The 2017 Proxy Season: What's Up and Coming?

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The 2017 proxy season brings forth a number of trending topics and new considerations public companies should bear in mind.

In this edition

Say-On-Frequency: Six Years Later

In the 2017 proxy season, many companies will, for at least the second time, be electing how frequently to hold say-on-pay votes. Under the Dodd Frank Act, not less than every six years, non-exempt public companies are required to elect whether to have a say-on-pay vote annually, biannually, or triennially. Typically, before shareholders vote on the matter, a company's board of directors will recommend how frequently the company should vote, and even though shareholder votes are non-binding, most of the Russell 3000 companies that had a say-on-frequency vote in 2011 followed their respective shareholders' preferences.

In 2011, a majority of the Russell 3000 companies elected to have say-on-pay votes annually. According to the Council of Institutional Investors, of the Russell 3000 companies that voted on say-on-frequency in 2011, 56 percent of the boards of directors of said companies recommended an annual say-on-pay vote, 2 percent recommended having a biennial vote, 39 percent recommended a triennial vote, and three percent of boards of directors did not make a recommendation. When put to a shareholder vote, more than 76 percent of shareholders voted in favor of an annual say-on-pay vote, 22 percent of shareholders favored in favor of a triennial vote, and less than 2 percent voted in favor of a biennial vote. Although most Russell 3000 companies followed the preferences of their respective shareholders, six chose to go against their shareholders' preferences and make say-on-pay votes more frequent than desired. When asked why they failed to follow their respective shareholders' preferences, four of the companies did not give a reason. The other two companies, however, expressed that they chose annual votes to protect the interests of a sizable minority of shareholders that requested annual votes.

Despite the mandate to have a say-on-frequency vote at least every six years, a handful of Russell 3000 companies have already had multiple say-on-frequency votes. According to a study done by Pearl Meyer & Associates, as of May 2016, less than 100 of the Russell 3000 companies have had multiple votes on say-on-frequency. In this regard, 66 percent of these companies reported no change in frequency preference, 27 percent reported a new preference for annual frequency, 7 percent reported a new preference for triennial voting, and no companies changed their preference to biennial voting.

Among the Russell 3000, published reports indicated that there was some correlation between the chosen frequency and concentration of executive ownership, as well as the chosen frequency and company size. The above mentioned study by the Council of Institutional Investors indicated that, in half of the Russell 3000 companies where shareholders voted in favor of triennial voting, executives controlled a majority of the shares entitled to vote. Furthermore, in 78 percent of the Russell 3000 companies where shareholders voted in favor of triennial voting, executives owned at least one-fifth of the shares entitled to vote.

Size appears to correlate with annual say-on-pay voting. The study by the Council of Institutional Investors also indicated that 94.5 percent of the companies in the top quartile by market cap elected annual voting, approximately 89 percent of the middle two quartiles elected annual voting, and less than 85 percent of the bottom quartile chose annual voting.

In 2017, we can expect more of the same: most of the Russell 3000 companies will probably elect to have a say-on-pay vote annually, and a small minority, mostly those with concentrated ownership, will probably elect to have a triennial vote. However, contrary to the recommendation by the Institutional Shareholder Services Inc. and Glass Lewis & Co. to hold annual say-on-pay votes, several institutional investors favor triennial votes, which could also affect a company's voting frequency. Moreover, experts have suggested publicly that more companies should consider holding say-on-pay votes triennially because, among other things, generally (i) neither positive nor negative results from any changes made by executives manifest within a year, (ii) triennial votes better match long-term performance, and (iii) triennial votes deter executives from making short-term decisions that may be to the detriment of the company's longevity.

Summary of 2017 ISS and Glass Lewis Policy Updates

Every year, proxy advisors Institutional Shareholder Services and Glass Lewis update their proxy voting policies for the upcoming proxy season. The most significant changes for the 2017 proxy season are summarized below.

ISS Updates:

Overboarded Directors. ISS, decreased the threshold number of public company directorships that would cause it to consider a director "overboarded" from six public company boards to five for 2017. Accordingly, ISS will generally vote against (1) individual directors who sit on more than five public company boards and (2) CEOs of public companies who sit on the boards of more than two public companies besides their own (in which case ISS will withhold only at their outside boards).

Equity-Based and Other Incentive Plans. ISS makes recommendations on a case-by-case basis with respect to proposals to approve certain equity-based compensation plans. Its determination is based on a variety of factors related to plan features and equity grant practices using an "equity plan scorecard" focusing on "three pillars:" plan features, plan costs and grant practices. Each pillar is comprised of multiple factors. One new factor was added this year to the "plan features" pillar: payment of dividends on unvested awards will be evaluated, and failure to specify in the plan that payment prior to vesting is prohibited will result in no points being earned for that factor. Accrual of dividends payable upon vesting, however, will continue to be permitted. ISS also modified the factor related to minimum vesting such that an equity plan must now specify a minimum vesting period of one year for all award types in order to receive full points and no points will be earned if the plan allows for individual award agreements that reduce or eliminate the one-year vesting requirement.

Amending Cash and Equity Plans. ISS updated and clarified its existing framework for evaluating the different types of proposals involving amendments to equity incentive plans. Notably, the updated policy language more clearly articulates the circumstances under which ISS will make its recommendation in connection with a proposal that seeks approval for Internal Revenue Code Section 162(m) purposes only, or involves multiple amendments.

Shareholder Ratification of Director Pay Programs. ISS adopted a new policy in 2017, which provides that ISS will recommend votes case by case on management proposals seeking ratification of non-employee director (NED) compensation, based on a series of factors, including but not limited to:

(i) director stock ownership guidelines and holdings requirements;

(ii) equity award vesting schedules;

(iii) the relative magnitude of director compensation compared to similar companies;

(iv) the presence of problematic pay practices related to director compensation;

(v) the mix of cash and equity-based compensation;

(vi) meaningful limits on director compensation

(vii) the availability of retirement benefits or perquisites; and

(viii) the quality of disclosure surrounding director compensation.

Equity Plans for Non-Employee Directors. ISS broadened the list of factors it uses to determine whether to vote for or against a NED compensation plan to be consistent with the factors used for evaluation of shareholder ratification of director pay programs. The changes also clarified that, if a NED equity plan is determined to be relatively costly, ISS's vote recommendation will be case-by-case, considering all of the factors together, rather than requiring that all of the stated factors meet a certain minimum criteria.

Shareholders' Ability to Amend the Bylaws. ISS adopted a new policy which states that it will generally recommend a vote against or withhold votes from members of the governance committee if a company's charter imposes undue restrictions on shareholders' ability to amend the bylaws. Such restrictions include, but are not limited to:

(i) outright prohibition on the submission of binding shareholder proposals; or

(ii) share ownership requirements or time holding requirements in excess of SEC Rule 14a-8.

Newly-Public Companies. ISS updated its policy on newly-public companies in 2017, providing that, with respect to these companies, ISS will generally recommend a vote against or votes be withheld from directors individually, committee members, or the entire board (except new nominees in certain cases) if, prior to or in connection with the company's public offering, the company or its board implemented a multi-class capital structure in which the classes have unequal voting rights.

Glass Lewis Updates:

Director Overboarding Policy. The 2017 policy on director overboarding codifies the policy outlined in last year's update, which provides that Glass Lewis will generally recommend voting against a director who serves as an executive officer of any public company while serving on more than two other public company boards and any other director who serves on a total of more than five public company boards. Glass Lewis will take other factors into consideration as well, including:

(i) the size and location of the other companies where the director serves on the board and the director's board duties at the relevant companies;

(ii) whether the director serves on the board of any large privately-held companies;

(iii) the director's tenure on the boards in question; and

(iv) "other relevant factors."

Glass Lewis will not typically recommend that shareholders vote against overcommitted directors at the companies where they serve as an executive.

Governance Following an IPO or Spin-Off. Glass Lewis clarified its policy on corporate governance at newly public entities to identify certain provisions that it has determined "severely restrict shareholder rights indefinitely." These provisions include supermajority vote requirements to amend governing documents, exclusive forum or fee-shifting provisions, prohibitions on shareholders calling special meetings or acting by written consent, prohibitions on the ability of shareholders to remove directors (except for cause), the presence of evergreen provisions in equity compensation plans and plurality voting standards for director elections. The presence of any of these mechanisms may trigger immediate negative recommendations for directors at newly public entities, and Glass Lewis will likely recommend voting against a newly public entity's nominating and governance committee chair if it includes an exclusive forum provision in its governing documents.

Board Evaluation and Refreshment. Glass Lewis clarified its policy on board evaluation, succession planning and retirement, which focuses on assessment and alignment of director skills with company strategy instead of solely relying on age or tenure limits. Glass Lewis has not stated when it might issue negative vote recommendations based on the updated policy, but it generally opposes sole reliance on age or tenure limits and supports routine evaluations, independent external reviews and periodic refreshment, as the goal is to encourage a shift toward more intentional and thought-through decisions on re-nominations based on individual directors' skillsets and experience and the company's needs going forward.

Proxy Access on the Rise

For the second year in a row, so-called "proxy access" shareholder proposals to adopt, or recommending that the board adopt, a bylaw permitting shareholders to include their nominees for a portion of the board of directors on management's proxy materials, dominated corporate governance matters during the 2016 proxy season, and it appears that these proposals will continue their prominence in the 2017 proxy season. More than 200 proxy access proposals were submitted in 2016, nearly doubling the number submitted during the 2015 season. Where implemented, shareholders gain the power to nominate a portion of the board without the board's approval and without undertaking the expense of a separate proxy solicitation.

Proliferation of Proxy Access

According to published reports, as of December 31, 2016, almost 50 percent of the S&P 500 companies have now adopted some form of proxy access. The increasing pace of proxy access implementation has coincided with a growing coalescence around a "3/3/20/20" model – allowing a holder (or group of holders up to 20 persons) of 3 percent or more of a company's shares for three years access to the company's proxy statement for nominees at the greater of two directors or 20 percent of the board. Commentators have noted a number of company-friendly features that have become standard over the last two years, such as a requirement that nominators continue to hold stock following the meeting and certain nomination and re-nomination restrictions.

Recent Proposals and "Substantially Implemented" No Action Letters

Under the SEC's proxy rules, a company may exclude a proxy access shareholder proposal from its proxy materials if the proposal or proponent fails to meet any of the procedural or substantive requirements of Rule 14a-8. Two substantive grounds that have been relied on in recent years by companies seeking to exclude a shareholder proxy access proposal are that the proposal directly conflicts with a management proposal (Rule 14a-8(i)(9)), or has already been substantially implemented by the company (Rule 14a-8(i)(10)). As described in our earlier memo, the SEC's Staff Legal Bulletin No. 14H released in late 2015, followed by a series of no-action letters in early 2016, imposed a narrow standard for excluding conflicting management and shareholder proposals under Rule 14a-8(i)(9). As a result, no-action requests during the 2016 proxy season largely shifted to a "substantially implemented" argument under Rule 14a-8(i)(10) in the face of two types of proxy access shareholder proposals: (1) proposals to adopt, or recommending adoption of, a proxy access bylaw, and (2) proposals to "fix" proxy access bylaws that are already in place by making them more shareholder-friendly. Recent responses to no-action letter requests illustrate that the SEC staff will distinguish between proposals seeking to adopt proxy access versus proposals seeking to "enhance" or "fix" an existing proxy access bylaw.

In response to the first type of proposal, issuers often implement a proxy access bylaw containing terms chosen by management that are not wholly consistent with those in the shareholder proposal and then argue that it has substantially implemented the shareholder proposal. These issuers have been largely successful in obtaining no-action relief to exclude these proposals on this basis where the bylaw adopted followed the 3/3/20/20 model, even if the bylaw contained other terms that were inconsistent with the shareholder proposal.

Fix-it proposals have typically addressed one or more of the following issues:

- reduce the ownership threshold to 3 percent;
- remove the limit on the number of shareholders whose holdings may be aggregated for purposes of meeting the requisite share ownership threshold;

- deny the board the power to amend the proxy access bylaw once it has been “fixed”;
- remove restrictions on the re-nomination of proxy access director candidates who receive less than a specified percentage of the vote in subsequent elections;
- eliminate post-meeting stock ownership requirements obligating a nominating shareholder to represent its intent to continue to own the shares after the annual meeting;
- permit loaned stock to be counted towards meeting the ownership threshold without restrictions relating to the right to recall the shares; and
- expand the percentage of the board that can be nominated to the greater of 25 percent or two directors.

Responses by issuers to “fix-it” proposals have been mixed, with some issuers seeking no-action relief on substantially implemented grounds after modifying their proxy access bylaw to address some but not all of the issues raised by the proposal and others seeking relief on the same grounds but choosing not to amend their proxy access bylaw. “Fix-it” proposals were voted on at only eight companies in 2016, passing at two of them, both of which had requested a reduction of the ownership threshold from 5 percent to 3 percent.

More recently, the SEC staff has refined its approach to fix-it proposals by drawing a distinction between proposals that address a sufficient number of changes to satisfy the “essential objective” of proxy access versus proposals that include an element that the staff views as “critical,” such as a reduction in the eligibility threshold from 5 percent to 3 percent.

What to Do

If a company that has not yet adopted proxy access receives a shareholder proposal recommending adoption, its options are fairly limited. It may choose to:

- include the proposal in its proxy materials with a recommendation and statement in opposition;
- negotiate with the proponent to withdraw the proposal by explaining why the board believes adoption is not in the shareholders best interests;
- adopt a “market” proxy access bylaw and then seek to exclude the shareholder proposal under Rule 14a-8(i)(10);
- adopt a “market” proxy access bylaw and include the shareholder proposal in the proxy materials with a recommendation and statement in opposition; or
- adopt a “market proxy access bylaw subject to shareholder approval and include both the shareholder proposal and a competing proposal to ratify the board’s proposed bylaw.

If a company has already adopted a proxy access bylaw and receives a “fix-it” proposal, its options are similarly limited. It may choose to:

- include the proposal in its proxy materials with a recommendation and statement in opposition;
- amend its bylaw to satisfy some or all of the requested changes, and then seek to exclude the proposal under Rule 14a-8(i)(10);
- amend its bylaw to satisfy some or all of the requested changes, and then include the proposal in its proxy materials with a recommendation and statement in opposition;
- include in its proxy materials a management proposal seeking a shareholder vote on the retention of its proxy access bylaw in its current form and then seek to exclude the shareholder proposal under Rule 14a-8(i)(9) as a directly conflicting proposal because “a reasonable shareholder could not logically vote in favor of both proposals.”

In evaluating its options under either of these scenarios, the board will need to consider the various terms and potential impact on the company of a proxy access bylaw to determine whether adoption may be in the shareholders’ best interests. The board should also consider, among other things, industry and peer company precedent, the likelihood that the proposal will receive shareholder approval, the views of the company’s largest shareholders, the risk of adverse ISS or Glass Lewis vote recommendations if the shareholder proposal recommending adoption of proxy access is approved and the board fails to adopt a bylaw, and the risk of litigation.

Virtual Shareholder Meetings in 2017

What's the Controversy About?

Virtual shareholder meetings are nothing new – a virtual meeting was reportedly utilized as a supplement to the physical annual meeting for the first time in 1996, and virtual-only meetings have been allowed under Delaware law for more than 15 years. So why are we seeing articles on the topic in the *New York Times*, *Washington Post*, *Forbes* and others in the past two years?

The answer is simple: more companies are using, or proposing to use, virtual meetings, either as a substitute for a physical meeting (the “virtual-only meeting”) or to supplement the physical meeting (the “hybrid meeting”). Broadridge, a provider of investor communications for companies, offers a Virtual Shareholder Meeting (VSM) service, and reports a substantial uptick in the number of companies employing the VSM service for either virtual-only or hybrid meetings. In 2009, only four meetings were hosted by VSM, whereas in 2015, 134 meetings were hosted, with 90 of those being virtual-only. Numbers released during 2016 indicated that Broadridge expected to host an even larger number of meetings that year.

Several factors outside the control of companies are potentially driving the increase in virtual meetings: availability of technology and decrease in its cost, as well as state law changes permitting virtual meetings – 22 states (notably, Delaware, Michigan and Texas) authorize virtual-only meetings, while another 11 allow for hybrid meetings. Some of the laws in these states, however, place burdens on companies thereby making virtual meetings impractical or undesirable, such as the requirement in California that a company must have unrevoked shareholder consent to hold a virtual meeting or the requirement in Michigan that shareholders have the ability to communicate with other shareholders throughout the meeting. Other states have instituted more attainable requirements by providing that corporations must institute certain reasonable measures to (1) verify that all persons deemed present and permitted to vote are shareholders or proxy holders, (2) provide shareholders and proxy holders a reasonable opportunity to participate and vote, and (3) maintain a record of any votes or actions taken by means of remote communication.

Other factors within the control of companies have probably contributed more to the proliferation of virtual meetings, such as cost, desire for shareholder participation, flexibility, image, security and ability to address shareholder questions. These considerations are prompting discussion between those in favor or in opposition of virtual-only meetings.

What do the Proponents of Virtual Shareholder Meetings Say?

Those who support the use of virtual-only shareholder meetings cite the following motives:

Cost Savings. Cost is probably the primary reason referenced in support of virtual meetings. This item is twofold: (1) the company realizes savings in the absence of logistical requirements for a physical meeting, such as location and equipment rental, food, security, travel and interruption of daily company activities, and (2) the shareholders can participate from anywhere in the world without travel costs or time away from their work. For example, one company that held a virtual-only shareholder meeting reported its expenses for the virtual-only meeting at one-tenth of its expenses for the previous year’s in-person meeting – even taking into account the cost of technology and software for the virtual meeting.

Shareholder Participation. Shareholders have easier access to shareholder meetings if held virtually because they are afforded the opportunity to interact with the company by simply logging into a website or dialing into a conference call rather than incurring the expense and spending the time necessary to attend in person. Easier access would appear to result in increased meeting attendance. One company cited the following numbers as a result of its virtual meeting format: in 2008 at its last in-person meeting, a total of three shareholders attended, while 186 shareholders attended the 2009 virtual-only meeting. Another company reported that two to three times the number of shareholders or proxy holders attended the virtual-only meeting as had previously attended the in-person meeting. Proponents argue that increased access to management results in greater director accountability.

Leveraging Technology to Enhance Question and Answer Session. Technology allows a company’s management to preview, prioritize and group questions submitted via email prior to or during the meeting. This allows for more efficient and thoughtful responses to questions, which may free up time to address other concerns. Another potential advantage is that when shareholders are allowed to ask questions anonymously, they may be encouraged to be more frank or candid than if they are communicating in-person at a meeting.

Scheduling Flexibility. If company directors can participate remotely through a virtual platform, the shareholder meeting and the board meeting can be decoupled which provides management with greater scheduling flexibility. Additionally, a virtual-only meeting can be less disruptive to the company's daily routine because management and employees don't need travel to the meeting facility.

Project a Tech-Savvy or Environmentally Conscious Image. Many companies are concerned about their image or reputation, especially with younger investors. For some companies, portraying a tech-savvy, eco-friendly or even socially conscious image is important to the company's branding. Companies boasting their technology as best in the field can show it off buy conducting a virtual shareholder meeting, or those companies seeking an eco-friendly reputation can cite their own contributions to reduction in emissions through elimination of the need to travel to an in-person meeting.

Increased Physical Security. Security at in-person meetings can be a concern for companies, especially those that are concerned with protests or attracting people who are displeased with the company. By conducting the meeting virtually, the concern for physical safety is almost completely eliminated, as well as any associated costs for the employment of security personnel or procedures like metal detectors.

What do the Opponents of Virtual Shareholder Meetings Say?

Those who oppose the use of virtual-only shareholder meetings cite the following motives:

Decrease Effective Shareholder Participation. While the number of shareholders participating might increase with a virtual-only meeting, opponents argue that virtual meetings decrease the effective shareholder participation. They claim that the ability of the company to insulate management from face-to-face interaction with shareholders, limit confrontations and generally promote a culture of disengagement by employing a virtual meeting strategy far outweighs any perceived benefits. They argue that a lack of face time and personal interaction can minimize management's accountability to shareholders and discourage relationship building between shareholders and management. Some opponents cite the effect that a spontaneous shareholder question, whether face-to-face or in a public Q&A session, can have on the way management thinks or acts in the future. It is also argued that virtual meetings can also create the appearance of a lack of transparency.

Leveraging Technology to Diminish Question and Answer Session. Virtual shareholder meetings would allow management to avoid surprise questions and could allow the company to limit or ignore shareholder questions, such as those raised by an activist shareholder, through the pre-screening process. Even Broadridge advertises that a company using its VSM service can "privately view and manage shareholder questions without broadcasting to other attendees." Additionally, if there is no video transmission, telling moments might be lost, such as facial or other non-verbal reactions. One shareholder has remarked that seeing the looks on the faces of the directors when the CEO refused to allow the audit committee to answer a question at a meeting was worth the cost of travel.

Decreased Ability to Effectively Address Hostile or Challenging Questions. While some opponents assert that the virtual meeting gives management an opportunity to filter shareholder questions and avoid surprises, others cite to the fact that communication by management could be stifled by the virtual format. It is much harder for a shareholder to walk out of a room during a heated debate than to hang up the phone or close a browser. A shareholder meeting is an opportunity for the company to assuage shareholder fears or concerns, and a decrease in the effectiveness of management's ability to communicate could diminish this important aspect of the meeting.

Cybersecurity, Hacking and Validity Concerns. Despite the decrease in physical security concerns discussed above, virtual shareholder meetings come with their own security risks. Recent years have seen an increase in cybercrimes and allegations of computer hacking. A 2012 study reported that 90 percent of the 583 companies surveyed in the U.S., U.K., France and Germany reported a data breach of some kind in 2011. In February 2011, Director's Desk, Nasdaq's board portal technology providing electronic boardroom service (and therefore storing critical information for more than 15,000 board members of several hundred Fortune 500 companies), reported a security breach. The confidential documents stored on the cloud were potentially accessible by hackers before the breach was remedied, and some sources claim there were multiple breaches of Director's Desk over the period of one year. These risks include data breaches, hacking of voting software, and ability of impostors to pose as shareholders. Virtual meetings also create a potential for other kinds of technology failure during the course of the meeting, such as the inability for the chair of the meeting or other participants to hear or be heard for some or all of the meeting, that may call the legal validity of the meeting into question.

Ability of Company to Predict Voting Results. Typically companies, and not shareholders, cite this as a reason for maintaining an in-person meeting. Shareholders attending a virtual meeting are less likely to vote via proxy, which results in more uncertainty for the company prior to the meeting on the expected outcome of the voting.

Compliance with Statutory Requirements for Virtual Meetings. As stated above, some states have strict procedures a company must follow in order to conduct a virtual-only meeting. Complying with these procedures may not be practicable or desirable. Many states, including Michigan, require that the list of shareholders be available online during the meeting in order to conduct a virtual-only meeting, something some companies do not wish to provide.

Does a Compromise Exist?

Proponents and opponents do agree on one thing; supplementing an in-person meeting with a virtual meeting, or the hybrid meeting, can alleviate some of the concerns addressed above (with the exception of cybersecurity). Hybrid meetings, however, are likely to be more costly to the company than either an in-person or virtual-only meeting, eliminating one of the main reasons for conducting a virtual meeting. Moreover, many of the negative aspects of a virtual meeting would be present in a hybrid meeting, such as the ability to pre-screen online questions, diminished ability by management to communicate, cyber security concerns, reduced ability to predict the voting results, and the need to comply with additional statutory requirements to permit virtual participation. On the other hand, it does give the company some flexibility and can address many of the other concerns listed above by both proponents and opponents.

Final Thoughts

Given the many arguments on both sides of the virtual meeting question, it seems unlikely a market consensus on whether annual meetings should be held virtually will be reached in the foreseeable future. Any company considering a virtual or hybrid shareholder meeting should consult with legal counsel regarding applicable state law, and carefully consider its shareholder composition and meeting objectives and what its peer companies are doing before making a decision regarding whether to hold a virtual or hybrid meeting.

Enhanced Focus on Disclosure of Non-GAAP Financial Measures

On May 17, 2016, the SEC's Division of Corporation Finance updated its Compliance and Disclosure Interpretations ("CDIs") relating to non-GAAP financial measures or "NGFMs." These revised CDIs provided guidance on, among other things, instances in which the use of adjustments in NGFMs could be misleading, the requirement to disclose GAAP financial measures with equal or greater prominence and restrictions on expressing liquidity-related NGFMs on a per share basis. In recent months, the SEC Staff has issued a significant number of comment letters related to NGFM disclosures made in SEC filings, reflecting an increased focus on NGFMs by the Staff. Companies should assume that the Staff will continue to review SEC reports, earnings releases and other publicly available communications containing NGFMs, and that it is likely to issue comments on those materials if NGFM presentation issues arise.

Companies should also be aware of the possibility of enforcement actions in connection with NGFM disclosures. In this regard, the SEC charged two former accounting executives last fall with overstating the financial performance of a large publicly-traded real estate investment trust by purposely inflating a key metric used by analysts and investors to assess the company.

Regulation G and Item 10(e) of Regulation S-K

In 2003, the SEC adopted Regulation G and Item 10(e) of Regulation S-K in accordance with its directive under the Sarbanes-Oxley Act of 2002. These regulations apply to any public disclosure of NGFMs, including SEC reports, press releases, website disclosures, investor presentations and conference calls, whether such disclosure is made in print, orally, telephonically, by webcast or by broadcast, by any company that is required to file reports under the Securities Exchange Act of 1934, as amended.

If the NGFM is disclosed in an SEC filing or in an earnings release attached as an exhibit to a Form 8-K, then the NGFM must be accompanied by:

- A presentation, with equal or greater prominence than the NGFM, of the most directly comparable GAAP financial measure;
- A quantitative reconciliation of the NGFM to the most comparable GAAP financial measure (unless the NGFM is forward looking and the reconciliation cannot be done without unreasonable effort);
- A statement disclosing the reasons why the company's management believes that presentation of the NGFM provides useful information to investors regarding its financial condition and results of operations; and
- To the extent material, a statement disclosing the additional purposes, if any, for which the company's management uses the NGFM.

With respect to NGFMs other than those contained in a filing made with the SEC, the NGFMs must be accompanied by a presentation of the most directly comparable GAAP financial measure and a quantitative reconciliation of the NGFM to the most comparable GAAP financial measure (unless the NGFM is forward looking and the reconciliation cannot be done without unreasonable effort).

These regulations also prohibit, in any SEC filing, (1) certain NGFMs, such as where the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years, (2) the use of misleading titles, and (3) inclusion of NGFMs on the face of any required financial statements.

Use of Adjustments

Four CDIs relate to the requirement that the use of a NGFM not be misleading when viewed in context with the information accompanying it, all of which have been addressed in a limited number of comment letters. The following new interpretations address practices that, in the Staff's view, can result in a NGFM that is misleading.

- Presenting a NGFM that excludes normal, recurring, cash operating expenses necessary to operate a registrant's business. [CDI 100.01]
- Varying the computation of NGFMs from period to period by adjusting for a particular charge or gain in the current period when other, similar charges or gains were not also adjusted in prior periods, unless the change between periods is disclosed and the reasons for it explained. The Staff also noted that it may be necessary to recast prior measures to conform to the current presentation. [CDI 100.02]
- For companies that present NGFMs that are adjusted only for non-recurring charges, failing to adjust that NGFM for non-recurring gains that occurred during the same period. [CDI 100.03]
- Presenting a NGFM that is adjusted to accelerate revenue recognized over time under GAAP as though the company earned revenue when customers were billed or using other individually tailored revenue recognition and measurement methods. [CDI 100.04]

Equal or Greater Prominence

The CDI guidance also addresses the requirement that the most directly comparable GAAP measure be presented with "equal or greater prominence," and the most significant proportion of the Staff's recently issued comments were in response to this requirement. The revised guidance interprets "equal" prominence to mean that the GAAP measure must precede any NGFM, and interprets "prominence" to refer not only to the location or ordering of GAAP measures and NGFMs, but also to apply to the manner in which GAAP measures and NGFMs are discussed and characterized and even to type style and size. CDI 102.10 provides examples illustrating when the presentation of NGFMs may not meet the "equal or greater prominence" requirement. These include:

- Presenting a full income statement of NGFMs or presenting a full non-GAAP income statement when reconciling NGFMs to the most directly comparable GAAP measures;
- Omitting comparable GAAP measures from an earnings release headline or caption that includes NGFMs;
- Presenting a NGFM using a style of presentation (e.g., bold, larger font) that emphasizes the NGFM over the comparable GAAP measure;

- Describing a NGFM as, for example, “record performance” or “exceptional” without an equally prominent descriptive characterization of the comparable GAAP measure;
- Providing tabular disclosure of NGFMs without preceding it with an equally prominent tabular disclosure of the comparable GAAP measures or including the comparable GAAP measures in the same table;
- Excluding a quantitative reconciliation with respect to a forward-looking NGFM in reliance on the “unreasonable efforts” exception in Item 10(e)(1)(i)(B), without disclosing that fact and identifying the information that is unavailable and its probable significance in a location of equal or greater prominence; and
- Providing discussion and analysis of a NGFM without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence. [CDI 102.10]

According to Corporate Counsel, approximately 30 percent of all comment letters issued after the new CDIs with respect to NGFMs have addressed some aspect of the “equal or greater prominence” requirement. Specifically, the Staff has focused its attention on discussions of NGFMs without a directly comparable discussion of the comparable GAAP measure in a place of equal or greater prominence, and reconciliations between NGFMs and the directly comparable GAAP measure where the GAAP measure should be presented first.

Prohibitions on Per Share Liquidity Measures

It has long been the Staff’s position that liquidity-related NGFMs should not be presented on a per share basis in documents filed with or furnished to the SEC. The new guidance reiterates the Staff’s view that most per share NGFMs are acceptable so long as they are reconciled to GAAP earnings per share, but NGFMs that measure cash generated must not be presented on a per share basis. The guidance makes clear that the Staff will make its own determination of whether a NGFM is a measure of liquidity. [CDI 102.05] The new guidance also makes clear that free cash flow, EBIT and EBITDA are liquidity measures that cannot be presented on a per share basis. [CDI 102.07 and 103.02] A small proportion of the Staff’s recent comment letters were in response to this requirement.

Tax Effects in Reconciliation

The new guidance modifies the manner in which income tax effects related to NGFMs should be calculated and presented, and comment letters have been issued with respect to this topic. Previously, companies could generally present adjustments “net of tax” when reconciling performance measures as long as the tax effect was shown parenthetically or there was a line in the reconciliation showing the tax effect. Based on the new CDIs, however, the presentation depends on the nature of the NGFM. With respect to NGFM liquidity measures that include taxes, it may be acceptable to adjust GAAP taxes to show taxes paid in cash. For performance-related NGFMs, companies should include current and deferred income tax expense commensurate with the NGFM. Adjustments to arrive at a NGFM should not be presented net of tax. Instead income taxes should be shown as a separate adjustment and clearly explained. [CDI 102.11] Some of the recent comment letters have been issued with respect to the new guidance on tax effects in reconciliations.

Practical Considerations

As discussed above, the largest number of comment letters have addressed the “equal or greater prominence” requirement, with some additional letters addressing tax effects on reconciliations, per share liquidity measures and some additional letters addressing other aspects of the CDIs. Generally, the Staff has also placed a significant focus on discussions of the importance of NGFMs and how they are useful to investors.

Companies should be prepared for continued scrutiny of their public disclosure of NGFMs. It is likely that the Staff will continue to actively review earnings releases as well as investor materials presented on company websites, and will be providing comments on NGFMs where the Staff feels that any such measure does not provide useful information to investors.

In light of the upcoming year end reporting season, public companies should review their use of NGFMs in public documents and communications to determine whether they need to make any changes to conform to the Staff’s guidance. Based on the SEC’s comment letters to date, companies should specifically focus on presenting directly comparable GAAP measures with “equal or greater prominence”, and companies should ensure that they are providing meaningful explanations with respect to the usefulness of NGFMs and proper reconciliations and labeling of NGFMs. When providing

NGFMs on a per share basis, companies should ensure that the NGFM relates only to performance measures and not to measures of cash generated, such as EBIT, EBITDA and free cash flow.

In addition, management and audit committees, in consultation with outside counsel, should reexamine their reasons for using NGFMs and the related disclosure of how such NGFMs provide investors with useful information, and either confirm the need for, or discontinue, their use. Companies should also reexamine the related disclosure controls and procedures to ensure that NGFM disclosures comply with SEC rules.

Disclosure of "Golden Leash" Arrangements

Nasdaq's new listing rule 5250(b)(3), which became effective on August 1, 2016, requires Nasdaq-listed companies to disclose the material terms of all agreements and arrangements between any director or director nominee and any third party relating to compensation or other payments in connection with such person's candidacy or service as a director. The new rule is only applicable to companies listed on Nasdaq and, thus far, the NYSE has not proposed or adopted a similar disclosure rule.

The new rule is intended to address concerns that undisclosed compensation arrangements between directors and third parties, commonly known as "golden leash" arrangements, potentially raise several issues, including that these arrangements may lead to conflicts of interest among directors, may call into question a director's ability to satisfy his or her fiduciary duties and may tend to promote a focus on short-term results at the expense of long-term value creation. Nasdaq believes that disclosure of golden leash arrangements helps address these issues and makes information available that is potentially relevant to investors' investment and voting decisions.

Scope of Disclosure and Exceptions

The rule is to be interpreted broadly to include non-cash compensation such as healthcare premiums and indemnification rights. The following types of compensation arrangements, however, do not need to be disclosed:

- Arrangements that relate only to reimbursement of expenses in connection with candidacy as a director;
- Arrangements that existed prior to the person's candidacy, including compensation paid to such person as an employee of a private equity, venture capital or other investment firm, if the relationship between the nominee or director and the third party has been publicly disclosed. If a director's or a nominee's compensation is materially increased in connection with their service or candidacy, however, the difference between the new and prior level of compensation needs to be disclosed.
- Arrangements that were already disclosed under either Item 5(b) of Schedule 14A or Item 5.02(d)(2) of Form 8-K in the current fiscal year. Such disclosure, however, will not relieve a company from its annual disclosure obligations in future years.

When and Where do Disclosures Need to be Made

Golden leash arrangements must be disclosed no later than the date on which a company files its definitive proxy statement in connection with the company's next shareholders' meeting at which directors are to be elected. Companies must then make this disclosure at least annually until the director resigns or one year following the termination of the arrangement, whichever is earlier. New arrangements do not need to be disclosed at the time they are entered into, provided that disclosure is made as required by the rule for the next shareholders' meeting at which directors are elected. The disclosure may be made through the company's website (or through a hyperlink to another website that is continuously accessible) or in the company's proxy statement.

Failure to Timely Disclose

If a company fails to timely disclose a golden leash arrangement, it must promptly disclose the arrangement by filing a Form 8-K or 6-K, where required by SEC rules, or by issuing a press release. The company's disclosure will not be considered deficient as long as the company made reasonable efforts to identify any golden leash arrangements, including asking each director or nominee whether they are a party to any such arrangement. Accordingly, D&O questionnaires should be updated to ask about the existence of golden leash arrangements and collect the information required to be disclosed by the rule.

If a company is deficient, the company must submit a plan within 45 days that satisfies Nasdaq staff that the company has adopted processes and procedures designed to identify and disclose golden leash arrangements in the future. If the company fails to submit such a plan, the company could be subject to delisting.

Form 10-K – What's New?

In December of 2015, Congress passed the Fixing America's Surface Transportation Act (the "FAST Act"), which includes two sections that direct the SEC to modernize and simplify the requirements in Regulation S-K (and related disclosure requirements). During 2016, the SEC issued several releases and proposed rules to address these requirements of the FAST Act, to amend disclosure requirements that may have become "redundant, duplicative, overlapping, outdated, or superseded."

The SEC published a concept release in April of 2016, seeking public comment for suggestions on modernizing some of the disclosure requirements in Regulation S-K. These included requests regarding how to make core company business information more effective, how to improve risk factor disclosure, and how to update or refine various other disclosure components regarding risk, risk management, and financial information.

In July 2016, the SEC issued an interim final rule creating a new Item 16 of Form 10-K. The new item gives issuers the option to include a summary of the information included in the Form 10-K, but only if each item in the summary is presented fairly and accurately and includes a hyperlink to the material contained in the 10-K to which such item relates. No previous rule prohibited summaries, but most issuers simply included a table of contents with hyperlinks to items in their reports. This rule provides companies additional flexibility when preparing the Form 10-K.

In an effort to reduce the burden on EDGAR users reviewing exhibits to company filings, in an August 2016 release, the SEC issued a proposed rule that would require issuers that file registration statements and reports that are subject to the exhibit requirements under Item 601 of Regulation S-K to include a hyperlink to each exhibit listed in the exhibit index of these filings. The proposed amendments would also require that issuers submit all of these filings in html format. As the rule is not yet final, compliance in the 2016 Form 10-K is not required.

Other proposed rules include an update to property disclosures for mining registrants, removal of references to the SEC's Public Reference Room and its physical location, and changes to the definition of "smaller reporting company" in Item 10(f) of Regulation S-K to expand the number of issuers that qualify as smaller reporting companies.

More Information

For more information regarding the 2017 proxy season, please contact D. Richard McDonald, who leads Dykema's public company practice group (248-203-0859), any of the Dykema attorneys listed on the left, or your Dykema relationship attorney.

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