, such as smaller reporting companies, emerging growth companies, business development companies and registered closed-end investment companies that have shares listed on a national securities exchange. However, foreign private issuers are not required to file proxy statements and thus would not be required to provide the proposed hedging disclosures.

For more information on the SEC's hedging disclosure proposal, see our Legal Update, "US Securities and Exchange Commission Proposes Hedging Disclosure Rules," dated February 20, 2015.⁸

Say-on-Pay and Related Compensation Disclosure and Litigation Considerations

Say-on-Pay. Shareholders, for the most part, approved their companies' say-on-pay proposals in 2015, often by wide margins. Of the Russell 3000 companies that held say-on-pay votes between January 1, 2015 and July 10, 2015, the average vote result was 91 percent in favor. Only 2.5 percent of these Russell 3000 companies had their say-on-pay proposal fail during that time period. Since say-on-pay first became required in 2011, 91 percent of these Russell 3000 companies have had their say-on-pay votes pass in all five years.⁹

A say-on-pay failure can result in weakened support for directors. Proxy Pulse, an initiative of Broadridge Financial Solutions, Inc., and PricewaterhouseCooper LLP's Center for Board

Governance (Proxy Pulse), reports that 46 percent of the companies that had a failed say-on-pay vote in 2014 and a director election between January 1, 2015 and June 30, 2015 had at least one director fail to receive 70 percent support.¹⁰

Failing to win majority support is not the only important benchmark for a say-on-pay vote. Significant opposition to an executive compensation program can impact future votes on say-on-pay and for the election of directors. For example, when the previous year's say-on-pay proposal receives less than 70 percent support of the votes cast, proxy advisory firm Institutional Shareholder Services Inc. (ISS) will consider recommending that its clients vote against compensation committee members (or, in exceptional cases, the full board).¹¹ Therefore, when holders vote a large percentage of shares against a company's say-on-pay proposal, the company may need to reach out to shareholders for feedback on the particular aspects of its executive pay program that shareholders found troubling, even if the company's advisory vote on executive compensation achieved majority approval.

According to Proxy Pulse, of the companies that held annual meetings between January 1, 2015 and June 30, 2015, approximately 10 percent failed to surpass the 70 percent support level for say-on-pay. Interestingly, of the companies that failed to attain at least 70 percent support for say-on-pay in the 2014 proxy season, 40 percent again failed to attain at least 70 percent support in 2015. On the other hand, another 36 percent of the companies that failed to attain 70 percent support for say-on-pay during 2014 achieved 90 percent or greater support in 2015.

Although say-on-pay is a nonbinding, 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 CD&A. Plain English is very important to a clear

presentation. Executive summaries have become a very common (although not required) component of the 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, recent changes to such programs and rationales supporting compensation decisions. It has become common for companies to highlight performance measures in order to demonstrate that compensation is performance-based. To the extent that non-GAAP performance measures are disclosed in proxy statements, companies must pay attention to the requirements of Item 10(e) of Regulation S-K and related compliance and disclosure interpretations.

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 the previous year's proposal passed or failed. Compensation committees should be reminded of this reporting obligation so that they can decide whether to specifically address the results of the say-on-pay advisory vote when making subsequent compensation decisions.

Negative Proxy Advisory Firm Recommendations and Responses. Proxy advisory firms, such as ISS and Glass Lewis & Co., LLC, recommend to their institutional clients how to vote on meeting agenda items, including say-on-pay. However, 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 voting 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 a 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 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 obligations, while some alleged insufficient compensation disclosures and sought to enjoin the shareholder vote and some challenged specific compensation actions. Although 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 2016 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.

Director compensation can also be the subject of litigation. For example, in April 2015 the Delaware Court of Chancery denied a motion to dismiss in *Calma v. Templeton*,¹² a case in which the plaintiff alleged that restricted stock unit awards (RSU Awards), when combined with cash payments to nonemployee directors, were excessive in comparison with director compensation at peer companies. Although the defendants argued that shareholders had ratified the RSU Awards, the court concluded that the defendants did not establish such ratification "because, in obtaining omnibus approval of a Plan covering multiple and varied classes of beneficiaries, the Company did not seek or obtain stockholder approval of any action

bearing specifically on the magnitude of compensation to be paid to its non-employee directors.” As a result, the court treated the RSU Awards as “self-dealing decisions” and held that “the operative standard of review is entire fairness.”

Companies should be cognizant of the lessons of *Calma v. Templeton* when determining director compensation or seeking approval of equity plans applicable to directors. Because directors might have to establish the entire fairness of their own compensation, there should be a meaningful process to determine amounts of compensation and types of awards. If an omnibus equity plan applicable to directors, or a specific outside director plan, is being submitted for shareholder approval, companies may want to consider providing for a maximum size of awards to nonemployee directors, as well as an explicit approval of such directors’ ability to grant awards to themselves, in each case in order to establish that shareholders specifically approved the granting and magnitude of compensation paid to directors.

Shareholder Engagement. While the say-on-pay vote is advisory and nonbinding 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 the 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.

Say-on-pay has heightened the need and demand for shareholder engagement. One effect of this is that institutional investors are increasingly asked to interact with companies in which they hold substantial positions. To make the most effective use of their investors’ time, companies seeking to engage their shareholders should focus their engagement initiatives on

specific goals. To the extent that a company seeks input on particular aspects of pay practices, it should contact influential and significant shareholders in time for the compensation committee to consider the feedback when making compensation decisions that will be disclosed in proxy statements.

Companies must ensure that their shareholder engagement efforts comply with proxy solicitation rules and filing requirements. In addition, companies must be careful not to selectively disclose material nonpublic information when engaging with any shareholders.

Shareholder Proposals

General Considerations. Rule 14a-8 under the Exchange Act permits shareholders who have either owned at least \$2,000 in market value or 1 percent of the voting stock for one year to submit a proposal that a company must include in its proxy statement, unless the proposal has specified procedural deficiencies or can be excluded based on 13 substantive grounds that are set forth in the rule. Because of Rule 14a-8’s deadlines for excluding shareholder proposals from a company’s proxy statement, shareholder proposals are often one of the first topics that companies address at the start of any proxy season.

If a company believes that Rule 14a-8 provides grounds to exclude the shareholder proposal from its proxy statement, it may submit a no-action request to the Staff seeking its concurrence, describing each applicable alternative basis upon which the company believes it may omit the shareholder proposal.

In recent years, some companies and shareholders have instituted court actions with respect to exclusion of shareholder proposals. For example, in a recent case involving a proposal relating to gun sales at Wal-Mart, the proponent, Trinity Church, turned to the courts to challenge an SEC no-action letter that

concluded with Wal-Mart's conclusion that there was a basis for omitting the shareholder proposal from its proxy statement. Although the district court held that the proposal was improperly excluded as a social policy matter, the circuit court reversed the decision, holding that the proposal was properly excluded as relating to the company's ordinary business operations.¹³ Trinity has recently petitioned the US Supreme Court to review the circuit court opinion, but it is not known whether the court will agree to hear the case. Most of the time, however, public companies and their shareholders rely on the Staff's no-action process, rather than litigation, to determine whether shareholder proposals may be excluded from the company's proxy statement.

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 complies with the Rule 14a-8 requirements and notifies the proponent in writing about the defect within 14 days of its receipt of the proposal. The company does not have to notify the proponent of a defect that cannot be remedied, such as late submission of the proposal. After receiving a notice of a procedural defect, the proponent has 14 days to correct the deficiency. Because 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 the company does not support, the company should carefully draft a persuasive statement of opposition. It must send this statement to the proponent of the proposal at least 30 days before the company files its definitive proxy statement. 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 to be 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.

Proxy Access. In 2010, the SEC adopted a proxy access rule that would have given shareholders holding at least 3 percent of a public company's voting shares for 3 years the right to use the company's proxy statement to nominate directors. However, that SEC proxy access rule was overturned by court action in 2011. Since that time, proxy access has been addressed on a company-by-company basis, frequently in the context of a shareholder proposal.

During the 2015 proxy season, the number of proxy access shareholder proposals dramatically increased, largely as a result of the actions of the New York City Comptroller, who sent proxy access proposals to 75 companies on behalf of New York City pension funds. According to Proxy Pulse, 70 percent of the more than 80 proxy access shareholder proposals voted on during the first six months of 2015 received majority support, with votes in favor averaging 57 percent. The momentum that proxy access gained during the 2015 proxy season is likely to continue into the 2016 proxy season.

In previous years, there have been situations where the Staff has taken no-action positions based on various grounds that permitted proxy access shareholder proposals to be excluded from proxy statements. One of the substantive grounds for excluding a shareholder proposal from a company's proxy statement is provided by Rule 14a-8(i)(9), which permits a shareholder proposal to be excluded when it conflicts with a

proposal that management is submitting for shareholder approval in the same proxy statement. In the past, the Staff has granted no-action relief on this basis even where the management proposal was not exactly the same as the shareholder proposal, including in situations when the management proposal was developed only after the shareholder proposal was received.

In December 2014, the Staff took a no-action position pursuant to Rule 14a-8(i)(9) with respect to the exclusion of a proxy access shareholder proposal received by Whole Foods Market Inc. that conflicted with a management proxy access proposal with different terms than the company intended to include in its proxy statement. Following the controversy generated by this no-action letter, SEC Chair Mary Jo White directed the Staff to review and report on the scope and application of the Rule 14a-8(i)(9) grounds for exclusion of shareholder proposals. The Staff then suspended giving no-action relief on this basis, not just with respect to proxy access proposals, but for all shareholder proposals. The Staff has not yet reported to the SEC on the use of the conflicting proposal grounds as a basis for exclusion of shareholder proposals from a company's proxy statement, including with regard to proxy access.

As a result of the suspension of the Rule 14a-8(i)(9) no-action positions, and the increasing sophistication of proponents in the drafting of proxy access shareholder proposals, it will be difficult for a company to exclude a proxy access shareholder proposal from its proxy statement unless the company has substantially implemented the proposed proxy access provision or if there is a procedural defect in the shareholder's proposal (such as insufficient proof of ownership or a late submission).

In preparation for the 2016 proxy season, it would be prudent for companies to review the variations of proxy access that exist in order to be in a position to evaluate what attributes they would prioritize if they receive a proxy access

shareholder proposal and choose to negotiate or adopt a proxy access provision in response. Examples of types of terms that differ in proxy access provisions include the percentage of ownership threshold (e.g., 3 percent or 5 percent), the holding period (e.g., 1 year or 3 years), the number of shareholders that can aggregate their holdings to reach the required threshold (e.g., 5, 10, 20 or 25), the maximum percentage or number of directors that can be nominated through proxy access (e.g., 20 percent, 25 percent or not less than 2 directors), restrictions on renominations if a candidate nominated through proxy access does not receive a specified threshold of votes in favor, and requirements to hold shares after the meeting.

A proxy access provision with a threshold enabling the holders of at least 3 percent of the outstanding voting shares who have held that minimum position for at least 3 years, as specified in the vacated SEC proxy access rule, seems to be gaining acceptance as a proxy access standard, but this threshold is not universal.

There are a number of actions that a company can take if it receives a proxy access shareholder proposal for the upcoming proxy season, including:

- Try to simply fight the proposal by recommending against it and soliciting its shareholders to reject it;
- Negotiate with the proponent to see if a compromise can be reached whereby the proponent agrees to withdraw a proxy proposal if the company commits to adopt the same or a different version of proxy access;
- Unilaterally adopt its own version of proxy access;
- Stay neutral, with the board of directors not recommending for or against the proxy access proposal; or
- Submit both the shareholder proxy access proposal and a different management proxy access proposal to its shareholders.

Some companies may consider adopting proxy access provisions before there is an actual shareholder request to do so in order to demonstrate corporate governance leadership or to possibly preempt a proxy access proposal with more onerous terms. However, even if a company already provides for proxy access, it may receive a shareholder proposal seeking further revisions to make it easier for shareholders to use the proxy access process.

The company's shareholder base may determine which course of action will be its most effective approach to proxy access and what variations of proxy access terms its shareholders may be more likely to accept. In this regard, companies considering proxy access provisions should try to determine the proxy access voting policies of their largest institutional investors to see what proxy access variations their institutional shareholders support. According to Proxy Pulse, institutional shareholders voted 61 percent of their shares in favor of proxy access proposals while retail shareholders, when they voted, cast 85 percent of their shares against proxy access proposals (with such retail voting being generally in line with management's recommendations). To the extent that retail shareholders may be more inclined to vote with management, companies that have a large retail shareholder base may have greater flexibility to modify proxy access terms, although they will nevertheless need to be cognizant of the viewpoints of their institutional investors on proxy access variations.

Other Proposals. ISS's Preliminary 2015 US Postseason Review, dated July 30, 2015 (ISS Review), reports that proxy access was the most prevalent shareholder proposal of the 2015 proxy season, representing more than 11 percent of shareholder proposals that were submitted for 2015 and more than 14 percent of the shareholder proposals appearing on proxy ballots through July 30, 2015. In addition, other governance proposals also saw a high frequency of submissions in 2015.

According to the ISS Review, independent chair and shareholder action by written consent proposals were the second and third most prevalent proposals, respectively, on annual meeting ballots during the first half of 2015. Although independent chair shareholder proposals represented a common shareholder proposal during this period, Proxy Pulse reports that of the 57 shareholder proposals to split the role of chair and chief executive officers that were voted upon during the first half of 2015, only three received majority shareholder support. In contrast, Proxy Pulse reports that 37 companies voted on declassification of the board of directors during the first half of 2015 and 100 percent of those proposals received majority support.

Although governance proposals, generally, and proxy access, in particular, were the most frequent shareholder proposals appearing on proxy ballots in 2015, the ISS Review reports that environmental and social policy proposals in the aggregate represented 45 percent of total shareholder proposals submitted for the 2015 proxy season. Popular topics for proposals in this category included political contributions and lobbying, climate change, sustainability, greenhouse gas, anti-discrimination and equal employment opportunities.

According to the ISS Review, only one proposal in the environmental and social policy category achieved majority support during the first half of 2015. However, proposals in this category can have an impact even when they do not receive majority approval. Proponents of shareholder proposals often 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).

Executive compensation proposals represented another category of shareholder proposals submitted for the 2015 proxy season. While the management say-on-pay proposal gives shareholders the opportunity to vote on the executive compensation program as a whole, compensation-related shareholder proposals that appear on the proxy ballot give shareholders the opportunity to vote on a specific element of executive compensation. Examples of executive compensation shareholder proposal topics during the 2015 proxy season included golden parachutes, clawbacks and equity compensation features (such as *pro rata* vesting of equity awards upon termination).

Many of the common shareholder proposal topics from the 2015 proxy season are likely to be raised again during the 2016 proxy season. In addition, there may be new proposals and proposals with increased prevalence for the 2016 proxy season, such as proposals addressing board tenure and diversity, particularly gender diversity, which are increasingly becoming hot button issues.

Other Proxy and Annual Reporting Season Matters

Director and Officer Questionnaires.

There are no recent rule changes under the federal securities laws or the New York Stock Exchange or The NASDAQ Stock Market listing standards that would require changes to director and officer questionnaires for the 2016 proxy and annual reporting season. However, public companies should review their existing forms of questionnaires to determine whether developments from the past few years are adequately addressed. For example, questionnaires should 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 ask compensation committee members about their source(s) of compensation, particularly indirect compensation. And, as a disclosure control, companies may want to confirm their director and officer questionnaires address the sanctionable activities identified by the Iran Threat Reduction and Syria Human Rights Act of 2012 that must be reported in annual reports on Form 10-K and quarterly reports on Form 10-Q.

Companies should also consider whether there are regulatory developments outside of the federal securities laws, or any new state or foreign law requirements, requiring additions or modifications to director and officer questionnaires for the 2016 proxy and annual reporting season.

Cybersecurity Disclosures. Cybersecurity continues to garner significant attention from the general public, the government and even boards of directors. Indeed, the Staff has identified cybersecurity as a matter it considers important from a disclosure perspective, and issues comments relating to cybersecurity when reviewing company filings. For example, the Staff may push for disclosure of actual and potential costs and consequences of an actual cyber attack or request a discussion of significant liability that could result from a cybersecurity breach. The Staff may explore whether disclosure of past incidents should provide context for cybersecurity risk factors. It is also possible that the SEC may pursue enforcement action with respect to a company that was the subject of a cyber attack if the company did not adequately disclose cybersecurity risk.

The Staff's "Disclosure Guidance: Topic No. 2," titled "Cybersecurity,"¹⁴ issued in 2011, still represents the most recent statement of how existing disclosure regulations require disclosure

of cybersecurity issues. For instance, even without the adoption of any specific cybersecurity rule, cybersecurity issues may need to be disclosed as part of a company's risk factors, management's discussion and analysis, business section or litigation disclosure.

What has changed for the 2016 annual reporting season is the growing number of cyber incidents, a greater understanding that cybersecurity issues can impact many types of businesses and an increased recognition of the serious risks that cybersecurity poses to the economy and to overall security. As a result, cybersecurity disclosure may receive heightened scrutiny. Therefore, when preparing upcoming annual reports (or other periodic reports), public companies should consider whether they need to expand or update prior year disclosures to make them more robust and to take into account new concerns in light of increasing sophistication and reach of global computer hacking. And, if a company does not already disclose cybersecurity issues in its SEC filings, it should examine its situation to determine if it needs to add a discussion of them.

Companies must discuss the role of the board of directors in risk oversight in their proxy statements. Given the current focus on cybersecurity generally, if cybersecurity is a risk for a company, it may want to expressly address oversight of cybersecurity in this section of its proxy statement. Also, if a nominee for director has particular experience relevant to cybersecurity risk, it may be useful for the company to highlight that expertise in the section of its proxy statement describing the attributes of individuals nominated for director.

Audit Committee Disclosure. On July 1, 2015, the SEC issued a concept release requesting comments on possible revisions to audit committee disclosures, focusing on three main areas of inquiry.¹⁵ A concept release reflects a preliminary investigation of the topics discussed, as opposed to a specific proposal.

The first area for which the SEC is seeking feedback relates to disclosure regarding the audit committee's oversight of the auditor. In this category, the SEC asked for comments on specific questions relating to disclosure of:

- Additional information regarding communications between the audit committee and the auditor;
- The frequency with which the audit committee met with the auditor;
- Review of, and discussion about, the auditor's internal quality review and most recent Public Company Accounting Oversight Board inspection report; and
- Whether and how the audit committee assesses, promotes and reinforces the auditor's objectivity and professional skepticism.

In its second major category of questions, the SEC asked for comments on the audit committee's process for selecting the auditor, highlighting the following issues:

- How the audit committee assessed the auditor, including the auditor's independence, objectivity and audit quality, and the audit committee's rationale for selecting or retaining the auditor;
- If the audit committee sought requests for proposals for the independent audit, the process the committee undertook to seek such proposals and the factors it considered in selecting the auditor; and
- The board of director's policy, if any, for an annual shareholder vote on the selection of the auditor and the audit committee's consideration of the voting results in its evaluation and selection of the audit firm.

For its third general topic, the SEC raised disclosure questions regarding the audit committee's consideration of the qualifications of the audit firm and members of the engagement team when selecting the audit firm. The comments requested in this area involve:

- Disclosures on individuals on the engagement team;
- Audit committee input in selecting the engagement partner;
- The number of years the auditor has audited the company; and
- Other firms involved in the audit.

The concept release has also requested comments on the location of audit committee disclosures in SEC filings and comments relating to audit committee disclosure by smaller reporting companies and emerging growth companies, as well as other miscellaneous questions related to audit committee disclosures. In total, the concept release contains 74 requests for comments, many of which include multiple questions.

The comment period for the audit committee disclosure concept release expired on September 8, 2015. It is not clear when or if the SEC will consider a proposal on the subject, so potential changes to audit committee disclosure will not directly impact the 2016 proxy season. However, the fact that the SEC is actively considering whether changes should be made to audit committee disclosure is itself highly relevant for public companies.

It is unlikely that all of the requests for comments regarding potential additional audit committee disclosures will result in new disclosure requirements. The SEC has specifically asked if these potential disclosures could chill communications between the audit committee and the auditor. The SEC also acknowledged that “[s]ome audit committee members, however, see additional reporting as possibly contributing to a state of ‘disclosure overload.’” In any event, it can take a long time—sometimes years—to get from concept release to final rulemaking.

However, the conversation about whether there should be more audit committee disclosure has begun. Therefore, public companies may want to discuss their audit committee report for the

upcoming proxy season with their audit committee and auditors to see if they consider it appropriate to expand any of their audit committee disclosures at this time.

Virtual Meetings. The number of companies conducting virtual annual meetings has increased over the past few years, although the total number is still small. Online shareholder meetings can take a variety of forms. Some are hybrid, with an in-person meeting supplemented by an audio and/or video option. Other companies conduct a fully virtual meeting. For example, in 2015 Hewlett-Packard Company conducted a completely virtual meeting, providing shareholders with the opportunity to submit questions online, but not the opportunity to be physically present with management or directors of the company. According to Broadridge data, 101 companies that mailed proxy statements between March 1, 2015 and June 14, 2015 allowed shareholders to participate in shareholders’ meetings online.¹⁶

Universal Proxy Developments. In a proxy contest, shareholders generally vote using either the management’s ballot or the ballot of the shareholder proponent proposing alternative candidates. This means that shareholders cannot pick and choose candidates from competing slates. To address this issue, there has been a renewed discussion of universal proxy ballots that would provide a single proxy card for proxy contests, listing both management’s and the proponent’s nominees for directors.

The SEC held a roundtable on universal proxy ballots in February 2015 and, in a speech given in June 2015, Chair White stated that she has “asked the staff to bring appropriate rulemaking recommendations before the Commission on universal proxy ballots.”¹⁷ There are a lot of details that would have to be worked out in any universal proxy rule. For example, Chair White identified the following issues: “whether it would be optional or mandatory and under what circumstances, whether any eligibility requirements should be imposed on

shareholders to use universal ballots, what the ballot would look like, and whether both sides must use identical universal ballots.” Chair White also indicated that companies involved in proxy contests could voluntarily consider using some form of a universal proxy ballot, even though they are not currently required to do so.

Because use of a universal proxy ballot has not reached the proposal stage at this time, and because it is relevant only in the context of a proxy contest, it should not impact the 2016 proxy season. However, people who work on proxy statements should be aware that potential rulemaking on this topic is on the horizon.

Design Features. Historically, a corporation’s glossy annual report received design attention and resources to be eye-catching as an investor relations document, while the proxy statement receives a simpler graphic treatment as a disclosure document. In recent years, largely as a result of say-on-pay, there has been a shift with investor relations playing more of a role in the proxy statement design. Many companies are including charts and graphs in their proxy statements, often in color, to enhance the readability of their CD&A and to support their say-on-pay proposals. There is widespread use of executive summaries for the CD&A, as well as the advent of proxy statement summaries. A table of contents, often with hyperlinks, has become a regular feature of proxy statements. Some companies have shifted to a higher grade of paper for their proxy statements, and a number of companies have retained designers to make their proxy statements more user-friendly and appealing. A few have prepared and filed additional materials, such as a separate glossy executive compensation overview.

New design features are not limited to proxy statements. Some companies have supplemented their annual reports with digital materials such as videos or interactive charts. (If such electronic materials are considered part of the annual report that accompanies or precedes the proxy statement pursuant to Rule 14a-3(b),

they will need to be filed with the SEC, along with the annual report.)

Companies assessing the addition of design elements should consider whether these optional features are worth the expense—an analysis that may depend on the company’s shareholder base and the issues that the shareholders are concerned about. However, with the growing use of e-proxy, many companies have seen a reduction of their proxy season printing and mailing costs, which may leave more money in the budget for designing and producing multicolored proxy statements.

SEC’s Interpretation of “Spouse” and “Marriage.” In June 2015, the SEC issued an interpretation of “spouse” and “marriage”¹⁸ in light of the Supreme Court’s ruling in *United States v. Windsor*.¹⁹ The interpretation applies whenever the terms “spouse” or “marriage” appear in federal securities statutes administered by the SEC or in related, rules, regulations, releases, orders or guidance of the SEC or its staff. According to the release, the terms “include, respectively, (1) an individual married to a person of the same sex if the couple is lawfully married under state law, regardless of the individual’s domicile, and (2) such a marriage between individuals of the same sex.”

Because the term “spouse” is used in a number of disclosure requirements applicable to the proxy statement, such as related person transaction disclosure, disclosure of family relationships and disclosure of perquisites such as spousal travel, companies should be sure that disclosure controls are sufficiently broad so that information is properly tracked for required disclosures.

Delinquent Filers. The Division of Corporation Finance updated its Financial Reporting Manual in August 2015.²⁰ Section 1320.4 of the updated manual provides guidance clarifying the circumstances under which the Staff generally will not require a delinquent registrant to separately file all delinquent filings

if the registrant files an annual report on Form 10-K containing all material information that would have been included in the delinquent filings. This guidance brings some consistency to a practice that previously was handled on a case-by-case basis and provides the procedures for a company to bring its SEC reporting up-to-date. However, the guidance also makes clear that the SEC could, nevertheless, take enforcement action with respect to delinquencies. In addition, the comprehensive annual report would not make the company “current” for the purposes of Regulation S, Rule 144 or Form S-8 registration statements. Moreover, the delinquent company would not be Form S-3 eligible until it has the requisite history of timely filings. While this guidance does not provide a cure for delinquent filers, it does provide a procedure that companies in this situation can follow by preparing a single Form 10-K that includes all requisite information.

Dodd-Frank Conflict Minerals and Resource Extraction Rulemaking

Conflict Minerals. While conflict minerals reporting is not part of the annual Form 10-K reporting process, Form SD filings for conflict minerals are required to be filed annually by those issuers subject to its requirements.

In April 2014, shortly before the first conflict minerals filings were due, a three-judge panel of the US Court of Appeals for the District of Columbia Circuit (DC Circuit Court) issued an opinion in litigation challenging the SEC’s conflict minerals rule.²¹ Although the court upheld many elements of the rule, it held that the conflict mineral statute and rule violated the First Amendment 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.’”

Following this court ruling, the SEC has required affected companies to file their reports on Form SD, complying with the portions of the conflicts mineral report that the DC Circuit Court upheld.

Keith Higgins, Director of the SEC’s Division of Corporation Finance, issued a statement in April 2014 (April 2014 Statement) specifying that as a result of the court opinion, companies are not required to describe their products as “DRC conflict free,” as having “not been found to be ‘DRC conflict free’” or as “DRC conflict undeterminable.” The April 2014 Statement also provided that no independent private sector audit (IPSA) would be required unless a company voluntarily elects to describe any of its products as “DRC conflict free” in its conflict minerals report.²²

The conflict minerals litigation has been continuing. A few months after the DC Circuit Court panel held that a portion of the conflicts minerals rule violated the First Amendment, the full DC Circuit Court issued an opinion in the appeal of *American Meat Institute v. US Department of Agriculture*²³ that addressed a similar question. The *American Meat Institute* opinion upheld a Department of Agriculture “country-of-origin” labeling requirement that had been challenged on First Amendment grounds.

In light of the *American Meat Institute* opinion, the SEC petitioned for a rehearing of the DC Circuit Court’s conflicts minerals ruling. In August 2015, the three-judge panel of the DC Circuit Court reaffirmed its prior conflict minerals opinion.²⁴ As a result, it appears that the April 2014 Statement will continue to be in effect, which means that there will be no IPSA requirement unless the company chooses to describe any product as “DRC conflict free.” Additional guidance from the Staff on the impact of the recent DC Circuit Court opinion with respect to the conflict minerals rule would be helpful.

Resource Extraction. In July 2013, the US District Court for the District of Columbia vacated the SEC’s resource extraction rule which required certain companies to disclose payments made to governments in connection with the

commercial development of oil, natural gas or minerals.²⁵

In September 2015, the US District Court for Massachusetts issued a memorandum and order dated September 2, 2015,²⁶ ordering the SEC to file an expedited schedule for promulgating the final resource extraction rule with the court within 30 days. Companies involved in commercial development of oil, natural gas or minerals should continue to monitor developments in resource extraction disclosure rulemaking.

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Endnotes

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