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Securities Advisory

Preparation for 2015 Fiscal Year-End SEC Filings and 2016 Annual Shareholder Meetings

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As our clients and friends know, each year Mintz Levin provides an analysis of the regulatory developments that impact public companies as they prepare for their fiscal year-end filings with the Securities and Exchange Commission (the "SEC") and their annual shareholder meetings. This memorandum discusses key considerations to keep in mind as you embark upon the year-end reporting process in 2016.[1]

As was the case last year, there are no SEC rule changes that will directly affect the year-end reporting process. There are, however, a few key changes pending, for which companies should take steps now to prepare for compliance.

- First among these is the "pay ratio" disclosure rule issued under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), that was finalized by the SEC in August. This new rule requires companies to disclose the ratio of median employee compensation to principal executive officer compensation and is set forth as Item 402(u) of Regulation S-K. The rule requires companies to begin providing this pay ratio information in their executive compensation disclosure with respect to the fiscal year beginning on or after January 1, 2017 in time for the 2018 proxy season. All public companies will be subject to this new disclosure requirement, with the exception of emerging growth companies, smaller reporting companies and foreign private issuers.
- The SEC proposed the remainder of the Dodd-Frank Act executive compensation rules in 2015. It proposed rules regarding hedging of shares by employees and directors in February, measuring pay for performance in April, and clawback of "erroneously awarded compensation" in July, but no time frame has yet been set for the finalization of these rules and they will not be in place this proxy season.

Shareholder activism remains strong, and institutional shareholders are continuing to put pressure on companies to conduct their affairs in a more transparent manner, encouraging the adoption of governance policies that benefit shareholders, such as executive compensation clawbacks, stock ownership guidelines, and majority voting, and discouraging policies such as plurality voting, staggered boards and "poison pill" plans. As the largest public companies have adopted many of these corporate governance initiatives already, institutional investors are moving their attention to smaller companies that may historically have lagged in the adoption of shareholder-friendly governance features.

We will continue to update you on important changes in these areas. Our blog, "Securities Matters," provides comprehensive coverage of all aspects of the federal and state securities laws and regulation, capital market trends and best practices, corporate governance matters, Delaware corporate law, developments in securities and shareholder litigation, SEC enforcement, and related topics. Please subscribe to our blog at http://www.securitiesmatters.com/ to stay current on new developments.

We have addressed topics that we believe will be of interest to this year's reporting season in further detail below.

"Pay Ratio" Disclosure Rules Finalized; First Disclosure Required in 2018 for 2017 Fiscal Year. On August 5, 2015, the SEC adopted a final rule[2] implementing Section 953(b) of the Dodd-Frank Act, requiring

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most reporting companies to disclose the ratio of median employee compensation to principal executive officer compensation. The final rule, which adds Item 402(u) to Regulation S-K with a conforming amendment to Item 5.02(f) of Form 8-K for companies whose salary and/or bonus information is not available at the time of filing the proxy statement, requires companies to begin providing pay ratio disclosure in filings that otherwise require executive compensation disclosure for the first full fiscal year beginning on or after January 1, 2017 in time for the 2018 proxy season. All public companies will be subject to this new disclosure requirement, with the exception of emerging growth companies, smaller reporting companies and foreign private issuers.

The pay ratio rule requires disclosure of:

- **Median Employee Compensation.** The median of the annual total compensation of a company's employees, excluding its principal executive officer;
- **CEO Compensation.** The annual total compensation of the company's principal executive officer; and
- **Pay Ratio.** The ratio of the company's median employee compensation to the compensation of its principal executive officer.

In addition to the ratio itself, disclosure describing the methodology used to identify the median employee, determine total compensation and any material assumptions, adjustments (including allowable cost-of-living adjustments) or estimates used to identify the median employee or to determine annual total compensation will also be required. Consistent with the proposed rule, when identifying the median employee, the final rule requires companies to include all employees, including full-time, part-time, temporary, seasonal, and foreign employees employed by the company or any of its subsidiaries and to annualize the compensation of permanent employees who were not employed for the entire year, such as new hires. Companies may not, however, annualize the compensation of part-time, temporary, or seasonal employees. Consultants and other advisors who are not employees and individuals who are employed by unaffiliated third parties are not to be included in the calculation.

The SEC made changes from the proposed rule to address concerns regarding the cost of compliance with the rule and to make the rule a bit easier for companies to implement. For example, the SEC changed the timing of the date of the ratio calculation. Instead of the determination being made based solely on the number of employees employed as of the last day of a company's prior fiscal year, the final rule allows a company to choose a date within the last three months of its last completed fiscal year on which to determine the employee population. In addition, companies may identify its median employee once every three years unless there has been a change in its employee population or compensation arrangements that the company reasonably believes would result in a significant change to its pay ratio and, if within those three years, the median employee's compensation changes, the company may use another employee with substantially similar compensation as its median employee.

To address the criticism regarding the inclusion of foreign employees, the final rule allows companies to exclude foreign employees from the calculation under two circumstances:

- **Foreign Data Privacy Law Exemption** — If the foreign employees are employed in a jurisdiction with data privacy laws that make the company unable to comply with the rule without violating those laws, provided that the company obtains a legal opinion from counsel to that effect and files the legal opinion with the SEC with its disclosure filing.
- **De Minimis Exemption** — If a company's foreign employees account for 5% or less of its total employees, it may exclude all foreign employees when making its pay ratio calculation. However if it chooses to exclude foreign employees, it must exclude all of them. If more than 5% of a company's employees are foreign employees, it may also exclude up to 5% of its total employees who are foreign employees. However, if a company excludes any foreign employees in a particular jurisdiction, it must exclude all foreign employees in that jurisdiction. In calculating the number of foreign employees that may be excluded under this de minimis exemption, a company must count any foreign employee exempted under the data privacy exemption.

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The rule allows for flexibility in identifying a median employee and does not specify a required methodology for purposes of such analysis. In determining the employees from which the median is identified, companies may choose to use their entire employee population, statistical sampling or other reasonable methods. The SEC will allow a company to apply a cost-of-living adjustment in the determination of its median employee, provided the same cost-of-living adjustment is used in calculating total compensation for that employee.

Once the company identifies a median employee, the company must calculate such employee's annual total compensation for the last completed fiscal year using the definition of "total compensation" in Item 402(c)(2)(x) of Regulation S-K. The rule permits a company to include perquisites that aggregate less than $10,000 and broad-based health coverage in the calculation of total compensation, provided that the company uses the same approach in calculating the CEO's total compensation.

Other Executive Compensation-Related Sections of the Dodd-Frank Act are Still to be Finalized. The SEC has proposed three additional rules, which would complete the executive compensation rules required to be promulgated by the SEC under the Dodd-Frank Act. These are the requirements to provide disclosure regarding the hedging of shares by employees and directors; the clawback of "erroneously awarded" compensation; and the relationship between executive compensation that was "actually paid" and the company's financial performance. We will update our clients and friends separately as final rules are issued.

The SEC has publicly stated that hedging may be the first rule to be adopted as the comments were not significant. The hedging proposal requires disclosure about whether directors, officers and other employees are permitted to hedge or offset any decrease in the market value of equity securities granted by the company as compensation or held, directly or indirectly, by employees or directors. The SEC's proposed rule takes a principles based approach in defining "hedging" in order for the rule to be flexible and cover new instruments that may be developed and not provide a "loophole" where certain types of instruments would not need to be disclosed. With respect to the clawback policy, the implementation of the rule is a two-step process. The SEC first must finalize its rule, which will contain a provision requiring the stock exchanges to require companies to have a clawback provision as part of its ongoing listing requirements. The stock exchanges will then have to amend their listing standards to comply. The exchanges will have up to 90 days after the final rule is published in the federal register to file their rules with the SEC. Companies will then have 60 days within which to adopt a clawback proposal. Therefore, it will be approximately 150 days between SEC approval of the clawback rules and the time clawback policies will have to be adopted by companies. The rule is expected to be adopted by the SEC sometime later this year with only minor changes from the proposal. In the meantime, companies may want to consider adding to their 2016 equity grants a provision allowing companies to clawback compensation from these grants based on clawback policies to be adopted in the future. The following is sample language that companies should consider adding to their equity plans if amending or adopting a new plan. Similar language could also be included in the grant agreement:

"Notwithstanding anything to the contrary contained in this Plan, the Company may recover from a Participant any compensation received from any Stock Right (whether or not settled) or cause a Participant to forfeit any Stock Right (whether or not vested) in the event that the Company's Clawback Policy then in effect is triggered."

Although as discussed above, the Dodd-Frank Act has not yet required companies to make changes regarding hedging and pledging and clawbacks, Institutional Shareholder Services (ISS) and institutional stockholders have pressured companies into adopting policies relating to these topics as part of good governance practices. Under ISS policy, a company that allows its executive officers or directors to hedge company stock or pledge a significant portion of company stock may receive an "against" or "withhold" vote for directors individually, committee members, or the entire board. ISS has not established a bright-line test for what constitutes "significant" pledging, but it has indicated that a determination of whether pledging is significant will be based primarily on the number of shares pledged as a percentage of the number of shares outstanding, market value and trading volume in the company's stock as well as the company's current views on future pledging arrangements.[3] ISS views both hedging and pledging as adverse to shareholder interests because these practices sever the alignment of directors and executive officers' interests with shareholders by reducing the director's or officer's economic exposure to holding company stock while maintaining voting rights. ISS believes that pledging, which often occurs in connection with a margin loan, can have a detrimental effect on a company's stock price in the event of forced sales to meet a margin call and such forced sales could also violate a company's insider trading policies. Therefore, if a company does allow these practices, and pledging is described in a company's beneficial ownership table, the company should be sure to address its policies on this practice in its Compensation, Discussion and Analysis section (CD&A) of its proxy statement.

Each year more companies are adopting clawback policies in response to investor pressure. Although many of these policies aim to comply with the Dodd-Frank Act, it seems that investors' primary concern is that companies have such a policy as opposed to the specific wording or requirements of such a policy. In addition, in 2013 certain institutional investors developed compensation recoupment principles aimed at pharmaceutical companies as many companies in the pharmaceutical industry have been increasingly entering into settlements because of executive misconduct. These recoupment policies are more rigorous than the provisions set forth by the Dodd-Frank Act and contemplate that that the compensation committee would have the discretion to determine if there was any material violation of a company policy related to the sale, manufacture or marketing of health care services that has caused significant financial harm to the company and should therefore trigger consideration of a possible recoupment of incentive compensation.

The rules on the relationship between executive compensation that was "actually paid" and the company's financial performance will be disclosed in a new table in the executive compensation section of a Company's proxy statement as new Item 402(v) of Regulation S-K. The table would be required to disclose the following information for five fiscal years (three years for smaller reporting companies):

- **Actual Compensation.**

  CEO — The total compensation of the principal executive officer as disclosed in the summary compensation table with certain adjustments for pensions and equity awards (subtracting grant date fair value of equity awards and adding vesting date fair value of equity awards vesting in the particular year) so that the amount would replicate actual compensation.

  Other NEOs — The average compensation actually paid to all remaining named executive officers from the summary compensation table, adjusted as set forth above for the principal executive officer.

- **Summary Compensation Table Reported Amounts.**

  CEO — total executive compensation as reported in the summary compensation table.

  Other NEOs — an average of the amounts reported in the summary compensation table for all remaining named executive officers.

- **Company Total Shareholder Return.** The company's total shareholder return on an annual basis, using the definition of total shareholder return (TSR) included in Item 201(e) of Regulation S-K, which sets forth an existing requirement for a stock performance graph.

- **Peer Group Total Shareholder Return.** The TSR on an annual basis of the companies in a peer group, using the peer group identified by the company in its stock performance graph or in its CD&A. This disclosure will not be required for smaller reporting companies.

In addition, using the information presented in the table, companies will be required to describe as a narrative or graphically the relationship between the executive compensation actually paid and a company's TSR, and the relationship between a company's TSR and the TSR of its selected peer group.

As proposed, emerging growth companies and foreign private issuers would not be subject to this new disclosure rule.

Say-on-Pay: Considerations for 2016. Shareholder support on say-on-pay resolutions continued to average above 90 percent across all companies in 2015. Say-on-pay continues to be perceived as a year-to-year item, in which success in past years is no guarantee of success in the current or future years, and companies should not become complacent about achieving the necessary support, even if they have enjoyed strong support in prior years. The advent of say-on-pay continues to cause companies to reevaluate their compensation-related disclosures in their proxy statements, in particular the CD&A section, with both advocacy and disclosure in mind.

In addition, issuer engagement with institutional shareholders has become an integral part of the say-on-pay process with many companies reaching out to their largest shareholders in the months following the annual meeting to discuss pay practices.

ISS continues to define the standard as to what constitutes a "passing" voting percentage on a say-on-pay proposal with 70% of the vote deemed by them to be acceptable and not require a company to alter its compensation strategy to demonstrate a stronger link between pay and performance.

ISS has not changed the way it analyzes say-on-pay this year[4] and continues to recommend a vote against a say-on-pay proposal if:

- there exists a significant misalignment between CEO pay and company performance (pay for performance);
- the company maintains significant problematic pay practices; or
- the board exhibits a significant level of poor communication and responsiveness to shareholders.

In addition, ISS will recommend a vote against or withhold from the members of a company's compensation committee and potentially the full board if:

- there is no say-on-pay proposal on the ballot, and an against vote on a say-on-pay proposal would be warranted due to pay for performance misalignment, problematic pay practices, the lack of adequate responsiveness on compensation issues raised previously, or a combination thereof;
- the board fails to respond adequately to a previous say-on-pay proposal that received less than 70 percent support of votes cast, with ISS looking at the following factors in evaluating whether a company has adequately responded;
    - disclosure of engagement efforts with major institutional investors regarding the issues that contributed to the low level of support;
    - specific actions taken to address the issues that contributed to the low level of support;
    - other recent compensation actions taken by the company;
    - whether the issues raised are recurring or isolated;
    - the company's ownership structure; and
    - whether the support level was less than 50 percent, which would warrant the highest degree of responsiveness.
- the company has recently practiced or approved problematic pay practices, including option repricing or option backdating; or
- ISS views the situation as egregious.

We continue to see a trend of companies including an executive summary at the beginning of the proxy statement in an effort to highlight key messages, clearly define the company's views on pay for performance, and ensure the company has a reasonable narrative to support its decisions for last year's pay. A trend of disclosing "realized" or "realizable pay" has also continued to assist shareholders in understanding the executive compensation value actually transferred during a fiscal year and ISS' standard research report now will generally show three-year realizable pay compared to the three-year granted pay for S&P 1500 companies. ISS will discuss realizable pay in its report when its quantitative analysis results in a "high or medium" concern that a company's compensation policies are not linked to overall corporate performance and will also look at realized and/or realizable pay at smaller companies to assist it in determining whether the company demonstrates a strong commitment to a pay-for-performance philosophy.[5]

In assessing executive compensation boards of directors should continue to bear in mind that their ultimate goal is not to secure a successful say-on-pay vote, but rather to attract, retain and incentivize executives who will contribute to the long-term value of the company. Directors should understand the executive compensation guidelines that ISS and similar groups promote, but should not allow this to override their own judgments as to the compensation programs and policies that are best for their companies. Directors should participate with management in soliciting favorable say-on-pay votes from major shareholders in order to overcome a negative recommendation by ISS.[6]

Class action law suits alleging that boards of directors breached their fiduciary duties by approving purportedly deficient proxy statement disclosure and claiming that shareholders need more information in order to cast an informed vote typically with respect to equity compensation plan approvals have continued but have not had much success in the courts. Plaintiffs typically bring these cases in state court and seek an injunction against the upcoming annual meeting until sufficient disclosure is provided in the proxy statement in order for shareholders to make an informed decision. The threat of an enjoined annual meeting has pushed many of these companies that have been sued into providing additional disclosures, thereby justifying a fee award to plaintiff's counsel. In many cases suits are never even filed as before filing a complaint plaintiff's counsel will send a demand letter to the company based on what it believes is misleading or omitted information in a proxy statement and at the same time post on its webpage that it is looking for plaintiffs. Many of these demand letters target smaller companies that do not spend their resources on expansive proxy disclosure. Unfortunately, many of these companies still end up paying a fee to plaintiff's counsel to prevent litigation from being filed and spend additional time and resources filing proxy supplements in response to plaintiffs' demands.

Therefore, companies with a low or negative say-on-pay vote and companies seeking authorization for new or additional shares to be issued pursuant to equity incentive plans should take a careful look at their disclosure to ensure that it complies with proxy statement disclosure requirements as well as consider enhanced disclosures to reduce the possibility of litigation. Many companies have boilerplate compensation policy language that is vulnerable to being exploited by plaintiffs, and which is not necessary to provide an accurate and reasonable basis for a company's compensation decisions. Some of the cases recently filed have focused on compliance with Section 162(m) of the Internal Revenue Code of 1986 by stating claims that the per share limit set forth in the company's equity plan has been exceeded or that there was inadequate or incorrect disclosure with respect to this rule in the CD&A and/or in the equity plan disclosure as language with respect to Section 162(m) was not properly drafted.

ISS 2016 Proxy Voting Guidelines. ISS has issued updates for its proxy voting guidelines for 2016 on the following topics:[7]

<u>Limitations on "Overboarding."</u> "Overboarding" refers to the concern that directors who serve on multiple boards simultaneously will be overextended and unable to devote sufficient time and energy to the boards on which they have agreed to serve. ISS's previous policy provided that it would recommend withholding votes with respect to directors who serve on more than six public company boards simultaneously. It has revised this position to provide that directors who are not public company CEOs may serve on up to five public company boards simultaneously. Directors who are public company CEOs are limited to service on two public company boards in addition to their own company's board. ISS had proposed to change the latter position to limit a public company CEO to one additional public company board, but has decided not to change that policy at this time. Public company CEOs who serve on more than two boards will receive a "withhold" recommendation at the outside board(s) only.

The guidelines provide for a grace period, until 2017, for the change from six to five simultaneous board seats to allow directors to make an orderly transition of their "excess" directorships, should they choose to do so.

<u>Unilateral/Pre-IPO Governance Changes.</u> Continuing its historic posture of distaste for bylaw or charter amendments that are adopted by a board "unilaterally," or without shareholder approval, ISS has proposed to recommend voting against or withholding votes from individual directors, committee members, or the entire board if the board amends the company's bylaws or charter without shareholder approval to classify the board or to establish supermajority voting requirements to amend the bylaws or charter. In 2015, ISS noted that it would

take the same actions if a board unilaterally amended a company's bylaws or charter "in a manner that materially diminishes shareholders' rights or that could adversely impact shareholders," so this is an amplification of that general theme. ISS noted that a public commitment by the issuer to put these provisions to a shareholder vote within three years of the IPO can be a mitigating factor.

Compensation of Externally-Managed Issuers. Externally-managed issuers (EMIs) are companies that do not directly compensate their executives, leaving compensation to an external manager who is reimbursed by the EMI through a management fee. ISS has noted EMIs typically do not disclose their compensation arrangements and payments in as much detail as non-EMIs, making it difficult for shareholders to assess pay programs and how they connect to company performance. ISS will recommend against say-on-pay proposals for EMIs that it believes include insufficient disclosure; disclosure will be considered insufficient if a comprehensive pay analysis is impossible with the information that is provided about compensation practices and payments.

Company Response to Proxy Access Proposals. After a shareholder proposal seeking proxy access has passed, ISS may issue an adverse recommendation if the form of proxy access implemented or proposed by a company contains material restrictions that are more stringent than those included in the majority-supported proxy access shareholder proposal, including:

- Ownership thresholds above three percent;
- Ownership for more than three years;
- Aggregation limits below 20 shareholders; and
- A cap on nominees below 20 percent of the board.

Where the nominee cap or aggregation limit differs from that specifically stated in a shareholder proposal that received majority support, ISS will evaluate the differences on a case-by-case basis, taking into account (and expecting to see) disclosure regarding shareholder outreach efforts. Most of the shareholder proxy access proposals that have previously passed asked companies to permit shareholders to "group" and aggregate shares they have individually held for 3 years in order to meet the 3% ownership threshold and were silent as to what a reasonable limit on aggregation would be; most (though not all) shareholder proponents have agreed to withdraw their proposals and major shareholders have been willing to support adopted proxy access bylaws where a company acts reasonably in selecting a group limit. If shareholders passed a proxy access proposal with a 25% nominee cap, the company should be able to propose a 20% cap without receiving an adverse recommendation from ISS, assuming it can demonstrate in its proxy statement sufficient shareholder outreach and support. The nomination cap is also an area where most shareholder proponents (and major shareholders) have been willing to show flexibility, and various approaches have emerged on the cap, including hybrid approaches that include both a percentage-based formulation and a numerical minimum or maximum.

Restrictions or Conditions on Proxy Access Nominees. On a range of "second-tier" issues that will have to be addressed as companies formulate proxy access bylaws to ensure that they are not abused, ISS will review proxy access implementation and restrictions on nominees on a case-by-case-basis. ISS considers the following restrictions to be "especially problematic" and to "effectively nullify" the proxy access right:

- Counting individual funds within a mutual fund family as separate shareholders for purposes of an aggregation limit; and
- Imposing post-meeting ownership requirements for nominating shareholders.

In addition, ISS views the following restrictions as "potentially problematic," especially when used in combination, in the context of evaluating board responsiveness to a shareholder-supported proxy access proposal:

- Prohibiting resubmission of failed nominees in subsequent years;
- Restricting third-party compensation of proxy access nominees (beyond requiring full disclosure of such arrangements);
- Restricting the use of proxy access and proxy contest procedures for the same meeting;

- How long and under what terms an elected shareholder nominee will count towards the maximum number of proxy access nominees; and
- When the new proxy access right will be fully implemented and accessible to qualifying shareholders.

ISS Policy for Evaluating Equity Plan Proposals. For the second year, ISS is using its equity plan scorecard (EPSC) to evaluate equity compensation proposals and has made only minor revisions to its review process. On December 18, 2016, ISS updated its FAQs on equity compensation plans to continue to provide detail on the approval process and FAQ 32 describes the changes made to the EPSC for this coming proxy season.[8] Last year, the first in which ISS used the EPSC model to evaluate equity plan proposals, the number of equity plan proposals recommended by ISS increased slightly and this new methodology generally provided companies with greater flexibility to structure key equity plan provisions and appropriately size their share requests.

The following are the key terms of the EPSC:

Plan Cost: The EPSC measures a company's shareholder value transfer relative to two benchmark calculations that consider:

- new shares requested plus shares remaining for future grants, plus outstanding unvested/unexercised grants, and
- only new shares requested plus shares remaining for future grants.

Plan Features: The following factors may have a negative impact on EPSC results:

- *Automatic single-triggered award vesting upon a change in control,* which may provide windfall compensation even when other options (e.g., conversion or assumption of existing grants) may be available;
- *Broad discretionary vesting authority* that may result in "pay for failure" or other scenarios contrary to a pay-for-performance philosophy;
- *Liberal share recycling* on various award types, which obscures transparency about share usage and total plan cost; and
- *Absence of a minimum required vesting period (at least one year)* for grants made under the plan, which may result in awards with no retention or performance incentives.

Grant Practices: The following factors may have a positive impact on EPSC results, depending on a company's size and circumstances:

- *The company's 3-year average burn rate relative to its industry and index peers* — this measure of average grant "flow" provides an additional check on plan cost. The EPSC compares a company's burn rate relative to its index and industry.
- *Vesting schedule(s) under the CEO's most recent equity grants* during the prior three years — vesting periods that incentivize long-term retention are beneficial.
- *The plan's estimated duration*, based on the sum of shares remaining available and the new shares requested, divided by the 3-year annual average of burn rate shares — given that a company's circumstances may change over time, shareholders may prefer that companies limit share requests to an amount estimated to be needed over no more than five to six years.
- *The proportion of the CEO's most recent equity grants/awards subject to performance conditions* — given that stock prices may be significantly influenced by market trends, making a substantial proportion of top executives' equity awards subject to specific performance conditions is an emerging best practice, particularly for large cap, mature companies.

- *A clawback policy that includes equity grants* — clawback policies are seen as potentially mitigating excessive risk-taking that certain compensation may incentivize, including large equity grants.
- *Post-exercise/post-vesting shareholding requirements* — equity-based incentives are intended to help align the interests of management and shareholders and enhance long-term value, which may be undermined if executives may immediately dispose of all or most of the shares.

ISS will continue to vote against equity plans that contain certain plan features that ISS deems egregious. These features, which have not changed from recent years, are:

- a liberal change in control definition that could result in vesting of awards before a change in control transaction is actually consummated;
- allowing for repricing or cash buyout of underwater options without shareholder approval;
- using the plan as a vehicle for problematic pay practices or a pay-for-performance disconnect; or
- any other plan features or company practices that are deemed detrimental to shareholder interests such as tax gross-ups.

Recent Securities Litigation and Regulatory and Law Enforcement Developments Affecting Public Companies

In 2015, securities class actions and SEC enforcement actions both increased over the prior year.

NERA's annual securities litigation review[9] for 2015 reveals that securities class action filings were at their highest point since 2008. According to NERA, "Electronic Technology and Technology Services" and "Health Technology and Services" were the two sectors that saw the greatest number of filings.

With respect to SEC enforcement proceedings, Cornerstone Research[10] notes that 807 actions were filed in the SEC's fiscal year 2015 (which spans from October 1, 2014 to September 30, 2015), up from 755 in fiscal year 2014. But the number of these actions involving a public company defendant or respondent held relatively flat at 33 in fiscal year 2015 compared with 34 in fiscal year 2014. Out of the actions filed against public companies in fiscal year 2015 (excluding actions for delinquent filings), 52% of them dealt with issuer reporting and disclosure issues, while 33% of them involved alleged violations under the Foreign Corrupt Practices Act.

The following represents a summary of certain of the developments from securities class action litigation and SEC enforcement actions that shape how public companies should review and (if necessary) revise certain of their disclosures or other practices in 2016.

2015 Brings Stricter Legal Standard of Review for Director Compensation

In *Calma v. Templeton*,[11] the Delaware Court of Chancery held that restricted stock units issued to the non-employee directors of Citrix System Inc. by its compensation committee (consisting of directors who also received these awards) would be assessed under Delaware law using the "entire fairness" standard. This standard requires the company to show that the grants were fair with respect to both price and process, and it is a stricter standard to meet than the business judgment rule, or the corporate waste standard, which is what the defendants in *Calma* argued applied. More significantly, when reviewing the defendants' argument that the entire fairness standard did not need to be met because the equity plan received approval of the company's disinterested stockholders, the court held that the stockholders had not ratified the authorization of the grants, even though all parties acknowledged that the restricted stock units were issued to the directors in accordance with and pursuant to the terms of the company's stockholder approved equity incentive plan, which authorized grants to be made to employees, officers, and directors.

In rejecting defendants' ratification argument, the *Calma* court noted that "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." The court observed how the equity incentive plan did not specify the number of restricted stock units that the company would grant to its directors or place any "meaningful" limits or caps on any such grants; rather, the plan simply provided a relatively high cap on the amount that could be granted to any single beneficiary per calendar year. Accordingly, the court concluded that "stockholder approval of the Plan was not a 'blank check' or 'carte blanche' ratification of any compensation that the compensation committee might award to the company's non-employee directors."

The *Calma* case confirms that companies should no longer assume that advance stockholder approval of an equity plan that allows for directors to receive grants will be enough to insulate non-employee director compensation awards from the entire fairness review under Delaware law.

As further corroboration of this sea change, this past week a settlement was filed by the parties in *Espinoza v. Zuckerberg*, C.A. No. 9745 (Del. Ch.), which is a suit that was initiated in 2014 against Facebook's directors claiming that the relevant directors' average fees of $461,000 for the prior year was about 46% higher than fees paid to non-employee directors at the company's peers. In light of a potential determination by the court that non-employee director compensation should be analyzed under the entire fairness standard, defendants argued for dismissal because its non-employee director compensation was approved by a stockholder majority, namely Mark Zuckerberg, whose stake in the company granted him control over the outcome of matters put up for a stockholder vote. However, the court allowed the case to continue stating that even though Zuckerberg had majority control over any stockholder decision, the corporate formalities required to implement a directive must still be followed, and the director compensation determination was not brought properly before the stockholders.

In light of the court's decision Facebook agreed to the following settlement (which will still need to be approved by the court):

- to amend its compensation committee charter to include an annual review of all cash and noncash compensation to be paid to non-employee directors, and bring in an independent consultant to help with deciding the size and type of any potential increase;
- submit to a vote at its 2016 annual meeting, two separate proposals for stockholder approval on compensation for non-employee directors: (i) to ratify the equity grants made in 2013, and (ii) to approve the annual compensation program for non-employee directors specifying an amount for annual equity grants and the amounts of annual retainer fees; and payment of attorneys' fees and expenses to plaintiff's counsel in an amount not to exceed $525,000.

Therefore, in order to minimize the risk of a derivative lawsuit regarding non-employee director compensation, and to comply with the "entire fairness" standard, we recommend that companies consider:

- adding meaningful director grant limits to their equity plans when asking stockholders to approve new plans or amend existing ones;
- when seeking stockholder approval of an amendment to an existing equity plan, consider proposing that the stockholders ratify director awards made under the plan during the prior year; and
- review director compensation data at comparable companies (with or without compensation consultants) and make sure director compensation is reasonable in light of these comparables (although it should be noted that the selection of comparables was successfully challenged at the motion to dismiss stage by the plaintiff in the *Calma* litigation).

When Are Statements of Opinion Actionable?

In *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*,[12] the Supreme Court examined when statements of opinion in a registration statement could be considered to be untrue or misleading for purposes of liability under Section 11 of the Securities Act. Specifically, Section 11 creates a cause of action based on any registration statement that contained, at the time of effectiveness, an "untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading…"

The *Omnicare* Court began its analysis by noting that Section 11 creates liability for two different types of representations: (1) untrue statements of material fact, and (2) statements that are misleading because of the omission of a material fact. The Court then noted that it would examine statements of opinion against each of these two prongs.

The Court first concluded that an expression of an opinion is not an "untrue statement of fact" unless:

- the speaker did not really hold the belief she professed to have, or
- the opinion contained a disclosure of a supporting fact that was later proved to be untrue.

The Court then focused on when an opinion can be a "misleading" statement by virtue of omitting a material fact. With respect to this analysis, the Court held:

- "if a registration statement omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor would take from the statement itself, then Section 11's omissions clause creates liability."

The Court further explained its holding by noting how – in order to be non-actionable – the opinion should "fairly align[] with the information in the issuer's possession at the time."

Significantly, the Court made it clear that to state a claim, an investor "must identify particular (and material) facts going to the basis for the issuer's opinion — facts about the inquiry the issuer did or did not conduct or the knowledge it did or did not have — whose omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context."

While the *Omnicare* decision focused on a claim brought pursuant to Section 11, several courts have applied its reasoning to cases involving Section 10(b) of the Exchange Act because the language from Section 11 that the Court construed is identical to language used in Section 10(b). The *Omnicare* decision, therefore, serves as an important guide for any public disclosures of opinion, and not just those contained in registration statements.

Update Those Risk Disclosures

The Court of Appeals for the D.C Circuit re-affirmed the need to review and revisit "boilerplate" and general risk disclosures on a regular basis given how a company's business and prospects can change quickly. The *In re: Harman International Industries* case involved a determination of whether three disclosures by a company fell within the PSLRA's safe harbor for forward-looking statements.[13]

One of the statements at issue was made by the company's CEO during an April 2007 analyst call. That statement consisted of a representation that the company planned to reduce its levels of inventory and was accompanied by a forecast of the anticipated reduction. The plaintiff alleged that this statement was misleading because, among other things, the company's inventory consisted of a high number of obsolete products that could not be sold easily or would have to be sold at a significant discount.

The company defended itself by arguing that these statements about its anticipated reductions in inventory fell within the PSLRA's safe harbor for forward-looking statements because they were preceded by the disclosure — in its 10-K for fiscal year 2006 — of several risk factors affecting its ability to sell its products.

The court was not convinced by the company's arguments, however. It explained how none of the company's disclosed risk factors sufficiently addressed the obsolescence of inventory that had allegedly arisen in early 2007 (just before the 10-K was filed and the analyst call occurred).

The court emphasized the importance of having risk factors that are frequently updated and reflect the true nature of the company's business and prospects at the specific time the forward-looking statements are made. The court faulted the company because its "cautionary statements remained unchanged despite a significant change in circumstances of material importance to an investor," and observed how "the consistency of the [company's] language over time despite changing circumstances belies any contention that the cautionary language was tailored to the specific future projection."

Whistleblower Developments: Protections for Employees Raising Internal Complaints; Confidentiality Agreements Cannot Restrict Ability of Whistleblowers to Make Complaints

As companies continue to struggle with how to handle purported whistleblowers and what the law may require in this respect, the Second Circuit and the SEC provided some guidance in this area:

- ***The Dodd-Frank Act's whistleblower protections extend to individuals making internal reports of alleged violations of the securities laws.*** In an issue that now presents a circuit-split in the Court of Appeals, the Second Circuit held that the Dodd-Frank Act's anti-retaliation provisions for whistleblowers cover employees who report alleged violations of the federal securities laws to their employers (but not to the SEC).[14] In reaching this holding, the Second Circuit explained that the pertinent whistleblower protection provisions of the Dodd-Frank Act were sufficiently ambiguous to trigger *Chevron* deference to the SEC's interpretation of the statute. This decision is contrary to the decision in *Asadi v. G.E. Energy (USA), LLC*[15] that found that the Dodd-Frank Act only protects whistleblowers who report alleged violations to the SEC.
- ***Confidentiality Agreements must be tailored so as not to deter whistleblowing activities.*** In a settled enforcement action against a public company,[16] the SEC imposed a civil penalty of $130,000 because the company — as part of internal investigations into employee complaints of allegedly illegal/unethical conduct — required employees to sign a confidentiality agreement prohibiting them from "discussing any particulars regarding this interview and the subject matter discussed during the interview, without the prior authorization of the Law Department." Notably, the SEC recognized that it did not appear as if the company took any active steps — beyond having employees execute the confidentiality agreement — to prevent employees from contacting the SEC. Nevertheless, the SEC found that this blanket confidentiality clause undermined Rule 21F-17(a), which prohibits any person from taking action "to impede an individual from communicating directly with the SEC staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement…with respect to such communications."

Reductions in Disclosure-Only Settlements?

Litigation over disclosures in proxy statements soliciting votes for a merger or acquisition has been — for the past several years — a near certainty, with multiple suits being filed in more than 90% of all transactions valued over $100 million and involving public companies.[17] For the past several years, more than 75% of these suits have settled with no monetary payment by the defendant; rather, the target corporation agrees to modify or make additional proxy disclosures while not opposing plaintiff's motion to certify a class, motion to approve the settlement, and motion for an award of fees for its counsel.

Delaware's Court of Chancery has grappled with the ubiquitous nature of this litigation for the last few years, and, in 2015 appears to have taken its first (impactful) steps for trying to reduce or eliminate the number of these cases that are filed. The Chancery Court has done so by either refusing to certify the class or refusing to approve the settlements in these "disclosure-only" cases in a series of decisions that were issued starting in the summer of 2015.[18]

These decisions have seemingly made an immediate (and significant) impact in the number of M&A class action suits that have been filed. The Wall Street Journal reported that class action litigation was filed in 81% of all transactions valued over $100 million in the first quarter of 2015. But this percentage declined to 34% for the fourth quarter of 2015, which was after the Chancery Court decisions noted above were issued.[19]

Now that companies may have an opportunity to avoid this type of litigation upon announcement of a transaction, extra attention should be paid to the types of disclosure issues that will still attract the attention of the courts (and the plaintiff's bar).

Department of Justice Clarifies Requirements for Corporate Cooperation with Department of Justice (DOJ) Investigations

On September 9, 2015, Deputy Attorney General Sally Yates issued a memorandum with the subject line "Individual Accountability for Corporate Wrongdoing." This memo provides information on when the DOJ will provide cooperation credit to a corporation that finds itself (or its employees) under investigation for potential violations of the law.

While commentators have debated whether the so-called "Yates memo" represents a policy shift in any way or if it simply re-emphasizes existing DOJ practice and policy, the memo does raise important considerations for companies when seeking to avoid criminal or civil liability and/or receive cooperation credit.

Significantly, the memo makes it clear that "[t]o be eligible for any credit for cooperation, the company must identify all individuals involved in or responsible for the misconduct at issue, regardless of their position, status, or seniority, and provide to the Department all facts relating to that misconduct." Assistant Attorney General Leslie R. Caldwell later clarified this provision by explaining "companies seeking cooperation credit must affirmatively work to identify and discover relevant information about culpable individuals through independent, thorough investigations…And internal investigations cannot end with a conclusion of corporate liability, while stopping short of identifying those who committed the criminal conduct." [20]

DOJ's focus on the corporate response to potential misconduct received an added boost in November 2015 when the DOJ hired its first-ever "Compliance Counsel" for its Fraud Section. DOJ explained that, in the context of making charging decisions, Compliance Counsel "will help us assess a company's [compliance] program, as well as test the validity of its claims about its program, such as whether the program truly is thoughtfully designed and sufficiently resourced to address the company's compliance risks, or essentially window dressing."[21]

Risk Factor Reviews: Cybersecurity in Focus. As set forth above, we highly recommend frequent review and revision (if necessary) to your Risk Factor disclosures. And as you prepare and update the Risk Factors section of your Form 10-K this year, it's important to take a fresh look at what new and emerging risks may require disclosure. In light of recent, high-profile cybersecurity breaches, we recommend that all companies consider their potential vulnerability to breaches and the consequences of those breaches.

The SEC and its Staff last provided broad guidance on this topic in October 2011, in Disclosure Guidance Topic No. 2.[22] However, the Staff continues to view this as a key focus area in its filings review and comment process, and it has been taken up as a cause by members of Congress, by board members, investors and by proxy advisors.

Here are a few suggestions for addressing this topic in your Risk Factors this year.

Don't use boilerplate, and be specific. To the greatest extent possible, tailor the language of the risk factor to your company's own security needs, risks and steps taken to guard against breaches. If you have encountered particular situations, such as cyber attacks, that are relevant to an investor's understanding of your risk profile in this area, address them. The SEC is aware of the tension between not wanting to provide disclosure that could give hackers a road map to launch a future attack and needing to provide sufficient disclosure to investors, but encourages sufficient detail that the disclosure is not merely applicable to all companies in a particular industry.

If a breach does occur… In addition to forward-looking disclosure about the consequences of a potential breach, the SEC asks for specific disclosure of actual breaches or attacks that take place. This would include information about

- the materiality of the breach;
- the consequences of the breach, as well as its scope and magnitude;
- known or potential costs of remediation or other costs; and
- what has been done to prevent future similar occurrences.

Of course, if an attack has occurred, the costs or consequences of the attack will likely need to be addressed elsewhere in the Form 10-K as well, such as in the MD&A or financial statements.

Consider cybersecurity as its own topic, and don't bundle it in with other risks. Most issuers with any degree of reliance on computer systems have recognized their risk at some level to cyber attacks, although their degree of vulnerability and appeal to hackers as a target may vary. To the extent you have not yet addressed your company's risks in this area, or have attached cybersecurity to another, general category of "risks of doing business in the 21st century," now may be a good time to give cybersecurity its due, with its own, separate profile.

Update on Conflict Minerals Rules. The debate continues over whether the conflict minerals rules, as implemented under Section 1502 of the Dodd-Frank Act, have made meaningful contributions to disclosure when compared to the very meaningful cost of compliance. The first such reports were due on May 31, 2014, and required issuers that manufacture (or contract to manufacture) products in which conflict minerals are "necessary to the functionality or production of the product" to disclose whether or not their products contain tin, gold, tantalum, or tungsten mined from the Democratic Republic of Congo (the "DRC") and nine of its neighboring countries. This provision was included in the Dodd-Frank Act at the request of legislators who believed that the process of mining for and producing these particular minerals in certain countries is contributing to a grave, ongoing humanitarian crisis in that region of Africa. Congress' intent was that this required disclosure would "enhance transparency" surrounding the use of these minerals, such that consumers will be able to make more informed decisions about purchasing a variety of products based on companies' direct or indirect involvement in the conflict minerals trade. Whether this has in fact occurred remains an open question.

In April 2014, a three-judge panel of the U.S. Court of Appeals for the District of Columbia Circuit issued a decision finding that a portion of the conflict minerals disclosure requirement violated the First Amendment of the United States Constitution, to the extent that issuers were required to state (if true) that their products were "Not DRC Conflict Free." [23] The Court stated:

> "At all events, it is far from clear that the description at issue — whether a product is "conflict free" — is factual and nonideological. Products and minerals do not fight conflicts. The label "conflict free" is a metaphor that conveys moral responsibility for the Congo war. It requires an issuer to tell consumers that its products are ethically tainted, even if they only indirectly finance armed groups. An issuer, including an issuer who condemns the atrocities of the Congo war in the strongest terms, may disagree with that assessment of its moral responsibility. And it may convey that "message" through "silence." By compelling an issuer to confess blood on its hands, the statute interferes with that exercise of the freedom of speech under the First Amendment….We therefore hold that [the conflict minerals rules] violate the First Amendment to the extent the statute and rule require regulated entities to report to the Commission and to state on their website that any of their products have 'not been found to be 'DRC conflict free.'"

In response to this decision, the SEC issued an order on April 29, 2014 noting that "[n]o company is required to describe its products as 'DRC conflict free,' having 'not been found to be DRC conflict free,' or 'DRC conflict undeterminable.'" The SEC (along with Amnesty International) filed a petition for a rehearing of the decision finding that the disclosure requirement violated the First Amendment. The petition was granted by the court in November 2014. In August 2015, the D.C. Circuit affirmed its earlier decision, and the SEC and Amnesty International again requested a rehearing. In November 2015, the D.C. Circuit denied the petition for a rehearing. As a result, the decision remains in effect, and accordingly all public companies making filings pursuant to Sections 13(a) and 15(d) of the Exchange Act, including smaller reporting companies and foreign private issuers, remain subject to these rules (with the change noted in the SEC's April 29, 2014 order). Public companies are required to make the necessary disclosures via EDGAR on a Form SD ("Specialized Disclosure Report"), by May 31 of the year following the assessment, if certain facts are present based on what the company determines in its conflict minerals evaluation.

The SEC's rules on this topic provide in-depth guidance on how to assess the need for disclosure using a three-step process. Companies must make a determination as to whether any conflict minerals are necessary to the functionality or production of a product manufactured, or contracted to be manufactured by the issuer (step one). If so then the company must then perform a "reasonable inquiry" into where the conflict minerals originated, and make disclosure of their efforts and conclusions on a Form SD (step two). If a company makes a determination that it manufactures (or contracts to have manufactured) a product using conflict minerals that originate or may originate from the Democratic Republic of Congo or one of the adjoining countries, it must conduct a supply chain due diligence analysis and include an additional Conflict Minerals Report as well as an auditors' report as an exhibit to its Form SD (step three).

If conflict minerals are not necessary to the functionality or production of a product manufactured, or contracted to be manufactured, by an issuer, the issuer will not be subject to the conflict mineral rules and no further action and no filing of a Form SD will be necessary.

Unless and until further decisions are made overruling all or any additional portion of the rules, Form SDs covering 2015 will be due on June 1, 2016.

Forum Selection Bylaws. Given the significant cost and management distraction that usually accompany shareholder lawsuits, many companies have amended their bylaws to include a provision requiring any derivative lawsuit, claim for breaches of fiduciary duties, or claim based on the corporate statute of the state in which the company is incorporated, to be brought in a state or federal court located in the company's own state of incorporation, as opposed to the state of residence of the stockholder bringing the claim, or another location. These so-called "forum selection" provisions are not generally supported by ISS and similar groups because they restrict the ability of shareholders to bring lawsuits in jurisdictions that are convenient for them. However, these clauses may have a significant benefit for the corporation and its management, as they are designed to prevent the expense and distraction that can occur when duplicative lawsuits asserting the same claims on behalf of the same constituencies, and seeking the same relief, are commenced at the same time by multiple shareholders in multiple courts. These provisions also allow corporations to better plan and manage the litigation landscape by imposing some degree of order and consistency on the process before litigation begins. Case law in the State of Delaware regarding these provisions has affirmed their validity as a mechanism to control the venue for shareholder lawsuits.[24]

Given the recent Court of Chancery decisions in the context of merger and acquisition transactions discussed above, it may be particularly important to have a forum selection bylaw (designated Delaware) in place at the time of announcement of a merger. Accordingly, we recommend preparing forum selection language to be included in bylaws in advance of the announcement of a merger, which can be implemented through a board vote to amend the bylaws at the same time as a merger is approved. This provides the protection of having the forum selection clause in place when it is most likely to be needed, without incurring the ire of ISS and similar groups in advance of a need to rely on the provision.

An alternative, which may be more palatable to ISS and similar groups, is to consider including a forum selection provision in an amendment to a company's certificate of incorporation. Including the provision in the charter would require shareholder approval under state corporate law, but receipt of shareholder approval for the provision should reduce the possibility of success of any subsequent shareholder challenge to the validity of the forum selection clause.

Corporate boards are increasingly considering forum selection bylaws as a means of avoiding the costs, inconvenience, and uncertainty of dealing with shareholder suits in multiple jurisdictions. While many Delaware corporations will focus on the Delaware courts as the natural choice for a forum selection bylaw, Delaware case law makes it clear that even Delaware corporations can validly choose another jurisdiction, such as the state in which the corporation is headquartered, as the exclusive forum for intra-corporate litigation.

Boards of directors generally have the ability to amend company bylaws to include this kind of a provision without the need for a shareholder vote; however, the bylaw amendment would need to be reported on a Form 8-K within four business days of the decision.

"Proxy Plumbing." In July 2010, the SEC issued a concept release on the U.S. proxy system.[25] This release, which has come to be known as the "proxy plumbing" release, addresses three principal questions regarding the current proxy system in the United States: whether the SEC should take steps to enhance the accuracy, transparency, and efficiency of the voting process; whether the SEC's rules should be revised to improve shareholder communications and encourage greater shareholder participation in the shareholder meeting process; and whether the voting power held by shareholders is aligned with the economic interest of such shares. The SEC is continuing to evaluate the issues it raised in that document.

On December 5, 2013 the SEC hosted a roundtable regarding proxy advisory services to continue its examination of the proxy process with a discussion about the use of proxy advisory services by investment advisors and institutional investors. The roundtable focused on the factors that have contributed to the use of proxy advisory services and the purposes they serve as well as current topics of interest, including conflicts of interest that may exist, the transparency and accuracy of the recommendations made by proxy advisory firms, and what the nature and extent of reliance by investors on proxy advisor recommendations is and should be. On June 30, 2014, the SEC issued Staff Legal Bulletin No. 20 ("SLAB 20") to provide guidance regarding investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms. SLAB 20 discusses the fiduciary duties of investment advisers, the level of oversight they should have on proxy advisors they engage, the consideration they should give to conflicts of interest at proxy advisory firms on which they rely and the solicitation exceptions that are provided for proxy advisory activities under the proxy rules. ISS has stated that since SLAB 20 was published they have seen an increase in inquiries and due diligence from investment advisers about ISS' conflicts of interest policy, as well as their internal procedures for ensuring the accuracy of the information that is contained in their analyses. As discussed above ISS has also launched a new data verification portal to verify data and request changes in connection with equity plan proposals.

The SEC recently announced another roundtable to take place on February 19, 2015 that will explore ways to improve the proxy voting process in two separate panel discussions. The first panel will focus on the state of contested director elections and whether changes should be made to the federal proxy rules to facilitate the use of universal proxy ballots by management and proxy contestants as well as state law, logistical, and disclosure issues presented by a possible universal proxy ballot process. The second panel will focus on strategies for increasing retail shareholder participation in the proxy process.

2016 Periodic Report Filing Deadlines-Reminder it is a Leap Year!

For companies that qualify as large accelerated filers and have fiscal years ending on December 31, annual reports on Form 10-K are due 60 days after fiscal year-end (Monday, February 29, 2016).[26] Form 10-K reports continue to be due 75 days following fiscal year-end for accelerated filers[27] (Tuesday, March 15, 2016 for December 31 year-end companies) and 90 days after fiscal year-end for non-accelerated filers (Wednesday, March 30, 2016 for December 31 year-end companies).

In addition, Form 10-Q reports filed by accelerated filers and large accelerated filers continue to be due 40 days after the close of the fiscal quarter. The deadline for Form 10-Q reports for non-accelerated filers continues to be 45 days after the close of the fiscal quarter.

These changes do not affect the existing proxy statement filing deadline of 120 days after fiscal year-end for companies that choose to incorporate by reference from their definitive proxy statements the disclosure required by Part III of the Form 10-K.

Other Year-End Considerations. We also recommend that companies take the opportunity while planning their year-end reporting to consider what amendments may be necessary or desirable to their corporate documents over the coming year that may require shareholder approval. Some items to consider are:

- Does the company have enough shares authorized under its certificate of incorporation to achieve all of its objectives for the year, including acquisitions for which it may want to use its stock as currency?
- Does the company have adequate shares available under its equity compensation plans to last throughout the year?
- Does the company need shareholder approval of its equity compensation plans for continued compliance with the tax deductibility of performance-based equity awards under Section 162(m) of the Internal Revenue Code?[28]
- Are there other material changes that should be made to the company's equity compensation plans that would require shareholder approval?
- Has the company reviewed its charter and by-laws to assess any anti-takeover measures in place?

To the extent that a company expects any proposal in its proxy statement to create controversy among its shareholder base, it may want to consider hiring a proxy solicitor to assist with the process of seeking the requisite shareholder vote.

Mintz Levin Website: Publications

We would also like to call your attention to the many client advisories and alerts regarding topics of current interest that are available to you on our website, www.mintz.com. New alerts and advisories are posted frequently, and we hope that you will find the information to be useful.

Please contact the Mintz Levin attorney who is responsible for your corporate and securities law matters if you have any questions or comments regarding this information. We look forward to working with you to make this year's annual reporting process as smooth as possible.

Endnotes

[1] We invite you to review our memorandum from last year, that analyzed regulatory changes that were new for fiscal year 2015. We would be happy to provide you with another copy upon request.

[2] Pay Ratio Disclosure, Rel. No. 33-9877 (August 5, 2015)

[3] Item 403 of Regulation S-K requires a footnote to the beneficial ownership table if a director or executive officer has stock subject to pledging.

[4] The ISS 2016 policy in evaluating say-on-pay is available on its website at: http://www.issgovernance.com/file/policy/2016-us-summary-voting-guidelines-dec-2015.pdf; and http://www.issgovernance.com/file/policy/us-executive-compensation-policies-faq-dec-2015.pdf

[5] See ISS Frequently Asked Questions on U.S. Executive Compensation Policies cited above that discusses how ISS will calculate a company's realizable pay.

[6] Companies must be mindful of Regulation FD (Fair Disclosure) and not disclose material nonpublic information selectively nor risk sending mixed messages from the disclosures contained in the company's proxy statement or other SEC filings when speaking with stockholders.

[7] A summary of the updates to the ISS 2016 voting guidelines can be found at: http://www.issgovernance.com/file/policy/executive-summary-of-key-2016-updates-and-policy.pdf.

[8] http://www.issgovernance.com/file/policy/1_us-equity-compensation-plans-faq-dec-2015.pdf

[9] Svetlana Starykh and Stefan Boettrich, *Recent Trends in Securities Class Action Litigation: 2015 Full-Year Review*, NERA ECONOMIC CONSULTING (Jan. 25, 2016).

[10] SEC Enforcement Activity Against Public Company Defendants: Fiscal Years 2010-2015, CORNERSTONE RESEARCH (2016).

[11] *Calma v. Templeton*, 114 A.3d 563 (Del. Ch. 2015).

[12] *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, 135 S.Ct. 1318 (2015).

[13] *In re: Harman International Industries, Inc. Sec. Litig.*, 791 F.3d 90 (D.C. Cir. 2015).

[14] Berman v. Neo@Ogilvy LLC, 801 F.3d 145 (2d Cir. 2015).

[15] *Asadi v. G.E. Energy (USA), LLC*, 720 F.3d 620 (5th Cir. 2013)

[16] *In the Matter of KBR, Inc.*, File No. 3-16466 (April 1, 2015).

[17] *Shareholder Litigation Involving Acquisitions of Public Companies: Review of 2014 M&A Litigation*, CORNERSTONE RESEARCH (2015)

[18] *Acevedo v. Areoflex Holding Corp.*, C.A. No. 7930-VCL (July 8, 2015) (refusing to approve a settlement because the modified deal terms and disclosures that plaintiffs procured did not justify the broad release of claims given by plaintiffs); *In re: Intermune, Inc. Stockholder Litig.*, C.A. No. 10086-VCN (July 8, 2015) (deferring approval of a settlement because the release seemed too broad); *In re: Riverbed Tech., Inc. Stockholders Litig.*, C.A. No. 10484-VCG (Sept. 17, 2015) (approving a settlement agreement, but noting that it only did so because

of the expectancy interest of the parties given that such settlements had been frequently approved by the court); *In re: Aruba Networks, Inc. Stockholder Litig.*, C.A. No. 10765-VCL (Oct. 9, 2015) (refusing to certify the class because of inadequate class representation). Chief Justice Strine of the Delaware Supreme Court has been an outspoken critic of the high volume of disclosure-only settlements. In 2013, while still sitting in the Court of Chancery, he refused to certify a class in a disclosure-only settlement case. *In re: Transatlantic Holdings Inc. Shareholder Litig.*, C.A. No. 6574-CS (Feb. 28, 2013). While, in some respects, that decision was a precursor to the 2015 decisions noted above, it – standing alone – did not seemingly have as much of an impact as the more recent decisions have had with respect to M&A class action filings.

[19] Liz Hoffman, *The Judge Who Shoots Down Merger Lawsuits*, WALL STREET JOURNAL, Jan. 6, 2016.

[20] Leslie R. Caldwell, Remarks at the Global Investigations Review Conference in New York (Sept. 22, 2015).

[21] Leslie R. Caldwell, Address at the SIFMA Compliance and Legal Society Regional Seminar in New York (Nov. 2, 2015).

[22] Our Client Alert on this Disclosure Guidance can be found here: http://www.mintz.com/newsletter/2011/Advisories/1443-1011-NAT-SECPRIV/web.htm.

[23] National Association of Manufacturers, et al., v. Securities and Exchange Commission, et al., 748 F.3d 359 (D.C. Cir. 2014).

[24] United Technologies Corp. v. Treppel, 109 A.3d 553, 2014 (Del. 2014) (en banc).

[25] Concept Release on the U.S. Proxy System (Release No. 34-62495, July 14, 2010), *available at* http://www.sec.gov/rules/concept/2010/34-62495.pdf.

[26] *Large accelerated filers* are domestic companies that meet the following requirements as of their fiscal year-end:

- have a common equity public float of at least $700 million, measured as of the last business day of their most recently completed second fiscal quarter (*i.e*., for calendar fiscal year-end companies, this test would be applied as of June 30, 2015);
- have been subject to the reporting requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, for at least 12 months;
- have previously filed at least one Annual Report on Form 10-K; and
- do not qualify as small business issuers under SEC rules.

[27] *Accelerated filers* are those that meet all of the above tests but have a common equity public float of at least $75 million, but less than $700 million, measured as of the last business day of their most recently completed second fiscal quarter (*i.e*., for calendar fiscal year-end companies, this test would be applied as of June 30, 2015).

[28] Section 162(m) denies a publicly held corporation a deduction for compensation paid to “covered employees” to the extent the compensation exceeds $1,000,000. “Performance-based compensation” is not subject to this deduction limitation. The material terms of a performance goal under which performance-based compensation is to be paid must be disclosed to and approved by the corporation’s shareholders before the compensation is paid and these goals must be disclosed to and reapproved by the shareholders every five years in order for the corporation to continue to rely on the performance-based compensation exception.