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Legal Update
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Preparing for the 2018 US Proxy and Annual Reporting Season—Are You Ready?

Advance planning is a key component of a successful proxy and annual reporting season. While work on proxy statements, annual reports and annual meetings typically kicks into high gear in the winter, autumn is the ideal time to begin preparations. This is especially important for the 2018 proxy season because this will be the first time that pay ratio disclosure will generally be required in proxy statements. This Legal Update provides an overview of key issues that companies should consider as they get ready for the upcoming 2018 proxy and annual reporting season.

Pay Ratio Disclosure

Most public companies will be required, for the first time, to include pay ratio disclosure in their 2018 proxy statements.

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

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

The pay ratio rule of the US Securities and Exchange Commission (SEC) contains many details regarding how this calculation should be made and disclosed. For more information about this rule and its practical implications, see our Legal Update "Understanding the SEC's Pay Ratio Disclosure Rule and its Implications," dated August 20, 2015,[1] our Legal Update "SEC Provides Pay Ratio Disclosure Guidance," dated October 25, 2016,[2] our Legal Update "Get Ready for Pay Ratio," dated September 6, 2017,[3] and our Legal Update "Pay Ratio Rule: SEC Provides Additional Interpretive Guidance," dated September 28, 2017.[4]

During the first half of 2017, many people were discussing whether the SEC's pay ratio disclosure rule would be repealed or have its implementation delayed. In early February 2017, then-acting SEC Chairman Michael S. Piwowar issued a statement seeking public input on any unexpected challenges companies were facing as they were preparing to comply with the rule and whether relief was needed. In addition, he directed the SEC staff to reconsider the pay ratio rule based on comments submitted and to determine whether additional guidance or relief may be appropriate.

In the spring of 2017, the House of Representatives approved the "Financial CHOICE Act," complex legislation that, among other things, would repeal the Dodd-Frank pay ratio requirement. Although it has been submitted to the Senate for its consideration, at this point it is not certain when the House-approved bill will be debated by the full Senate. Given legislative priorities, it does not seem likely that action by the Senate on the Financial CHOICE Act, including its pay ratio repeal provision, will be considered before the 2018

proxy season. And, if the Financial CHOICE Act is considered by the Senate, there is no assurance that all of its current provisions, including the pay ratio repeal provision, will remain in what ultimately is adopted.

On September 21, 2017, the SEC and the staff of its Division of Corporation Finance (Staff) issued guidance on the pay ratio rule, which in addition to providing interpretations, effectively signaled that the SEC would not be delaying the implementation of this new disclosure requirement. The SEC issued an interpretive release providing guidance on using reasonable estimates, assumptions, methodologies, statistical samplings and internal records, as well as tests for determining independent contractor status, to assist companies in their efforts to comply with the new pay ratio disclosure requirements.[5] At the same time, the Staff provided additional guidance, including examples, to assist companies in determining how to use statistical sampling and other reasonable methods to identify the median employee's compensation.[6] Finally, the Staff revised one previously issued compliance and disclosure interpretation (CDI), added a new CDI and withdrew one previously issued CDI relating to guidance on the methodology for applying compensation measures and determining the employee population to identify the median employee.[7]

Pay ratio preparations can be time consuming. In addition to working through the complexities of the actual calculation and the required disclosure, companies should allow time to potentially modify the overall compensation discussion and analysis to put the ratio in context as well as consider what, if any, implications this additional disclosure will have on the annual say-on-pay advisory vote and other compensation matters the issuer may be presenting to shareholders for consideration (e.g., revised equity plans or awards). For all the reasons discussed above, companies should now be actively preparing for pay ratio disclosure.

Say-on-Pay and Other Compensation Matters

Say-on-Pay. After being on proxy ballots for seven years, the advisory vote on the compensation of the named executive officers has become a regular feature of annual shareholder meetings, often involving year-round planning. This agenda item has shaped a new look for proxy statements as companies increasingly incorporate graphic design elements to explain their executive compensation programs. Say-on-pay has also driven shareholder engagement on executive compensation. Many companies have made changes to their compensation programs in response to their say-on-pay vote and related conversations with their key investors.

Although say-on-pay is an advisory vote, there are real consequences to a failed say-on-pay vote. Generally, if investors vote against executive compensation in large numbers, they will expect the company to make changes to its compensation program. If the company does not, its investors may cast a binding vote against compensation committee members or other directors in addition to voting against named executive officer compensation when the next say-on-pay vote is conducted. As a result, companies are very focused on receiving not only majority approval of their executive compensation, but achieving high levels of support.

For the most part, companies were successful with their say-on-pay votes in 2017. Executive compensation consultant Semler Brossy reports that through September 11, 2017, only 1.4 percent of Russell 3000 companies had failing say-on-pay votes during the 2017 proxy season. The average support for say-on-pay during this period was 91.7 percent, representing the highest average since the commencement of mandatory say-on-pay voting. The percentage of companies receiving support above 90 percent

of the votes cast was 78 percent in 2017, which was slightly higher than in any other year.[8]

Proxy advisory firms such as Institutional Shareholder Services (ISS) have become very influential in the say-on-pay process. As a result, if a company receives a negative proxy voting recommendation from a proxy advisory firm, it often (but not always) prepares additional material in support of its executive compensation program, which it must file with the SEC as definitive additional soliciting materials not later than the date first distributed or used to solicit shareholders. According to Semler Brossy, when ISS recommends an "Against" vote for a say-on-pay proposal, shareholder support for the proposal is 26 percent lower than at companies that receive a "For" recommendation. Although an "Against" recommendation does not always result in a failed say-on-pay vote, the drop in shareholder support may influence the ongoing level and tone of shareholder engagement on compensation matters and director nominees in the coming year.

Say-When-on-Pay. Many companies were required to conduct an advisory vote in 2017 to see if their shareholders preferred that the say-on-pay vote be conducted every year, every two years or every three years. An annual say-on-pay vote was supported as the desired frequency in the vast majority of these say-when-on-pay votes.

Equity Plan Voting. Semler Brossy reports that the failure rate for equity plan proposals during 2017 was 0.7 percent. While only a small number of companies had equity plans that failed to achieve the support of the majority of the votes cast, this percentage represents the highest failure rate for equity plans since mandatory say-on-pay was instituted in 2011. Although nearly all equity plan proposals passed in 2017, the failure rate serves as a reminder that investors may use the tool of a binding vote on an equity plan or equity plan amendment if they are not happy with how a company makes equity awards or on other matters.

Compensation Litigation. Because executive compensation sometimes has been the subject of litigation, compensation decisions should be made, and compensation disclosures should be prepared, with care, especially for companies that anticipate resistance to their compensation program. Compensation committee members should be able to demonstrate that they exercised due care in applying their business judgment to determine executive compensation by reviewing adequate information, asking questions and understanding the pros and cons of various alternatives, any or all of which can involve the assistance of company personnel or outside experts, as appropriate.

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

Shareholder Proposals

General. There have been some efforts to change the shareholder proposal process. For example, the Financial CHOICE Act, as approved by the House of Representatives, would increase the share ownership and resubmission thresholds and would prohibit

shareholders from authorizing other persons to submit a proposal on their behalf. It is not yet known when, if at all, the House-approved bill will be considered by the full Senate. In addition, if the Senate does act, there is no assurance that they will not make changes to the Financial CHOICE Act as adopted by the House of Representatives. Therefore, at the present time, the current requirements of Rule 14a-8 continue to govern the shareholder proposal process.

Companies must be ready to react promptly when they receive any shareholder proposal and to evaluate their most appropriate course of action in response to the particular proposal. Under Rule 14a-8, if there are specified procedural deficiencies with a proposal (such as failing to provide the requisite proof of ownership) or if the proposal falls within one or more of the 13 substantive grounds that are set forth in the rule, the company can seek a no-action letter from the Staff concurring with the exclusion of the shareholder proposal from its proxy statement. Whether a company is seeking exclusion based on procedural or substantive grounds, it will need to comply with deadlines set forth in the rule. Alternatively, or in addition to submitting a no-action request, companies often attempt to negotiate with the proponent to see if an agreement can be reached, resulting in the withdrawal of the proposal.

Shareholder proposals do not only represent investor relations issues. They may give rise to publicity if they become the subject of a no-action request or if they are included in a company's proxy statement. Accordingly, when shareholder proposals are received, companies should assemble teams comprised of members of management, investor relations and public and media relations, as well as the law department. The Board of Directors or appropriate committees also should be apprised of the proposals promptly.

Proxy Access. An increasing number of companies in the United States have adopted proxy access bylaws over the past three years, largely as a result of shareholder proposals requesting companies to conduct shareholder votes on proxy access, an initiative that gained traction when the New York City Comptroller and the New York City Pension Funds launched the Board Accountability Project in 2014 to push for proxy access. Many companies that received proxy access shareholder proposals for the 2017 proxy season adopted proxy access bylaw provisions before their 2017 annual meetings, with the proposals being withdrawn or otherwise omitted from the proxy statements. When shareholder proposals requesting the adoption of proxy access were voted upon in 2017, they often received majority support of the votes cast. Currently, more than 60 percent of the companies in Standards & Poor's 500 Index have adopted proxy access bylaw or charter provisions and that percentage may increase by the end of 2017.

As the number of companies with proxy access has grown, a consensus has developed for what constitutes "market" practice for proxy access. Most of the US proxy access provisions have a 3 percent-for-3-year-ownership threshold, allow aggregation by groups of up to 20 holders to reach the designated threshold, limit the number of proxy access nominees to 20 percent of the board, but often with a minimum of two nominees, and specify a minimum level of support for re-nominations in future years. There are quite a few other details on which proxy access provisions vary, although there have been a sufficient number of US proxy access provisions adopted that there is general agreement as to which variations are viewed as customary.

Some shareholders submitted proposals for the 2017 proxy season to companies that had already adopted proxy access, seeking to amend a number of specific proxy access features to broaden the right, such as by raising the maximum number of directors eligible for election through proxy access from 20 percent to 25 percent, removing a limit on the number of shareholders whose holdings could be

aggregated to meet the proxy access ownership threshold or eliminating refinements such as ownership definitions or nominee qualifications. In response to no-action requests to exclude such "fix it" proposals, the Staff generally permitted the proposals to be excluded as substantially implemented if a company had already adopted a proxy access bylaw that conformed to market practice of a 3 percent for 3-year ownership threshold, a 20 holder limit on aggregation and a 20 percent cap on proxy access directors. However, in July 2017, the Staff refused to permit the exclusion of a proxy access amendment proposal as substantially implemented where the proposal addressed only a single feature: the elimination of a cap on the number of shareholders that can aggregate their shareholdings for the purpose of satisfying the ownership requirement necessary to make a proxy access nomination.[9] Nevertheless, during the 2017 proxy season, proposals to amend proxy access provisions containing what is now considered the standard features so far have failed to receive majority support.

Companies that do not have proxy access provisions in place should be familiarizing themselves with the latest developments in this area. It would be useful for them to examine market provisions so that they are ready to react quickly if they receive a proxy access shareholder proposal for the 2018 proxy season. Companies in this position may want to develop a draft proxy access provision for internal discussion purposes to better understand the mechanics for such a nomination procedure and how it would interact with existing advance notice bylaws and other governing documents and law.

Although many US companies have adopted proxy access in the last few years, to date proxy access has not been successfully used to actually nominate directors. An asset management company and affiliated companies filed a Schedule 14N in November 2016 to disclose a proxy access nomination. However, the company determined that the nomination did not satisfy the "passive investment" requirement of its bylaws, the nominee withdrew and the investor group reported in an amended Schedule 13D that they were not pursuing proxy access.[10]

Other Shareholder Proposals. While proxy access proposals have garnered attention over the past few years, there are also other areas that have been a focus of shareholder proposals, especially in the environmental, social and governance areas. According to the database maintained by Proxy Monitor, 50 environmental shareholder proposals were voted on at Fortune 250 companies in 2017 through September 15, 2017. More than half of these proposals received support in excess of one quarter of the votes cast and three proposals requesting reports on the impact of policies to limit global warming received majority support.[11] The number of shareholder proposals relating to board diversity increased in 2017, although many were withdrawn after companies agreed to address board diversity through recruitment. Lobbying and political spending continued to be popular topics for shareholder proposals in 2017, often receiving in excess of one quarter of the votes cast. Requests that the chairman of the board be an independent director remained a relatively common topic for shareholder proposals in 2017, but none received majority shareholder support. Executive compensation shareholder proposals, on the other hand, have been declining.

The shareholder proposal topics described above are likely to be common subjects for shareholder proposals that companies receive for the 2018 proxy season, although there may be variations in approach or frequency of some of the submissions this year. Certain proposal categories may be refined in light of Staff no-action positions. Other proposal types may become more prevalent as a result of successful voting results in 2017. There also may be changes in the shareholder proposal landscape to reflect the fact that many of the 2017 shareholder proposals were sent to companies before the change in the US administration and

related developments. For example, as a result of the US decision to withdraw from the Paris climate accord and changing environmental regulation, there may be an increase in climate change shareholder proposals as investors turn to "private ordering" to address global warming concerns on a company-by-company basis. And, as always, there may be some shareholder proposals submitted on subjects of concern to a limited number of companies or a small group of shareholders.

Institutional Shareholder Initiatives

Submitting shareholder proposals for inclusion in a company's proxy statement is one way shareholders attempt to force companies to take certain actions or to publicize particular issues. Institutional shareholders, by virtue of their larger holdings, have additional ways to influence companies, such as through their proxy voting policies and engagement practices. Companies should therefore not only track who their large shareholders are but should also pay attention to positions these investors have taken with respect to various topics.

While mandatory say-on-pay has made executive compensation a frequent subject of shareholder engagement, compensation is not the only issue of concern to institutional investors. For example, State Street Global Advisors has identified board diversity, and in particular gender diversity, as a key issue for its 2017 proxy voting.[12] State Street Global Advisors carried through on this policy during the 2017 proxy season, voting against the reelection of directors having the responsibility to nominate new board members at 400 companies that failed to make any significant effort to address the lack of a single woman on their board of directors.[13] And, the ISS 2017-2018 Global Policy Survey, published September 25, 2017, (ISS Survey) found that out of 129 investors who responded prior to the survey deadline, 69 percent consider it problematic for there to be no female directors on a public company board, and the largest number of these investors identified engaging with the board and/or management as the most appropriate response for shareholders to take on this issue.[14]

In its August 31, 2017, open letter to directors of public companies worldwide, Vanguard identified the functioning and composition of the board, governance structures, appropriate compensation and risk oversight as the four pillars that it considers in evaluating corporate governance.[15] In this letter, Vanguard articulated its increased focus on climate risk and related disclosure and gender diversity, making clear that these are ongoing priorities. The New York City Comptroller and the New York City Pension Funds issued a press release on September 8, 2017, announcing the launch of their Boardroom Accountability Project 2.0 to "ratchet up the pressure on some of the biggest companies in the world to make their boards more diverse, independent, and climate-competent." This campaign is asking the boards of 151 US companies, 92 percent of which have adopted proxy access, to disclose race and gender of their directors, together with board members' skills, in a standardized matrix format and to enter into a dialogue on their board "refreshment process."[16]

Companies should remain aware of the topics that their large shareholders have identified as important to them. Even when such areas are not the subject of proposals being voted on at the annual meeting, companies may choose to add or expand disclosures in their proxy statements and annual reports as a form of shareholder engagement to highlight their efforts and progress.

Virtual Meetings

With technological advances, a growing number of companies have begun to hold virtual annual meetings, although such meetings have remained a minority practice. Online shareholder meetings can take a

variety of forms. Some are hybrids, with in-person meetings supplemented by audio and/or video options. Other companies conduct fully virtual meetings.

The number of companies conducting virtual annual meetings has been increasing steadily over the past few years. According to the New York City Comptroller, the number of companies holding virtual-only meetings increased 700 percent since 2010, from just 19 in 2010 to 155 in 2016.[17] Broadridge reports that, during 2016, 187 companies held virtual meetings, of which 155, or 83 percent, were virtual-only.[18] Broadridge identifies approximately 200 companies that have held or scheduled virtual meetings in the first three quarters of 2017.[19] Some investors have criticized virtual-only meetings. A number of companies received shareholder proposals for the 2017 proxy season requesting in-person meetings, but on December 28, 2016, the Staff issued a no-action letter permitting a proposal requesting a corporate governance policy to initiate or restore in-person meetings to be excluded from a proxy statement as dealing with ordinary business operations in reliance on Rule 14a-8 (i)(7).[20]

In early spring 2017, the New York City Comptroller called upon more than a dozen major corporations to host in-person annual meetings rather than continuing to hold virtual-only meetings.[21] In addition, the New York City Pension Funds adopted a policy in its proxy voting guidelines in April 2017 to vote against incumbent directors serving on a nominating committee who are up for re-election at a virtual-only meeting.[22]

The ISS Survey found that 87 percent of its investor respondents generally consider holding hybrid shareholder meetings to be an acceptable practice. In addition, a majority of the investor respondents indicated that virtual-only meetings would be acceptable, at least in certain circumstances, with 19 percent of the investor respondents reporting that they generally consider virtual-only meetings to be acceptable and 32 percent indicating that they would be comfortable with virtual-only shareholder meetings if they provided the same shareholder rights as a physical meeting. On the other hand, the ISS Survey found that 44 percent of the investor respondents objected to virtual-only meetings.

Notwithstanding the concerns raised by some investors, many companies hosting virtual meetings often emphasize shareholder engagement as well as cost savings and observe that web participation may exceed physical attendance, allowing shareholders the ability to attend the annual meeting from any location around the world. Thus, using technology provides a platform that encourages meaningful shareholder engagement at the annual meeting.

Companies considering or planning a virtual meeting should begin preparations early. They should confirm that their governing law permits virtual meetings and that their charter and bylaws contemplate the practice. They should decide whether they will retain an in-person component of the meeting and whether the virtual component will be audio only or will include video. A very important aspect of a virtual meeting is how shareholder questions will be handled. Another issue is whether anyone will be permitted to observe the virtual meeting or whether only shareholders will be allowed access. Therefore, it is critical for companies conducting virtual meetings to be sure the technology is in place and adequately tested before the meeting.

Annual Report Risk Factors

Updating risk factors is an important part of a company's process for preparing its annual report on Form 10-K or Form 20-F. This section of the annual report must explain in plain English the specific risks that impact the company and its securities. The risk factors must be tailored for the specific issues affecting the company under current circumstances. While the prior year's risk factor presentation can be

the starting place for analysis, companies must be sure the risk factors are current.

When drafting the risk factors that will appear in the current year's annual report, companies must consider whether it is appropriate to disclose new risks, to provide additional details on existing risks or to delete any risks. The answer will vary by company—there is no one-size-fits-all approach. Some key risk factor topics to consider at this time, either as stand-alone risk factors or in conjunction with other risk factor discussions, include the following:

Cybersecurity. Cybersecurity is now recognized as an issue that impacts companies of all types, with cybersecurity risks from both an economic and security perspective increasing. Therefore, companies should assess whether they need to expand or revise their cybersecurity disclosures to avoid potentially incomplete or misleading disclosures, especially in light of any events that may have occurred over the past year, whether or not such events affected them directly. Updated cybersecurity disclosure can also be helpful from a shareholder engagement perspective to demonstrate that the company is aware of the significant impact of cybersecurity risk and is taking steps to address it.

Political Changes. Changes and potential changes in law, regulation and policy resulting from the Trump presidency and the dynamics of the majority-Republican Congress may impact the risk profile of certain companies, thereby requiring modifications to risk factor disclosure that consider the potential uncertainty in the regulatory environment. For example, travel and immigration policies may present risks to companies that rely on foreign employees or consultants. Some companies may be facing increased risks with respect to potential withdrawal or modification of international trade agreements. Other companies may be concerned about changes in tax policy, such as the elimination of renewable energy tax credits or significant changes to the current tax system. Companies in the health care or insurance industries may face risks relating to efforts to repeal and replace the Affordable Care Act. Some companies have already disclosed risks from such recent political changes in their SEC filings. It is a worthwhile disclosure control exercise for companies to consider whether they face particular risks as a result of the current political climate, even if they ultimately determine that they do not need to address this topic as a risk factor.

Brexit. Following the United Kingdom referendum in favor of leaving the European Union, some companies began including Brexit risk factors in their periodic reports to address political, social and economic uncertainty, as well as stock market volatility and currency exchange rate fluctuations. For example, Brexit has been mentioned in the context of risk factors on topics such as currency exchange rates, global economic conditions and international operations, as well as having been discussed as a separate risk factor. Brexit is an ongoing process that will still take some time to fully negotiate and implement. As Brexit negotiations progress, impacted companies should continually evaluate whether Brexit poses a risk to their business, what level of Brexit-related disclosure is appropriate under the circumstances and whether any prior Brexit risk factor needs to be updated.

Climate Change and Sustainability. Sustainability and climate change have garnered increasing attention, including in the context of risk factor disclosure. Climate change risk factor disclosure may discuss the impact of existing or pending legislation, regulation or international accords, as well as the physical impact of climate change or the impact of public awareness of sustainability issues on a company's business. To the extent deemed relevant, a risk factor could also discuss uncertainties with respect to a company's business from potential changes in climate change regulation and treaties,

especially in light of the US withdrawal from the Paris climate accord. Because climate change is an evolving area, the necessity for and scope of a climate change and sustainability risk factor is something that a company should carefully consider.

Shareholder Activism. Some companies are now including shareholder activism as a risk factor, either as part of a litany of matters that can impact the share price or as a separate risk factor describing how the company's business could be impacted as a result of actions by activist shareholders or others. For example, risk factors have stated that actions taken by activist shareholders could cause the company to incur substantial costs, including litigation, and could divert management attention and resources. Some have indicated that actions by activists could create uncertainty, making it more difficult to attract and retain employees, business partners and customers, and could result in the loss of business opportunities. Risk factors have mentioned that shareholder activism may hinder investment or other strategies and impact stock price.

Terrorism and Armed Conflict. Companies should consider whether they should add or expand risk factors addressing the potential impact of terrorism, armed conflict, possible use of nuclear weapons or other geopolitical issues in light of developments during the past year.

Non-GAAP Financial Measures

The Staff has continued to review compliance with the requirements for use of non-GAAP financial measures since issuing new and updated CDIs on the subject in May 2016. Many of the Staff's comments on SEC filings containing non-GAAP financial measures have been directed at the requirements for presenting the most directly comparable GAAP measure with equal or greater prominence and the company's justification for use of the non-GAAP measure outside of the context of pay-related proxy statement discussions as noted below. Companies should actively consider the most recent CDIs and Staff comments when preparing their annual reports and related earnings releases if they contain non-GAAP financial measures.

Regulation S-K and Staff interpretations provide limited special relief regarding non-GAAP financial measures used in pay-related proxy statement discussions with respect to target levels for performance. These interpretations afford additional relief as to the location of required GAAP reconciliation and other information when non-GAAP financial measures are disclosed in pay-related circumstances. However, companies sometimes include non-GAAP financial measures in their proxy statements in circumstances which do not relate directly to compensation, such as in a summary or a letter included in the proxy statement. Therefore, it is prudent for companies to carefully consider the limits of Staff's guidance on non-GAAP financial measures when preparing their proxy statements.

Audit Committee Disclosure

The technical requirements for the audit committee report for the proxy statement are quite modest. Item 407(d) of Regulation S-K only requires the audit committee report to state whether:

- The audit committee reviewed and discussed the audited financial statements with management;
- The audit committee discussed with the independent auditors the matters required to be discussed by Public Company Accounting Oversight Board (PCAOB) auditing standards;
- The audit committee has received the written disclosures and the letter from the independent accountant required by the PCAOB regarding the independent accountant's communications with the audit committee concerning independence and

- discussed the independent accountant's independence with the independent accountant; and
- Based on such review and discussions, the audit committee recommended to the board of directors that the audited financial statements be included in the company's annual report on Form 10-K.

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

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

The comment period for the audit committee disclosure concept release has expired, but the SEC has not issued any specific proposals in response to the issues raised by the concept release. However, in the interest of transparency, some companies have already expanded their audit committee disclosures beyond the mandatory requirements.

In a recent analysis of 75 companies in the Fortune 100 list that filed proxy statements in each year from 2012 to 2017 (for annual meetings through August 15, 2017), Ernst & Young LLP (EY) found a continued increase in voluntary audit committee disclosures.[23] According to this EY study, in 2017, 87 percent of such Fortune 100 companies explicitly stated that the audit committee is responsible for the appointment, compensation and oversight of the external auditor, 84 percent stated that the audit committee considers non-audit fees/services when assessing auditor independence, 77 percent named the audit firm in the audit committee report, 75 percent stated that the audit committee was involved in the lead partner selection and 73 percent stated that the choice of external auditor is in the best interest of the company and its shareholders.

Expanding audit committee reports may be well received by institutional investors, some of which advocated for additional audit committee disclosures even before the SEC issued its concept release. As the 2018 proxy season approaches, those responsible for preparing the proxy statement may want to discuss with their audit committees and auditors whether they consider it appropriate to voluntarily expand any audit committee disclosures at this time.

New Auditors' Report Requirements

The PCAOB has adopted a new standard for unqualified auditors' reports of financial statements.[24] As of the date of this Legal Update, the SEC has not yet approved the PCAOB's changes to auditors' reports. Some commentators have expressed objections to certain of the new PCAOB provisions.

The PCAOB's changes would, among other things, require:

- Disclosure of critical audit matters, as well as communication to the audit committee, relating to accounts or disclosures that are material to the financial statements which involved especially challenging, subjective or complex auditor judgment;
- Disclosure of the year in which the auditor began serving consecutively as the company's auditor; and
- Improvements to the auditor's report to clarify the auditor's role and responsibilities, and make the auditor's report easier to read.

Subject to SEC approval, the provisions for the new audit report, other than those related to critical audit matters, are proposed to become effective for audits of fiscal years ending on or after December 15, 2017. Provisions related to critical audit matters are proposed to become effective for audits of fiscal years ending on or

after June 30, 2019, for large accelerated filers and for fiscal years ending on or after December 15, 2020, for all other companies to which the requirements apply. Once the SEC approves the final standard, auditors may elect to comply with the new requirements early. Companies and audit committees should discuss the new audit committee report requirements with their auditors.

New Revenue Recognition Standard

The new revenue recognition standard, ASU No. 2014-09, goes into effect starting with fiscal years beginning after December 15, 2017. Calendar year companies will need to apply this new standard in their first quarterly report for 2018 rather than in their annual reports for 2017. However, companies that are required to apply the new standard should include robust transition disclosures in their annual reports to enable investors to understand the anticipated effects of the new standard. Companies affected by the new revenue standard should be discussing the anticipated effects of the new standard with their accountants and audit committees and preparing appropriate disclosure for their financial statement footnotes, management's discussion and analysis and/or other sections of their annual reports.

Companies transitioning to the new revenue recognition standard have a choice of two methods: the full retrospective method and the modified retrospective method. For a discussion of how the choice of method may affect registration statements of Form S-3, see our Legal Update "Implications of New Revenue Recognition Standard on Certain Form S-3 Registration Statements," dated September 20, 2017.[25]

Exhibit Hyperlinks

The SEC now generally requires the exhibits listed in the exhibit index of specified filings, including annual reports on Form 10-K or Form 20-F, to be hyperlinked. The hyperlink requirement covers both exhibits that are filed as part of a report and exhibits that are incorporated by reference to prior filings. The technical instructions for providing the required hyperlinks are contained in Chapter 5 of Volume II of the EDGAR Filer Manual. Note that Item 601(a)(2) of Regulation S-K and Item 102(d) of Regulation S-T require the exhibit index to appear before the required signatures in the registration statement or report.

Because an annual report on Form 10-K or Form 20-F generally has a substantially longer list of exhibits than other SEC registration statements and reports, it would be very useful for companies to identify the URLs for the exhibits that will be incorporated by reference into their annual reports well before the filing is due. Companies can start this process by gathering the exhibit indexes from last year's annual report and subsequent periodic and quarterly reports filed with the SEC and annotating them with the URLs. Appropriate company personnel should review the relevant EDGAR instructions and coordinate with their financial printers, EDGAR filing agents or software providers to understand what has to be done to ensure that their annual report exhibit indexes are appropriately prepared so that technical glitches do not interfere with the annual report filing when made.

For more information on the exhibit hyperlink requirement, see our Legal Update "SEC Requires Hyperlinks for Exhibits in Company Filings," dated March 9, 2017,[26] and our Legal Update "Get Ready to Hyperlink SEC Exhibit Filings Beginning September 1," dated July 20, 2017.[27]

Form 10-K Developments

Summary. The SEC issued an interim final rule in 2016 amending Form 10-K to expressly allow, but not require, companies to include a summary of information required by that form.

Item 16 of Form 10-K authorizes optional summary information that is presented fairly and accurately if there is a hyperlink to the material contained in the Form 10-K, including exhibits, disclosed in the summary. Many companies chose not to include such a summary in annual reports on Form 10-K for the year ended December 31, 2016, often referencing Item 16 in their Form 10-Ks, indicating "none" or similar words. If used, the summary may only refer to information that is included in the Form 10-K at the time it is filed. Companies do not need to update the summary for information required by Part III of Form 10-K that is incorporated by reference to a proxy or information statement filed after the Form 10-K, but in that case the summary must state that it does not include Part III information because that information will be incorporated from a later-filed proxy or information statement involving the election of the board of directors.

Cover Page. There have been some technical changes to the cover page of Form 10-K. In addition to the boxes indicating whether the registrant is a large accelerated file, an accelerated filer, a smaller reporting company or a non-accelerated filer, there must also be a box for an emerging growth company to check. In addition, the cover page must include a check box designed to indicate whether a registrant that is an emerging growth company has elected not to use the extended transition period for complying with any new or revised financial accounting.

Status of Other Dodd-Frank Compensation-Related Rulemaking

In addition to pay ratio disclosure, Dodd-Frank directed the SEC to adopt rules in the following areas involving compensation-related matters. Unlike pay ratio, these rules have stalled at the proposal stage, without the adoption of final rules.

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

Pay Versus Performance Disclosure. In 2015, the SEC proposed a "pay versus performance" rule to require companies to disclose in a clear manner the relationship between executive compensation actually paid and the financial performance of the company, with performance measured both by company total shareholder return (TSR) and peer group TSR. This proposal would require companies to add a new pay versus performance table to their proxy statements to separately provide annual compensation information for the chief executive officer for each of the past five fiscal years. In addition, the table would have to provide average annual compensation for the named executive officers (other than the chief executive officer) identified in the summary compensation table for those years. A clear description of the relationship between pay and performance would have been required to accompany the proposed new table.

Hedging Disclosure. The SEC also proposed a new disclosure requirement in 2015 addressing hedging by employees, officers and directors. This proposal would require companies to disclose in their proxy statements whether their employees (including officers) or directors are permitted to engage in transactions to hedge or offset any decrease in the market value of their companies' equity securities granted to them as compensation or held directly or indirectly by them.

Current Status. The Financial CHOICE Act, as approved by the House of Representatives, would, among other things, limit the Dodd-

Frank clawback requirement and repeal the Dodd-Frank hedging disclosure requirement. At this point it is not certain when, if at all, the House-approved bill will be considered by the full Senate, let alone what legislative changes, if any, will be made to these or other compensation-related initiatives.

During the summer of 2017, the SEC moved its Dodd-Frank clawback, pay versus performance disclosure and hedging disclosure proposals from the proposed action section of the unified agenda of regulatory actions to long-term actions, which is the section of the agenda for items under development for which the SEC does not expect to have a regulatory action within 12 months.

Based on the above, it does not seem likely that any of these Dodd-Frank compensation-related proposals will directly impact the 2018 proxy season. However, it is possible that some investors, proxy advisory firms or organizations that rate corporate governance may be influenced by voluntary disclosures in this area.

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Endnotes

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