MINTZ LEVIN
Mintz Levin Cohn Ferris Glovsky and Popeo PC

Securities Advisory

Preparation for 2017 Fiscal Year-End SEC Filings and 2018 Annual Shareholder Meetings

01.30.2018

BY PAMELA GREENE, ANNE BRUNO, AND MEGAN GATES

Pamela Greene, *Member*

Anne Bruno, *Special Counsel*

Megan Gates, *Member*

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 2018.[1]

The primary change for many companies this year is the new requirement to comply with the "pay ratio" disclosure rule, which was adopted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), and applies to all companies except for emerging growth companies, smaller reporting companies and foreign private issuers. This rule, which is discussed in more detail below, 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 disclosure 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. Contrary to many people's hopes, Congress did not repeal the rule prior to its enactment. However, in September 2017, the SEC provided some additional practical guidance that the SEC hopes will reduce the cost of compliance with the new rule.

In addition to the pay ratio disclosure rule, there are a few additional key issues that companies should focus on this year.

- **Elimination of Section 162(m) Performance-Based Compensation Exemption on Corporate Tax Deductions for Executive Compensation in excess of $1 million.** The Tax Cuts and Jobs Act (the "Tax Act"), which was signed into law in December 2017, significantly expands the limitations on corporate tax deductions under Section 162(m) of the Internal Revenue Code for executive compensation in excess of $1 million. Prior to the Tax Act, executive compensation that was performance-based did not count against the $1 million corporate tax deduction limit. Now, no compensation paid to "covered employees" that is above $1 million will be deductible by the employer company; and there will no longer be an exemption available for performance-based bonuses, compensation attributable to the exercise of stock options and the vesting of certain stock awards. The Tax Act also broadens the applicability of Section 162(m) to individuals in two ways. First, the definition of "covered employee" has been expanded to include the chief financial officer of the employer, and second, any employee deemed a "covered employee" in 2017 will remain subject to Section 162(m) for as long as they are employed by the company and beyond. This means companies will no longer be able to defer an employee's compensation to a year when the employee is no longer deemed a "covered employee."

  The Tax Act grandfathers certain compensation in excess of the $1 million cap subject to the performance-based exemption which becomes payable pursuant to a binding contract that was in effect on November 2, 2017, and which is not modified in any material respect on or after that date. The details respecting the grandfathering provision are still unclear, and IRS interpretations on this topic are expected. However, deductions in 2018 for performance-based awards granted in previous years in compliance with the Section 162(m) performance-based exception may still be allowed, and compensation pursuant to an employment agreement with the chief financial officer entered into prior to November 2, 2017 and not subsequently modified may also still qualify for the tax deduction without limitation.

Companies submitting compensation plans or agreements for a shareholder vote may need to revise the standard tax discussion in their proxy statements to reflect the absence of the exemption under Section 162(m). In addition, we expect that new compensation plans will no longer set forth pre-established performance goals to be approved by stockholders, although we expect performance-based awards to continue to be prevalent but designed with more flexibility. In addition, despite the renewed interest in compensation limits for directors, we expect that caps on equity plans for employees also will be eliminated. In order for existing plans and agreements to remain grandfathered under the Section 162(m) performance-based exception, we recommend that companies that are considering amending their equity plans instead adopt a new plan.

- **Director Compensation Remains in the Spotlight.** As we noted last year, the Delaware courts have shifted direction towards more shareholder protection in the area of alleged "excessive" director compensation by applying an entire fairness standard of review instead of the business judgment rule with respect to such claims. This trend continued throughout 2017, and culminated in a new decision by the Delaware Supreme Court making it clear that the entire fairness standard of review will be applied to decisions by directors concerning their compensation, unless the specific decision is ratified by stockholders. Even decisions made pursuant to shareholder ratified plans that include a cap or other "meaningful limit" on the total amount of compensation that the directors can award themselves will be subject to this more stringent standard of review. Because the entire fairness standard makes it easier for plaintiff shareholders to survive a motion to dismiss, companies face an increased risk of shareholder litigation in this area. To eliminate this litigation risk in its entirety, a company would have to create a non-discretionary shareholder approved director compensation program. Unless this becomes the new norm (or the "old norm," as it used to be required in order for grants to be exempt under Section 16 of the Exchange Act of 1934, as amended (the "Exchange Act")), our prior guidance on how to best structure director compensation remains the same. For example, the equity compensation plan should include a shareholder-approved cap representing the maximum amount that the company may compensate its non-employee directors with equity on a yearly basis, which cap should be set at a meaningful limit. If the cap is based on a number of shares, we recommend that an absolute dollar cap based on a valuation formula such as Black-Scholes also be included to prevent outsized value awards from being granted based on dramatic changes in stock price. This cap should be included in the equity plan when the plan is next brought to shareholders for approval. Companies should continue to evaluate director pay each year and make adjustments accordingly and confirm that director compensation is in line with the company's peer group.

- **Cybersecurity Risk Disclosure.** In the wake of recent well-publicized cybersecurity breaches, cybersecurity disclosure is expected increasingly to become the focus of both shareholders and the SEC. Shareholders are calling for proactive management and transparency in cybersecurity risk mitigation. The SEC is also focused on cybersecurity risk disclosure. The SEC Investor Advisory Committee, which is tasked with advising the SEC on regulatory priorities, has put forth a discussion draft on the issue of cybersecurity. The draft includes recommendations for enhanced substantive disclosure of potential risks, the scope and progress of programs aimed at addressing those risks and a discussion of board of director and management skills and resources available to address those risks on an ongoing basis. We expect that the SEC will likely issue updated guidance on cybersecurity risk disclosure soon. Until then, companies should carefully consider whether to include or augment disclosure of company-specific cybersecurity risks and the capacity to respond to those risks in their Form 10-K.

- **Technical Changes to Form 10-K: Changes to Form 10-K Cover Page, Hyperlinks Required to all 10-K Exhibits; and Requirement that Exhibit Index Appear <u>Before</u> Signature Pages.** Several technical rule changes became effective in 2017 that will affect upcoming Form 10-K filings for all public companies. First, there are changes to the Form 10-K cover page requiring inclusion of additional required language and check boxes regarding emerging growth companies. Second, there are changes that will affect every company's exhibit index. Companies must now include a hyperlink to each exhibit that is set forth in the exhibit index of filings made with the SEC, rather than simply including cross-references to the location of the original filing, to allow readers to gain easier access to those filings. Additionally, the exhibit index must now appear prior to (not following) the signature page to a registration statement or report. Companies' Form 10-K filings generally contain a substantially longer list of exhibits than other SEC filings. Therefore, it would be prudent for companies to begin to identify the URLs for their Form 10-K exhibits well before the filing of the report, and to coordinate with their financial printers in advance to ensure the hyperlinks will be functioning as of the Form 10-K filing.

- If a registrant that is a “smaller reporting company,” as defined in Rule 405 of the Securities Act of 1933, as amended and Exchange Act Rule 12b-2, or that is neither a “large accelerated filer” nor an “accelerated filer,” as defined in Exchange Act Rule 12b-2, submits its filings generally in ASCII it need not comply with the final rules until September 1, 2018, one year after the effective date of the new technical changes.

- **Say-on-Frequency: Consider need for another shareholder vote.** For companies that held their first say-on-pay vote six years ago, it is now time to revisit the say-on-frequency vote. Companies that first held a say-on-frequency vote at their 2012 annual meeting are required to again include a non-binding resolution in their proxy statements to ask shareholders how often they want to conduct say-on-pay votes for the next six years: once a year, once every two years, or once every three years. Institutional Shareholder Services (ISS) has stated that based on its 2016 ISS Policy Survey, two-thirds of investor respondents indicated they preferred annual say-on-pay frequency. ISS believes that holding a say-on-pay vote every year enables the vote to correspond to the majority of the information presented in the accompanying proxy statement, and allows investors to comment upon issues in annual incentive programs in a more timely fashion.

- **Form 8-K for Say-on-Frequency.** Companies that are required to conduct their say-on-frequency vote this year must remember to report, under Item 5.07 of Form 8-K, the company’s determination as to how frequently it will hold the say-on-pay vote in the Form 8-K required to be filed within four business days of the shareholder meeting (or by amendment to that Form 8-K filed no later than 150 calendar days after the date of the shareholder meeting at which the say-on-frequency vote was taken), but in no event later than 60 days prior to the deadline for the submission of shareholder proposals under Rule 14a-8 of the Exchange Act for the subsequent annual meeting.

- **Say-on-Pay: Considerations for 2018.** As in past years, shareholder support of say-on-pay resolutions in the 2017 proxy season continued to average above 90% across all companies. 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 Compensation Discussion & Analysis (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.

- **Caution when using Non-GAAP Financial Measures.** Increasingly the SEC has been providing comments regarding compliance with the rules on the use of non-GAAP financial measures. As a result of its review of these disclosures, in May 2016 the SEC issued Compliance & Disclosure Interpretations (“C&DIs”) reflecting its concern that companies are not complying with Regulation G and are supplanting and not supplementing their press releases and SEC reports with non-GAAP financial measures, resulting in distorted financial disclosure. Under Regulation G, companies must include a reconciliation of the differences between each non-GAAP financial measure used with the most directly comparable financial measurement from GAAP. Management also must disclose why it believes the non-GAAP measures provide useful information to investors about the company’s financial condition and results of operations. In addition, many proxy statements now include non-GAAP financial measures. If non-GAAP financial measures are presented in the proxy statement for any purpose other than disclosure of target levels relating to compensation, such as to explain the relationship between pay and performance or to justify certain levels or amounts of pay, then those non-GAAP financial measures are subject to the requirements of Regulation G and Item 10(e) of Regulation S-K. However, in these pay-related circumstances only, the SEC allows a company to include the required GAAP reconciliation and other information in an annex to the proxy statement, provided the proxy statement includes a prominent cross-reference to such annex or, if the non-GAAP financial measures are the same as those included in the Form 10-K that incorporates by reference the proxy statement’s Item 402 disclosure as part of its Part III information, by providing a prominent cross-reference to the pages in the Form 10-K containing the required GAAP reconciliation and other information.

- **Section 16 in the News; Potential Section 16(b) Liability Relating to Tax Withholding and Net Exercise Transactions.** Shareholder litigation has persisted seeking disgorgement of short-swing profits under Section 16(b) of the Exchange Act from Section 16 officers when the company has withheld shares to cover an officer’s tax obligation or the officer has net exercised a stock option and such transaction (which is deemed to be a sale to the company) occurs within six months of the officer’s open market purchase of securities of the company. Plaintiff shareholders contend that the approval of a plan or agreement by the board of directors (or an appropriate committee) that provides discretion for an insider to determine how a tax obligation may be paid, or allows for net withholding of shares to satisfy the exercise price of a stock option, creates a non-exempt disposition of securities under Section 16(b). Although we believe that these transactions should be considered exempt under Rule 16b-3(e) (which rule exempts officer and director transactions that are approved in advance by the board of directors or an appropriate committee thereof), if the agreement that sets forth these provisions was previously approved by the board of directors or an appropriate committee until more of these cases are settled favorably for companies, we recommend that prior to *any* withholding to cover taxes with respect to equity awards, or *any* withholding of shares to net exercise a stock option, the board of directors or a properly constituted committee should specifically approve the transaction, including referencing the individual agreement and exact date of the netting out of the shares to cover the tax or exercise price and the formula to be applied in such transactions, in order to provide written proof that the withholding or net exercise constitutes an exempt sale transaction under Rule 16b-3(e) and may not be matched with a non-exempt purchase.

- **Status of Other Dodd-Frank Act Executive Compensation Proposals.** Although the SEC proposed the three remaining Dodd-Frank Act executive compensation rules in 2015—hedging of shares by employees and directors; measuring pay for performance; and clawback of "erroneously awarded compensation"—none of these three remaining rules have been finalized. The Financial CHOICE Act, as approved by the House of Representatives in June 2017, would repeal the hedging disclosure requirement and limit the clawback requirement. It is not clear when, if ever, the Senate will consider the legislation. In any event, the SEC has removed the remaining Dodd-Frank Act rules from the proposed action section of its regulatory agenda, which suggests to us that final action on them is not imminent. It remains to be seen when and whether these rules will be adopted and, if adopted, whether material changes will be made to the proposals. However, the rules will not be in place for this proxy season.

- **Status of Proxy Access.** Over 50% of the S&P 500 companies have adopted some form of proxy access by-law, a mechanism that allows shareholders to nominate directors and have those nominees listed in a company's proxy statement, thus sparing a dissident the expense of conducting its own, separate proxy contest. To date, we are aware of only one shareholder request to add a director candidate using a company's proxy access by-law provision. However, the process did not fully play out and the director nominee withdrew his candidacy. The board of directors, in its review of the candidate in compliance with its by-laws, concluded that the candidate nominated did not meet the specifications required in the by-laws because the company shares that were owned by the proponent were not acquired in the ordinary course of business but with the intent to influence control of the company based on a Schedule 13D filing. The candidate (and the proponent backing him) did not fight the company's determination and withdrew the nomination. Recently, the SEC has waded back into this arena[2] with a proposal for a "universal proxy".[3] This proposal would change the way that shareholders vote in contested elections where a proponent files a competing proxy statement with their own slate of directors and separate proxy card (not through proxy access, which generally involves a proposal to add only one or two directors). The universal proxy would allow a single proxy card to set forth all proposed candidates so shareholders can pick and choose amongst the company nominees and the shareholder nominees. The SEC believes that this process would be more equitable, as currently the only way to mix and match candidates is to attend the shareholder meeting and vote for the directors in person. Critics of the proposal believe that a universal proxy card will cause too much confusion and that the mix of directors elected may not be suitable for the particular company.

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 have further addressed some of these topics as well as additional items that we believe will be of interest to this year's reporting season in 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[4] implementing Section 953(b) of the Dodd-Frank Act, requiring 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 are subject to this new disclosure requirement, with the exception of emerging growth companies, smaller reporting companies and foreign private issuers. As it will take time for companies to compile the information necessary to determine the median employee, companies should begin work on this analysis now if they have not already begun.

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. When identifying the median employee, the 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. Certain 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, a company 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 criticism from commenters regarding the burdens imposed by the inclusion of foreign employees, the final rule allows companies to exclude foreign employees from the calculation under the following 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.[5]
- **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.

The rule provides 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 now refers to this as the "CACM" – a consistently applied compensation measure. 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. In addition, the SEC will allow a company to apply a cost-of-living adjustment in the determination of its median employee only if it provides the same cost-of-living adjustment when calculating total compensation for that employee.

In October 2016, the SEC issued five C&DIs[6] to provide some clarification on the determination of the median employee and the employee population. The C&DIs demonstrate that the SEC expects the determination of the median employee to be calculated using a principles-based approach based on the type of company and its compensation practices. The SEC issued additional interpretive guidance in September 2017,[7] with a focus on making it easier for companies to calculate the pay ratio, and at the same time the SEC deleted the C&DI that made "employee-like" independent contractors subject to the rule. These C&DIs:

- Provide additional flexibility as they allow the company to choose the median employee that makes "sense" and is representative of the employee population so that the individual may be used for the next three years
- Allow companies to use their existing internal records even if imperfect so many companies will not have to rely on statistical sampling and will be able to do the calculation internally. In addition, companies may state in their disclosure that the pay ratio is an estimate and no audit of the information is required
- State that absent a lack of good faith the SEC would take no enforcement action on the determination of the pay ratio

We expect that companies will insert the pay ratio disclosure as a separate section at the end of the executive compensation discussion rather than include it as a part of the CD&A or proxy summary. We expect that companies will disclose the ratio, provide a paragraph on the methodologies and assumptions used and a final paragraph stating that the ratio is an estimate and should not be used to compare one company's results to those of other companies. Although the rule requires that the pay ratio is deemed filed with, and not furnished to, the SEC, this recent SEC guidance has provided much relief regarding the risk of enforcement action, and the ability to provide disclaimers should aid in preventing plaintiffs' derivative litigation.

ISS and Glass Lewis have stated that they will report a company's pay ratio in their proxy voting report, but will not provide substantive comment on it. We expect that the media will be most interested in analyzing this information to compare companies. In addition, in certain industries the "median" employee may be a surprise to those within the company and precautionary communications prior to the public disclosure of the pay ratio may be required as an investor relations matter.

2017 Confirms A Stricter Legal Standard of Review for Director Compensation

In December 2017, in *In re: Investors Bancorp, Inc. Stockholder Litigation*,[8] the Delaware Supreme Court set forth an even stronger pro-shareholder position with respect to review of excessive director compensation claims by shareholders and held that when directors award compensation to themselves pursuant to a discretionary plan, those awards will be subject to the strict "entire fairness" standard of review, even in situations where stockholders ratified the plan. This decision is the culmination of a trend towards a higher level of scrutiny regarding director compensation. Prior to this decision, certain director compensation litigation brought before the Chancery Court allowed directors to assert a "shareholder ratification defense," which resulted in director compensation decisions being subject to the less-stringent business judgment rule so long as the plan had shareholder approved "meaningful limits" on the awards that the directors could make to themselves. The *Investors Bancorp* court rejected this defense. So while the inclusion of shareholder approved meaningful annual limits on the amount of equity compensation to be paid to directors under a plan is still recommended and will provide a defense that compensation is fair with respect to process when the directors deliberate on such limits, such limits will no longer be sufficient – standing alone – to invoke a shareholder ratification defense subject only to the business judgment rule.
The *Investors Bancorp* case involved an equity compensation plan – ratified by 96.25% of the voting shares – allowing the directors to award themselves an aggregate amount of up to 30% of the equity to be issued under the plan but setting no yearly limit. The company's Compensation and Benefits Committee met four separate times before making awards to the directors. After the awards were made, stockholders brought suit against the directors, and alleged that they breached their fiduciary duties in making the awards. After the Chancery Court dismissed the claims, the plaintiffs appealed and the Delaware Supreme Court rendered its decision.

The Delaware Supreme Court's ruling made it clear that the shareholder ratification defense to analyze the director's fiduciary duty under the business judgment rule will be unavailable no matter what the specific terms of a plan may be. Specifically, the court held that "when stockholders have approved an equity incentive plan that gives the directors discretion to grant themselves awards within general parameters, and a stockholder properly alleges that the directors inequitably exercised that discretion, then the ratification defense is unavailable to dismiss the suit, and the directors will be required to prove the fairness of the awards to the corporation." This entire fairness standard of review requires the directors to show that the grants were fair with respect to both price and process, a stricter standard than the business judgment rule.

In imposing this more exacting level of review, the court reasoned that "[w]hen stockholders approve the general parameters of an equity compensation plan and allow directors to exercise their broad legal authority under the plan, they do so precisely because they know that that authority must be exercised consistently with equitable principles of fiduciary duty." The court continued by observing that given that actual awards made under a discretionary plan "are self-interested decisions not approved by the stockholders, if the directors acted inequitably when making the awards, their inequitable action does not become permissible simply because it is legally possible under the general authority granted by the stockholders."

The Court did, however, confirm that the shareholder ratification defense and analysis based on the business judgment rule is still available when fully informed, un-coerced, and disinterested stockholders approve:

1. specific compensation decisions made by directors; and
2. self-executing plans, which are plans that make specific and fixed awards over time based on fixed criteria.

In light of this decision, we recommend that companies that are concerned about the level of compensation paid to directors consider:

- adopting a self-executing plan in order to continue to have director compensation awards be subject to the less-stringent business judgment rule; or
- adding shareholder approved meaningful yearly compensation limits based on a documented process that takes into account the amount of previous awards paid to directors and peer company review and if these limits are based on share amounts, an absolute dollar cap based on a valuation formula such as Black-Scholes should also be included to prevent outsized value awards from being granted based on dramatic changes in stock price.

For companies that have not had their equity plans approved by shareholders with director compensation limits, we recommend taking the following steps intended to help meet the entire fairness standard, to the extent that the compensation decisions are challenged by stockholders in court:

- reviewing director compensation data at comparable companies (with or without compensation consultants) and ensuring director compensation is reasonable in light of these comparables (although it should be noted that the selection of comparables sometimes can be successfully challenged at the motion to dismiss stage in stockholder actions); and
- documenting the decision making process thoroughly in the minutes.

Corporate Governance Reforms in Advance of Dodd-Frank Compensation Proposals. Although, as discussed above, the Dodd-Frank Act has not yet required companies to make changes regarding hedging and pledging and clawbacks, 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 of directors. 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.[9] 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 if 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 the CD&A section 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 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.

Say-on-Pay Approval Requirements

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 overall way it analyzes say-on-pay this year[10] and continues to recommend a vote against a say-on-pay proposal if:

- a significant misalignment between CEO pay and company performance (pay for performance) exists;
- the company maintains significant problematic pay practices; or
- the board of directors 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 of directors 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 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's 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.[11]

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.[12]

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 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 Policy for Evaluating Equity Plan Proposals. ISS continues to use its equity plan scorecard (the "Scorecard") to evaluate equity compensation proposals and has made some minor revisions to its review process this year, mostly with respect to how it scores the items.

The following continue to be the key terms of the Scorecard:

<u>Plan Cost</u>: The Scorecard 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.

<u>Plan Features</u>: The following factors may have a negative impact on Scorecard 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;
- *Dividends payable prior to the vesting of the award* as dividends should be paid only after the underlying awards have been earned and not during the performance/service vesting period*;* 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.

<u>Grant Practices</u>: The following factors may have a positive impact on Scorecard results, depending on a company's size and circumstances:

- *The company's 3-year average burn rate relative to its industry and market cap peers* – This measure of average grant "flow" provides an additional check on plan cost. The Scorecard compares a company's burn rate relative to its market cap peers 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.

2018 Periodic Report Filing Deadlines

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 (Thursday, March 1, 2018).[13] Form 10-K reports continue to be due 75 days following fiscal year-end for accelerated filers[14] (Friday, March 16, 2018 for December 31 year-end companies) and 90 days after fiscal year-end for non-accelerated filers (Monday, April 2, 2018 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 questions to consider are:

- Does the company have enough shares authorized under its charter 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?
- Has the company reviewed its charter and by-laws to assess any anti-takeover measures in place?
- Has the company promised any disclosure changes pursuant to SEC comments or discussions with shareholders?

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.

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, which analyzed regulatory changes that were new for fiscal year 2017, and we would be happy to provide you with another copy upon request. We also thank Bret Leone-Quick for his contributions to this memorandum.

[2] You may recall that the SEC vacated its proxy access rule after it was challenged in a lawsuit.

[3] Universal Proxy, Rel. No. 34-79164 (October 26, 2016).

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

[5] Most practitioners believe this exemption will have little value as it will be difficult to obtain the requisite legal opinion.

[6] https://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm – see Section 128C.

[7] https://www.sec.gov/rules/interp/2017/33-10415.pdf.

[8] No. 169, 2017 (Del. 2017).

[9] 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.

[10] The ISS 2018 policy in evaluating say-on-pay is available on its website at: https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf; and https://www.issgovernance.com/file/policy/active/americas/US-Compensation-Policies-FAQ.pdf.

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

[12] 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.

[13] *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, 2017);
- 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.

[14] *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, 2017).