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Preparing for the 2016 Proxy Season

December 10, 2015

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Agenda

- **Focus on Directors**
  - **Compensation**
  - **Proxy Access and Universal Proxy Ballots**
  - **Board Composition and Performance**
- **Preparing for this Proxy Season**
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  - **Resource Extraction Payments**
- **Conflict Minerals**

Focus on Directors

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PREPARING FOR THE 2016 PROXY SEASON

Director Compensation

- How much discretion should directors have in granting themselves compensation awards?
- *Calma v. Templeton* raised the issue of the judicial standard of review applicable to director compensation awards under shareholder approved plans
  - Business judgment rule v. entire fairness?
  - No clear answer, it depends on the facts and circumstances
- In *Calma*, a derivative suit was filed claiming a breach of fiduciary duty, corporate waste and unjust enrichment for excessive RSU awards to directors
  - Equity plan approved by disinterested shareholders
  - Few limits contained in the plan (only 162(m) limit, equal to approximately $55 million)

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PREPARING FOR THE 2016 PROXY SEASON

Director Compensation after *Calma*

- Plaintiff contended:
  - Directors had conflict of interest since they were receiving RSUs
  - Conflict not "cleansed" by shareholder approval of plan due to lack of "meaningful limits" on the non-employee director awards
- Defendants contended:
  - Shareholder approval of the plan ratified the awards and was sufficient to overcome the conflict
  - Appropriate standard should be the business judgment rule (plaintiff must show board's decision cannot be attributed to any rational business purpose – the standard for waste)

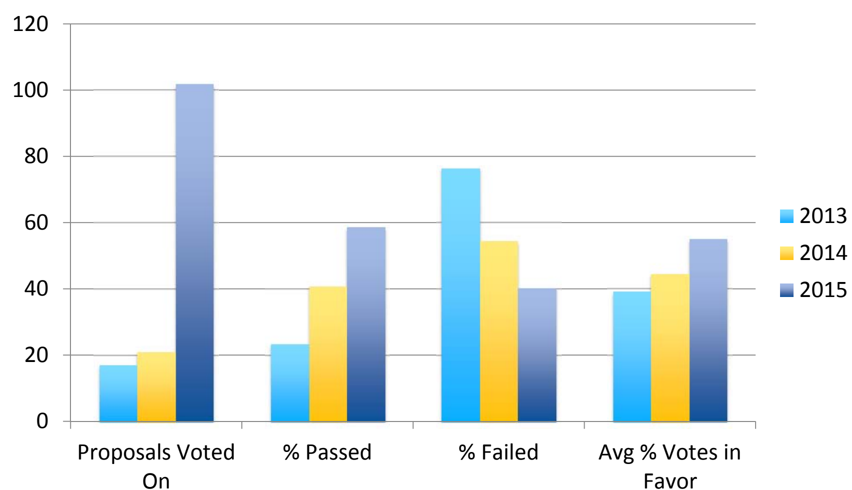
Director Compensation after *Calma*

- Court Held
  - The RSU grants were self-dealing decisions
  - "Blank check" approval from shareholders not sufficient to ratify awards
  - Shareholder approval of a plan with few limits on compensation not effective to approve the specific awards
  - As a result, the appropriate standard for review is "entire fairness", not waste
- Considerations
  - Are there limits or parameters on non-employee director awards? Formula plan?
  - If directors desire greater flexibility, consider ability to withstand "entire fairness" review or seek ratification of specific awards

Proxy Access

- Proxy Access permits shareholder-nominated directors to be included with management nominees in proxy statement and on proxy card
- It continues to be the major topic from last proxy season and is one of the most widely discussed governance initiatives in boardrooms
- Many institutional investors support it
  - Vanguard: "We consider it a meaningful tool that can promote accountability and protect shareholders' long-term interests. . . We also engaged with more than 60 recipients of shareholder proposals and urged them to adopt proxy access."

Proxy Access Proposals 2013-2015



Proxy Access – most common provisions and related questions

- Shareholder ownership requirement: 3%
  - Do loaned shares count as owned?
- Ownership duration: 3 years
  - Must shares continue to be held following the annual meeting?
- Group size limit to meet ownership requirements: 20
  - Activists prefer no limit
- Number of shareholder nominated candidates: 20%
  - Activists prefer 25%
- ISS will release new FAQs this month addressing which proxy access provisions it considers overly restrictive

Proxy Access Proposals – can they be excluded?

- For companies who have not implemented proxy access
  - The proposal will not be excludable under the “directly conflicts” exclusion (Rule 14a-8(i)(9)) if the company has a dueling management proposal for its own version of proxy access
- For companies who have implemented proxy access, a shareholder proposal proposing different proxy access terms may be excludable as having been "substantially implemented“ (Rule 14a-8(i)(10))
  - GE had adopted a proxy access bylaw with thresholds of 3%/3 years, with a cap of 20% of the board and a group limit of 20
  - GE received a shareholder proposal proposing proxy access with the same thresholds, but without the group limit
  - In Spring 2015, the SEC agreed it could be omitted

Proxy Access Proposals – can they be excluded?

- **However, the "second wave" of proxy access proposals that seek to "fix" the adopted bylaw provision might not be excludable under the "substantially implemented" exclusion**
  - This type of proposal seeks specific modification of the existing bylaw provisions, such as eliminating the group limit, allowing nomination of up to 25% of the board, etc.
- **In a speech to the ABA this Fall, Keith Higgins said that if a proposal is submitted that requests that the 20 person limit be eliminated, he wasn't sure what would "substantially implement" that proposal and that the standard might shift**

Universal Proxy Ballots

- **Universal proxy ballots allow shareholders to vote for management and proponent nominees on a single ballot in a contested election**
  - It would allow shareholders to use a proxy to mix and match nominees from different slates
  - Currently, in order to vote for nominees on different ballots, the shareholder must attend the meeting in person and vote
  - If a shareholder attempted to vote using two different proxies, the later dated proxy would revoke the earlier proxy
- **Universal ballots would be a powerful tool for shareholder activists when combined with proxy access**

Universal Proxy Ballots

- SEC Chair White has requested the Staff to prepare rulemaking recommendations relating to universal proxy ballots
  - The SEC originally considered universal ballots back in 1992
  - Last year, the CII petitioned the SEC for reforms to the proxy rules to "facilitate" use of universal proxies
  - As White stated, "[p]roviding shareholders with the same voting rights that they would have if they were present at the meeting and eliminating procedural obstacles should be a shared goal of both companies and shareholders"
- Not surprisingly, activists generally favor use of universal proxies and companies generally oppose
  - During the Trian-DuPont proxy contest, Trian requested that DuPont permit use of a universal proxy card as a best-in-class practice. DuPont said no.

Universal Proxy Ballots

- Questions and Considerations
  - Would universal proxy ballots embolden activists? Or encourage settlements?
  - Should universal proxy ballots be voluntary or mandatory?
  - Whether any eligibility requirements should be imposed on shareholders to use universal ballots?
  - What would the ballot look like?
  - Must both sides must use identical universal ballots?
- SEC Chair White encouraged companies to consider using universal proxies even though it is not required

Board Composition

- PwC's 2015 Annual Corporate Directors Survey
  - Nearly 40% of directors say someone on their board should be replaced
    - Top three reasons cited are diminished performance due to aging, unpreparedness for meetings, and lack of expertise
  - 95% of directors view diversity as at least a "somewhat" important director attribute
    - But, less than one quarter "very much" believe there is a sufficient number of qualified diverse candidates
    - Directors of the largest companies prioritize diversity more highly

Board Composition- tenure

- CalPERS is considering revisions to its Global Governance Principles relating to director tenure
  - Proposed revision - director independence can be compromised at 10 years of service
  - Internationally, recommended director tenure limits are common
    - UK Corporate Governance Code (9 years); European Commission (12 years); Hong-Kong (9 years); France (12 years)
  - But, only 3% of the S&P 500 have terms limits in their guidelines
- Benefits and risks of tenure limits
  - Benefits - increased independence and diversity, new perspective
  - Risks – lack of deep company knowledge, loss of valuable directors due to arbitrary measure

Preparing for this Proxy Season

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Shareholder Proposal Exclusions – SEC Guidance and the next battleground

- Many companies routinely seek to omit shareholder proposals for technical or substantive reasons
- Two of these exclusions were the subject of considerable attention in the last year
  - "ordinary business operations" (Rule 14a-8(i)(7))
  - "directly conflicts" (Rule 14a-8(i)(9))
- Many anticipate the next battleground will be the "substantially implemented" exclusion (Rule 14a-8(i)(10))
  - GE was able to omit a proxy access proposal which was slightly different from the proposal GE had already adopted

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Shareholder Proposal Exclusions

- "Ordinary business operations" exclusion: Trinity Wall Street v. Walmart
  - In 2013, Trinity submits shareholder proposal seeking a board policy to review the sale of dangerous products
  - Walmart sought to exclude the proposal under the "ordinary business operations" exclusion
    - The SEC granted a no-action letter
    - Litigation commenced
    - Ultimately, the Third Circuit permitted Walmart to omit the proposal from its proxy materials
  - The Third Circuit also encouraged the SEC to update and clarify its exemption standards for "social policy" issues
  - Trinity initially appealed the decision to the U.S. Supreme Court but withdrew the appeal after SLB 14H was issued

Shareholder Proposal Exclusions

- "Directly conflicts" exclusion: Whole Foods
- In late 2014, the SEC provided no-action relief to Whole Foods' to exclude a shareholder proxy access proposal in favor of a management proposal with much higher ownership threshold levels
  - In midst of 2015 proxy season, Ch. White called for a review of the SEC's approach to Rule 14a-8(i)(9)
  - The SEC thereafter took no position on no-action requests under that Rule

Shareholder Proposal Exclusions

- In October, the SEC published Staff Legal Bulletin 14H with guidance on 14a-8(i)(9) and 14a-8(i)(7)
- "directly conflicts" exclusion
  - Narrowed the exclusion significantly
  - direct conflict exists only if a reasonable shareholder could not logically vote in favor of both proposals
    - Shareholder proposal to reject a merger excludable as it directly conflicts with management proposal to approve merger
    - Shareholder proxy access proposal not excludable with dueling management proxy access proposal
- "ordinary business operations" exclusion
  - Reaffirms prior interpretation and application of exclusion
  - Proposals that focus on a "significant policy issue transcend a company's ordinary business operations and are not excludable under Rule 14a-8(i)(7)"

Audit Committee Disclosure

- In July, the SEC published a concept release seeking public comment on expanded disclosure requirements for audit committees
  - disclosure requirements relating to audit committees have not changed substantively in over 15 years
  - focus of the concept release is the relationship between the audit committee and auditor, but also sought comment on:
    - roles and responsibilities of the committee
    - committee qualifications
    - oversight of financial reporting, and
    - oversight of internal control over financial reporting
- The PCAOB is also considering initiatives regarding additional disclosure requirements related to the auditor

Audit Committee Disclosure

- Institutional investors and funds have been seeking additional information
  - In the 2015 proxy season, the United Brotherhood of Carpenters sent letters to 91 Fortune 500 companies seeking expanded disclosure regarding audit committee oversight and process
- The EY Center for Board Matters has reviewed the audit committee disclosure of the Fortune 100 for the past four years
  - From 2012 to 2015, the companies "significantly increased the information available about how they appoint, compensate and oversee their external auditors"
  - The study noted an emerging approach in 2015 that "retention disclosure was observed as some companies discussed the benefits of longer tenure while providing a description of measures to protect auditor independence"

Audit Committee Disclosure

- According to PwC's 2015 Annual Corporate Directors Survey,
  - approximately 10% of audit committee members say their boards are considering providing additional proxy disclosure pertaining to auditor compensation and tenure
  - over one-third already do so
- What are the perceived benefits and risks of expanded disclosure?

Omnicare – Liability for Statements of Opinions or Belief

- ***Omnicare Inc. et al. v. Laborers District Council Construction Industry Pension Fund et al.*** **(March 2015)**
  - Supreme Court addressed an issuer's liability under Section 11 for statements of opinion or belief contained in a registration statement
  - Section 11 of the Securities Act imposes liability if the issuer's registration statement either (i) contains an untrue statement of a material fact, or (ii) omits to state a material fact required to be stated or necessary to make the statements not misleading
  - Under Section 11, an investor need not prove that the issuer intended to deceive or defraud

Omnicare –Liability for Statements of Opinions or Belief

- **The Supreme Court found two possible bases for liability under Section 11 for opinions**
  - An untrue statement of material fact
    - An opinion is not an untrue fact if the issuer honestly believed the statement at the time it was made
      - "a sincere statement of pure opinion is not an "untrue statement of material fact," regardless whether an investor can ultimately prove the belief wrong"
    - An opinion statement can be considered an untrue statement if the statement contained embedded statements of fact that were untrue
      - "I believe our TVs have the highest resolution available because we use a patented technology to which our competitors do not have access."
      - The above statement contains both a belief and embedded fact – the use of patented technology

Omnicare – Liability for Statements of Opinions or Belief

- Omits to state a material fact
  - Context of the opinion and the surrounding language are relevant, statements are not viewed in a vacuum
  - "if a registration statement omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor . . .would take from the statement itself, then §11's omissions clause creates liability."
  - "And the investor takes into account the customs and practices of the relevant industry. . . The reasonable investor understands a statement of opinion in its full context, and §11 creates liability only for the omission of material facts that cannot be squared with such a fair reading."

Omnicare – Liability for Statements of Opinions or Belief

- Takeaways
  - Review non-factual statements in SEC filings to determine if they are true opinions or forward-looking statements
    - Forward-looking statements should be identified as such
    - provide meaningful cautionary disclosure identifying important facts that could cause actual results to materially differ
  - For true opinion statements, consider disclosing:
    - the basis for the opinion, or
    - the real tentativeness of the issuer's belief

Voting Standard Disclosure

- Check the description of voting requirements, particularly relating to the election of directors, for clarity and accuracy
- CII submitted a rulemaking petition in June 2015 (echoing the petition made by the United Brotherhood of Carpenters in 2011)
  - Requested Staff guidance regarding disclosure of voting requirements for items on the ballot and the presentation of voting options on proxy cards
  - Noted that proxy descriptions are sometimes inaccurate or ambiguous
  - Some issuers describe "plurality plus" as "majority voting"
    - "plurality plus" requires a nominee who receives more votes "withheld" than votes "for" is required to tender his or her resignation for consideration by the board
  - Some companies with standards described as majority voting, only provided shareholders with the option to vote "For" and "Withhold" but not "Against"

ISS 2016 Guidelines

- ISS (and Glass Lewis) updated guidelines apply to meetings held on or after February 1, 2016
- Director Overboarding
  - Beginning in 2017, ISS will recommend against a director other than the CEO who serves on a total of more than five public company boards (a reduction from the current six)
  - For CEOs, the limit remains at two public company boards (besides their own)
  - 2016 will be a transition year during which ISS will issue cautionary language when a director serves on more than five public company boards, but adverse voting recommendations will not be issued unless the current limit of six boards is exceeded

ISS 2016 Guidelines

- Unilateral Board Actions
  - ISS will continue to issue adverse vote recommendations for directors who have unilaterally adopted charter or bylaw provisions that significantly reduce shareholder rights without approval by shareholders
    - Actions include adopting a classified board structure, implementing supermajority voting requirements to amend the bylaws or charter or eliminating the ability of shareholders to amend the bylaws
    - The adverse vote recommendation will continue until the action is unwound or ratified by shareholders
    - The prior policy only called for an adverse vote recommendation at the next annual meeting
- Externally-managed Issuer (EMI) Problematic Pay Practice
  - Insufficient disclosure to reasonably assess compensation for the NEOs will be deemed to be a problematic pay practice, and generally warrant a recommendation to vote against the say-on-pay proposal
- Companies may submit updated self-selected peer groups through December 11, 2015.

Glass Lewis 2016 Guidelines

- Director Overboarding
  - Beginning in 2017, it will recommend against a director who
    - serves as an executive officer of any public company while serving on more than one public company board (besides their own), and
    - any other director who serves on a total of more than five public company boards
    - Like ISS, 2016 will be a transition period when it will note the concern of overboarding but not issue a negative recommendation on that basis
- Environmental and Social Risk Management
  - Will recommend against directors responsible for risk oversight where the board or management has failed to sufficiently identify and manage a material environmental or social risk that did or could negatively impact shareholder value
- Nominating Committee Chairman
  - May recommend against the chair of the nominating committee where the board's failure to ensure that the board has directors with relevant experience, either through periodic director assessment or board refreshment, has contributed to a company's poor performance

Glass Lewis 2016 Guidelines

- Conflicting Proposals. When determining whether to support conflicting management and shareholder proposals, Glass Lewis will consider the following:
  - The nature of the underlying issue;
  - The benefit to shareholders from implementation of the proposal;
  - The materiality of the differences between the terms of the shareholder proposal and management proposal;
  - The appropriateness of the provisions in the context of a company's shareholder base, corporate structure and other relevant circumstances; and
  - A company's overall governance profile and, specifically, its responsiveness to shareholders as evidenced by a company's response to previous shareholder proposals and its adoption of progressive shareholder rights provisions
- U.S. companies in the Russell 3000 Index may submit an new self-selected peer group by December 31

Preparing Now for Future Proxy Seasons

CEO Pay Ratio – no disclosure yet, but time to starting thinking about it

- New Item 402(u) of Regulation S-K requires disclosure of the ratio of:
  - the median of the annual total compensation of all employees of the reporting issuer, except its principal executive officer (the "PEO");and
  - the annual total compensation of its PEO
- Disclosure is required with respect to the first full fiscal year starting on or after January 1, 2017
  - For most calendar-year reporting companies, the first required pay ratio disclosure will be in the proxy statement for their 2018 annual meeting

CEO Pay Ratio – who is included?

- Who is an Employee for the calculation?
  - It includes all employees, even part-time, temporary and seasonal employees
  - However, employees and independent contractors whose compensation is set by unaffiliated third parties are not counted as employees
- Limited Exemptions for Non-US Employees
  - As a result of data privacy laws of foreign countries
  - A de minimis exemption for up to 5% of total employees who are non-U.S. employees
- Who is the "Median Employee"?
  - Generally identified once every three years
  - Permitted to select a date within the last three months of its last completed fiscal year
    - This can be an important consideration for companies with significant seasonal fluctuations

CEO Pay Ratio

- Additional disclosure permitted (not required)
  - Companies may supplement the required pay ratio disclosure with
    - narrative discussion, or
    - additional ratios
  - Any additional discussion or ratios must be
    - clearly identified,
    - not misleading, and
    - not presented with greater prominence than the required pay ratio

CEO Pay Ratio – everyone knows this is meaningless, why should we care?

- External Considerations
  - Many institutional investors do not consider this useful or meaningful information
  - The published ratio will likely be utilized by shareholder activists
  - The ratio will be fodder for the press, but the press will likely focus on the largest and most well-known companies
  - Will the company's customer base care about the ratio?
- Internal Considerations
  - Employee morale
  - Labor negotiations (unions have been long-time supporters of this disclosure)

FAST Act (which won't be that fast)

- **Fixing America's Surface Transportation Act (the FAST Act) enacted December 4, 2015**
- **Mostly a transportation bill, but also includes provisions relating to capital raising and public company reporting**
- **Within 180 days, the SEC must:**
  - **issue regulations permitting issuers to submit a 10-K summary page, so long as each item on the summary page includes a cross-reference (by electronic link or otherwise) to the related material in the 10-K**
  - **revise Regulation S-K:**
    - **to further scale or eliminate requirements of Regulation S-K to reduce the burden on EGCs, accelerated filers, smaller reporting companies and other smaller issuers, while still providing all material information to investors;**
    - **to eliminate provisions of Regulation S-K, for all issuers, that are duplicative, overlapping, outdated or unnecessary; and**
    - **that the SEC determines no further study (below) to be necessary to determine their efficacy.**

FAST Act

- **Within 360 days, the SEC must:**
- **conduct a study of Regulation S-K and issue a report to Congress:**
  - **to determine how best to modernize and simplify it while still providing all material information;**
  - **to emphasize a company-by-company approach that avoids boilerplate or static requirements while preserving completeness and comparability of information across registrants; and**
  - **to evaluate methods of information delivery and presentation and explore methods for discouraging repetition and the disclosure of immaterial information.**
- **Proposed rules due 360 days after the study**

Proposed Clawback Policies

- Proposed July 2015
- Listed companies must adopt and publish clawback policies as required by their securities exchange
- Recovery would be required from:
  - any current or former executive officer
  - who received incentive-based compensation during the three fiscal years preceding the date on which the issuer is required to prepare an accounting restatement to correct a material error
  - whether or not any misconduct occurred or the executive officer had responsibility for the error in the financial statements

Proposed Clawback Policies

- The recovery amount equals the excess over the amount the executive officer *would have received* had the incentive-based compensation been determined based on the restated financial statements
- Following restatements, the issuer must disclose specified, detailed information regarding the amounts subject to clawback
- Most concerning, the proposed rules
  - impose a “no fault” clawback requirement on a broad group of the issuer’s officers
  - cover incentive-based compensation that is tied not only to financial reporting measures, but also to stock price and total shareholder return, and
  - provide limited discretion for an issuer’s compensation committee to determine not to pursue a clawback

Proposed Pay for Performance

- Proposed April 2015
- Disclosure intended to show relationship between compensation actually paid to executives and the financial performance of the company
- If adopted as proposed, proxy statements would include a table covering five years (three for smaller reporting issuers) showing
  - Executive compensation actually paid to the CEO, which would be the total compensation as disclosed in the summary compensation table already required in the proxy statement with adjustments to the amounts included for pensions and equity awards
  - Average compensation actually paid to the remaining NEOs
  - Total executive compensation paid to the CEO as reported in the summary compensation table
  - Average total executive compensation paid to the remaining NEOs
  - The company's total shareholder return (TSR) on an annual basis
  - The TSR on an annual basis of the companies in a peer group, using the peer group identified by the company in its stock performance graph or in its CD&A

Proposed Pay for Performance

- Graphical or narrative description of the relationship between
  - the executive compensation actually paid and the company's TSR, and
  - and the relationship between the company's TSR and the TSR of its selected peer group

Proposed Hedging Disclosure

- Proposed February 2015
- Proxy statement disclosure
- Covers directors, officers and employees
- Companies must disclose if hedging transactions or similar transactions to offset any decrease in market price are permitted with respect to
  - equity securities granted to the director, officer or employee as compensation, or
  - held directly or indirectly by the director, officer or employee
- Many companies already include disclosure on their hedging policies

Payments by Resource Extraction Issuers – resurrected from the dead

- Dodd-Frank mandated disclosure from natural resource companies of payments to the U.S. government or foreign governments for the purpose of the commercial development of oil, natural gas, or minerals
  - Original rules vacated in 2013, but not yet re-proposed
  - Oxfam America, Inc. brought an action in an effort to expedite the long-delayed rules
- On September 2, a federal judge gave the SEC 30 days to file with the court an expedited schedule to finalize the rules
  - The SEC schedule calls for proposed rules by year-end and on the final rules by June 27, 2016
  - The SEC noted a number of reasons that the schedule may not be met

Conflict Minerals

Conflict Minerals

- The SEC's current guidance remains in place, which provides:
  - No requirement to describe products as "DRC conflict free," having "not been found to be 'DRC conflict free,'" or "DRC conflict undeterminable;" and
  - No independent private sector audit is required unless a company voluntarily elects to describe a product as "DRC conflict free"
- At some point we expect the SEC to modify the guidance and require audits
- Tulane University and Assent Compliance published the second annual "Dodd-Frank Section 1502 – RY2014 Filing Evaluation" which reviewed all 1,267 filings for legal compliance and good governance
  - The full results were released in November
  - The study includes some measurements in the legal compliance score that aren't actually legally required
  - If it cares, an issuer can revise its disclosure in 2016 next year to match the requirements of the study in order to boost its score

Thanks for joining us today!

Questions?

February 10, 2015

SEC Issues Proposed Rules for Director, Officer and Employee Hedging Disclosures

Charles F. Sawyer and Rachel Benedict

On February 9, the Securities and Exchange Commission proposed rules to implement Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires annual meeting proxy statement disclosure of a company's policy on hedging transactions by directors, officers or employees. The proposed rules can be found at http://www.sec.gov/rules/proposed/2015/33-9723.pdf.

Currently, companies are required to disclose any policies that address hedging activities by named executive officers in the Compensation Discussion and Analysis. Additionally, the disclosure of officer and director ownership of company stock required under Item 403(b) of Regulation S-K also requires disclosure of the amount of shares that have been pledged as security for hedging transactions.

The proposed rules add a new paragraph (i) to Item 407 of Regulation S-K and require companies to disclose, in their proxy or information statements with respect to the election of directors, company policy regarding hedging transactions. The proposed rules require disclosure of whether the company has a hedging policy and, if the company has a policy, what the policy prohibits and does not prohibit. In particular, the company must describe its policies with respect to:

- any type of transaction that offsets decreases in the market value of equity securities;
- hedging transactions by any director or employee (including officers) of the company; and
- hedging transactions related to any equity securities of the company, a parent of the company, a subsidiary of the company or a subsidiary of a parent of the company, that are registered under Section 12 of the Exchange Act.

The proposed disclosure rules cover hedging transactions by a much broader group of individuals than the existing rules, but do not require companies to adopt policies addressing hedging transactions or that such policies, if adopted, comprehensively prohibit hedging transactions. Nevertheless, companies should take this opportunity to review their insider trading policy and code of conduct and to consider whether they adequately address the company's policies on hedging transactions. We invite you to reach out to us for any assistance you may require as you review your policies and consider how to prepare for the upcoming hedging policy disclosure requirements.

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DORSEY

CORPORATE UPDATE

A PUBLICATION OF THE CORPORATE GROUP OF DORSEY & WHITNEY LLP

June 8, 2015

SEC Staff Issues Economic Analysis Related to the Proposed Pay Ratio Rule

David Marx and Michael Newton

On June 4, 2015, the SEC staff issued an economic analysis related to its proposed pay ratio rule. This economic analysis, conducted by the SEC's Division of Economic and Risk Analysis, looks at the potential effects on the pay ratio calculation when different percentages of employees are excluded from the calculation. The SEC's staff believes that the analysis will help in evaluating the potential effects on the accuracy of the pay ratio calculation of excluding different percentages of certain categories of employees.

This economic analysis relates to the SEC's pay ratio rule that was proposed initially in September 2013. The proposed rule would add a new paragraph to Item 402 of Regulation S-K that would require disclosure of the following:

- the median of the annual total compensation of all employees of a company, except for the principal executive officer,
- the annual total compensation of the principal executive officer of a company, and
- the ratio of the median of the annual total compensation of all employees to the annual total compensation of a company's principal executive officer.

Some commenters to the proposed rule suggested that certain employees should be excluded from the pay ratio, such as part-time, foreign, seasonal and temporary employees. The SEC's economic analysis is meant to evaluate the potential effects on the pay ratio if different percentages of these employees are excluded from the pay ratio calculation. The SEC will accept comments on the proposed rules until July 6, 2015.

The SEC determined in its analysis that excluding some employees from the determination of median employee compensation may affect the pay ratio calculation. For example, according to the study, the exclusion of 15% of a company's employees may potentially decrease or increase the pay ratio estimate by up to 9.9% or 11%. The full text of the analysis, including a description of the different variables that may affect the pay ratio calculation can be found at http://www.sec.gov/comments/s7-07-13/s70713-1556.pdf

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July 1, 2015

SEC Issues Proposed Rules for Clawback Policies and Related Disclosure

Jason Brenkert and Kimberley R. Anderson

On July 1, 2015, the Securities and Exchange Commission proposed rules regarding clawback policies and disclosure, requiring the recovery of incentive-based compensation of officers in cases of material non-compliance with accounting reporting requirements. These proposed rules are required by Section 10D of the Securities Exchange Act of 1934, as added by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The rules would be implemented through new listing standards to be adopted by national securities exchanges. The proposed rules were approved by a 3-2 vote of the Commission and drew sharp criticism from Commissioners Gallagher and Piwowar. Commissioner Gallagher referred to the proposed rules as the Commission's "newest Goya, tortured and nightmarish." The proposed rules can be found at http://www.sec.gov/news/pressrelease/2015-136.html.

The proposed rules impose significant additional detailed requirements to the framework established by Dodd Frank and Section 10D. Of particular concern to issuers is the sweeping scope of the proposed rules. They (i) impose a "no fault" clawback requirement on a broad group of the issuer's officers, (ii) cover incentive-based compensation that is tied not only to financial reporting measures, but also to stock price and total shareholder return, and (iii) provide limited discretion for an issuer's compensation committee to determine not to pursue a clawback. Further, as proposed, emerging growth companies, smaller reporting companies and foreign private issuers are not exempt from the rules.

The proposed rules would add a new Exchange Act Rule 10D-1 and amend Regulation S-K, Form 20-F and Form 40-F to address the new clawback requirements for listed companies.

As proposed, the clawback regime for listed companies would include the following features:

- Listed companies must adopt and publish clawback policies as required by their applicable securities exchange.
- Recovery would be required from any current or former executive officer who received incentive-based compensation during the three fiscal years preceding the date on which the issuer is required to prepare an accounting restatement to correct a material error. The recovery would be required regardless of whether any misconduct occurred or whether an executive officer had responsibility for the error in the financial statements.

- Incentive-based compensation would be deemed “received” for purposes of triggering the recovery policy in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award is attained, even if the payment or grant occurs after the end of that period.

- The executive officer definition in the proposed rules tracks the definition of an “officer” under Section 16 of the Exchange Act, which is much broader than the named executive officer definition for whom compensation disclosure is required in a company’s proxy statement. The proposed definition includes an issuer's president, principal financial officer, principal accounting officer, any vice-president of the issuer in charge of a principal business unit, division or function, any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer. Officers of the issuer's parent or subsidiaries may fall within the proposed definition, if they perform such policy-making functions for the issuer.

- “Incentive-based compensation” is defined as compensation granted, earned or vested, based wholly or in part on the attainment of any financial reporting measure. “Financial reporting measures” are those based on the accounting principles used in preparing the issuer’s financial statements, any measures derived wholly or in part from such financial information, and stock price and total shareholder return.

- The recovery amount equals the amount of incentive-based compensation received by an executive officer that exceeds the amount the executive officer would have received had the incentive-based compensation been determined based on the restated financial statements.

- If the incentive-based compensation is based on stock price or total shareholder return, companies are permitted to use a “reasonable estimate” of the effect of the accounting restatement to determine the recovery amount.

- Companies are required to pursue recovery of **all** incentive-based compensation, except under two limited circumstances. Recovery is not required if the committee of independent directors that is responsible for executive compensation decisions (or, if there is no such committee, a majority of the board’s independent directors) determines that (i) it would be impracticable to seek recovery because the direct expense of seeking recovery would exceed the recoverable amounts, or (ii) for foreign issuers, it would violate the issuer’s home country law. The proposed rules impose the following additional conditions if an issuer desires to use these exceptions:

  - **Expense exceeds recovery amount exception**: The issuer must make a reasonable attempt to recover applicable incentive-based compensation, document attempts to recover the applicable incentive-based compensation, and provide the documentation to its securities exchange.

  - **Foreign law exception**: The foreign issuer must obtain an opinion of foreign local counsel that recovery violates the issuer's home country law. This opinion will only be accepted with respect to home country laws adopted prior to the date of publication of proposed Rule 10D-1 in the Federal Register.

- The proposed rules would also add requirements to Item 402 of Regulation S-K as well as require the listed issuer's clawback policy to be added as an exhibit to the issuer's annual report (Form 10-K, 20-F or 40-F). In addition, if, at any time during its last completed fiscal year, either (i) a restatement that required recovery of excess incentive-based compensation pursuant to the issuer's compensation recovery policy was completed or (ii) there was an outstanding balance of excess incentive-based compensation from the application of that policy to a prior restatement, the following disclosure items must be included:

  - For each restatement, the date on which the issuer was required to prepare an accounting restatement, the aggregate dollar amount of excess incentive-based compensation attributable to such accounting restatement and the aggregate dollar amount of excess incentive-based compensation that remains outstanding at the end of its last completed fiscal year.

  - The estimates used to determine the excess incentive-based compensation attributable to such accounting restatement, if the incentive payment related to a stock price or total shareholder return metric.

  - The name of each person subject to recovery of excess incentive-based compensation attributable to an accounting restatement, from whom the issuer decided during the last completed fiscal year not to pursue recovery, the recovery amount forgone for each such person, and a brief description of the reason the issuer decided in each case not to pursue recovery.

  - The name of, and amount due from, each person from whom, at the end of the issuer's last completed fiscal year, excess incentive-based compensation had been outstanding for 180 days or longer since the date the issuer determined the amount the person owed.

  - Issuers would also be required to block tag the disclosure using XBRL.

- Issuers are not permitted to indemnify officers against any amounts recovered under its clawback policies or to pay premiums on an insurance policy covering an officer's potential clawback obligations. This is similar to the SEC's position that liability for short-swing profits under Section 16(b) of the Exchange Act may not be indemnified or insured.

We expect significant comments to be submitted regarding the proposed rules, and do not expect the rules to be in place for next year's annual report/proxy season. Nevertheless, issuers should take this opportunity to review their current clawback policies and incentive-based compensation plans to determine how the proposed rules could impact the issuer's compensation policies.

We invite you to reach out to us for any assistance you may require as you review your policies and plans and consider how to prepare for the upcoming clawback requirements.

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DORSEY

CORPORATE UPDATE

A PUBLICATION OF THE CORPORATE GROUP OF DORSEY & WHITNEY LLP

July 2, 2015

SEC Publishes Concept Release on Audit Committee Disclosures

Kimberley R. Anderson

On July 1, 2015, the Securities and Exchange Commission published its long-expected concept release seeking public comment on expanded disclosure requirements for audit committees. The Commission noted that, although audit committees play a vital role overseeing a company's independent auditor, the disclosure requirements relating to audit committees have not changed substantively in over 15 years. While the focus of the concept release is on the audit committee and auditor relationship, the Commission has invited public comment on other aspects of audit committee disclosures, including roles and responsibilities of the committee, committee qualifications, oversight of financial reporting, and oversight of internal control over financial reporting. The concept release can be found at https://www.sec.gov/rules/concept/2015/33-9862.pdf.

The Commission noted that voluntary disclosure of audit committee activity has been increasing in recent years. In addition, some investor groups, such as the Council of Institutional Investors, have called for additional disclosure from audit committees. Further, other jurisdictions outside the United States are looking into expanded audit committee disclosures. The Public Company Accounting Oversight Board (the "PCAOB") is also considering initiatives regarding additional disclosure requirements related to the auditor, including a requirement that the auditor disclose the auditor's tenure in the auditor's report. Another PCAOB proposal would require the auditor to disclose in the audit report (i) the name of the engagement partner; (ii) the names, locations, and extent of participation of other independent public accounting firms that took part in the audit; and (iii) the locations and extent of participation, on an aggregate basis by country, of certain nonaccounting firm participants in the audit. In response to concerns over potential liability, the PCAOB is considering other locations for the proposed disclosure.

The Commission is specifically seeking public comment regarding the following potential changes to audit committee disclosures:

- The audit committee's oversight of the auditor
  - Additional information regarding the communications between the audit committee and the auditor, such as the audit committee's consideration of the required communications with the auditor; the fact that those communications occurred would no longer be sufficient
  - The number of times the audit committee met with the auditor
  - Whether the audit committee has reviewed and discussed with the auditor its internal quality review and most recent PCAOB inspection report

    - Whether, and if so, how, the audit committee assesses, promotes and reinforces the auditor's objectivity and professional skepticism

- The audit committee's process for selecting the auditor

    - How the audit committee assessed the auditor, including the auditor's independence, objectivity and audit quality, as well as its rationale for selecting or retaining the auditor. This could include disclosure of the criteria considered by the audit committee

    - If the audit committee sought requests for proposal for the independent audit, the process the audit committee used to seek the proposals and the factors considered in the selection. This could include the number of auditors asked to submit proposals

    - The Board of Directors' policy, if any, for an annual shareholder vote to ratify the selection of the auditor, and whether the audit committee considers the results of the vote in selecting the audit firm

- The audit committee's consideration of the qualifications of the audit firm and certain members of the engagement team when selecting the audit firm

    - Identification of the engagement partner or additional members of the engagement team, the length of time they have served in their respective roles, and descriptions of their experience

    - The involvement of the audit committee in selecting the engagement partner

    - The number of years the auditor has audited the company

    - Identification of other firms, such as affiliated or non-affiliated accounting firms, tax advisors or actuaries, involved in the audit

The Commission is also seeking public comment on (i) whether audit committee disclosures should be part of registration statements and prospectuses in registered offerings, as those disclosures may inform investment decisions, and (ii) the application of audit committee disclosure requirements to smaller reporting companies and emerging growth companies.

Given the increasing interest in audit committee disclosures, we expect significant public response to the concept release and for the Commission to propose rules regarding enhanced audit committee disclosures. Issuers should take this opportunity to discuss with their audit committees the potential expansion of audit committee disclosures. We invite you to reach out to us for any assistance in understanding the potential changes to disclosure outlined in the concept release. Additionally, we intend to submit comments to the Commission in response to the concept release and welcome your input.

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August 6, 2015

SEC Issues Final Rule for Pay Ratio Disclosure

Jason Brenkert and Whitney Holmes

On August 5, 2015, the Securities and Exchange Commission (the "SEC") approved its final rule subjecting most public companies to the so-called "Pay Ratio Disclosure" mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The final pay ratio rule requires annual disclosure of the ratio of a reporting company's principal executive officer's total annual compensation to the median of the total annual compensation of all its employees. The final rule can be found at http://www.sec.gov/rules/final/2015/33-9877.pdf.

Most public companies will be required to make the pay ratio disclosure following their first full fiscal year beginning on or after January 1, 2017. For a typical, calendar-year reporting company, the first pay ratio disclosure would be made in its proxy statement for its 2018 annual meeting. Smaller reporting companies, emerging growth companies and foreign private issuers are exempt from the disclosure requirements and are given a one-year transition period to comply with the disclosure requirements if they lose their exempt status.

The final rule addresses several concerns raised by the SEC's September 18, 2013 proposed pay ratio rule. Nevertheless, compliance with the pay ratio disclosure requirement will be a significant additional burden on reporting companies.

Changes from the Proposed Rule

The following differences between the final rule and the proposed rule should provide some relief to the compliance burden on reporting companies:

- As mentioned above, the final rule pushes out the initial compliance date by a year, to follow the reporting company's first full fiscal year beginning on or after January 1, 2017.
- The final rule permits a reporting company to determine its median employee every three years, unless there has been a change in its employee population or employee compensation arrangements that it reasonably believes would result in a significant change in its pay ratio disclosure.
- The final rule permits a reporting company to exclude non-U.S. employees under two limited circumstances: (i) non-U.S. employees may be excluded if compliance with the rules for determination of the median employee would violate the data privacy laws of the foreign jurisdiction in which the non-U.S. employee is located; and (ii) non-U.S. employees consisting of up to 5% of the

reporting company's total employees may be excluded pursuant to a *de minimis* exemption.

- The final rule requires a reporting company to include employees of a subsidiary only if the subsidiary is consolidated with the reporting company in preparing its financial statements.

- The final rule permits a reporting company to select any date within three months prior to the last day of its last completed fiscal year to determine who is an employee for purposes of determining the median employee of the reporting company.

- The final rule grants new reporting companies, smaller reporting companies, emerging growth companies, and foreign private issuers a transition period following registration or loss of exempt status before they will be required to comply with the pay ratio disclosure requirements.

Summary of the New Pay Ratio Disclosure Requirements

General

The final rule adds a new paragraph (u) to Item 402 of Regulation S-K, which requires disclosure of:

(A) the median of the annual total compensation of all employees of the reporting company, except the reporting company's principal executive officer (as defined in Item 402, the "PEO");

(B) the annual total compensation of the reporting company's PEO; and

(C) the ratio of the amount in (B) to the amount in (A), presented as a ratio in which the amount in (A) equals one, or, alternatively, expressed narratively in terms of the multiple that the amount in (B) bears to the amount in (A).

Companies subject to the final rule will be required to include the pay ratio disclosure in registration statements, proxy and information statements, and annual reports that are currently required to include executive compensation information pursuant to Item 402 of Regulation S-K and the requirements of the relevant form. The pay ratio disclosure is not required in reports that do not require executive compensation information under Item 402 of Regulation S-K, such as current reports on Form 8-K and quarterly reports on Form 10-Q. As a result, the pay ratio disclosure will be included with a reporting company's annual executive compensation disclosure—typically in its the annual proxy statement but, in any event, not later than 120 days after the end of each fiscal year.

Determination of Employees

"Employee" is defined as an individual employed on any date of the reporting company's choosing within the last three months of its last completed fiscal year. Subject to limited exceptions, all U.S. and non-U.S. full-time, part-time, temporary and seasonal employees of the reporting company or any of its consolidated subsidiaries are to be included in the pay ratio

calculation. Employees of unaffiliated third parties or independent contractors are not considered employees. Employees acquired in a business combination or acquisition transaction may be omitted in the fiscal year the transaction occurred, but the reporting company must disclose the transaction and the approximate number of employees omitted.

Non-U.S. employees may be excluded in two circumstances:

- *Foreign Data Privacy Laws* – A reporting company may exclude its non-U.S. employees who are employed in a jurisdiction where data privacy laws would be violated by compliance with the pay ratio disclosure requirement. To rely on this exclusion, however, the reporting company must: (i) use reasonable efforts to obtain the information necessary for compliance, including seeking an exemption or other relief under the applicable data privacy law or regulation and (ii) obtain a legal opinion from counsel on the inability of the reporting company to obtain or process the information necessary for compliance with the rule without violating the jurisdiction's data privacy laws or regulations.

- *De Minimis Exemption* – Reporting companies may exclude non-U.S. employees consisting of up to 5% of their total employees in the following cases:

  - Reporting companies whose non-U.S. employees make up 5% or less of their total U.S. and non-U.S. employees may exclude all non-U.S. employees when identifying their median employee. A reporting company choosing to exclude any non-U.S. employees under this exemption must exclude all of them.

  - Reporting companies with more than 5% non-U.S. employees may also exclude non-U.S. employees up to the 5% threshold, provided that, if such a company excludes any non-U.S. employees in a specific foreign jurisdiction, it must exclude all employees in that jurisdiction.

Non-U.S. employees excluded under the data privacy law exclusion are included in the de minimis calculations as excluded non-U.S. employees.

Reporting companies may, but are not required to, annualize the total compensation for a permanent, full-time or part-time employee who did not work for the entire year. By contrast, full-time equivalent adjustments for part-time workers and annualizing adjustments for temporary and seasonal workers are not permitted when calculating the required pay ratio.

Identification of Median Employee

To meet the requirement of reporting the median of the annual total compensation of all employees, the final rule establishes a two-step process: (1) use a compensation measure methodology to determine a median employee of the reporting company and (2) once the median employee is selected, use the compensation disclosure requirements of Item 402(c)(2)(x) to determine that median employee's annual compensation. In identifying the median employee, the final rule permits each reporting company to select any reasonable methodology for compensation measure based on that specific company's own facts and circumstances. The adopting release mentions using, for example:

- Annual total compensation as determined under existing executive compensation rules;
- Any consistently-applied compensation measure from compensation amounts reported in its payroll or tax records; and
- Use of statistical sampling or reasonable estimates.

A reporting company is permitted to make a cost-of-living adjustment to the compensation measure used to identify the median employee for employees that live in a different jurisdiction than the PEO, provided that the adjustment is applied to all such employees included in the calculation. The adjustment would be to the cost-of-living of the jurisdiction of the PEO. If a reporting company applies this adjustment, it is required to use the same cost-of-living adjustment in calculating the median employee's annual total compensation under Item 402(c)(2)(x) of Regulation S-K. A reporting company must still disclose the median employee's annual total compensation and the pay ratio without any cost-of-living adjustment.

As mentioned above, the final rule permits a reporting company to determine the median employee only once every three years unless there has been a change in its employee population or employee compensation arrangements that it reasonably believes would result in a significant change to its pay ratio disclosure. The final rule also permits that if within those three years the median employee's compensation changes in a way that the company reasonably believes would result in a significant change in the pay ratio or the median employee is no longer employed, the reporting company may choose a new median employee by selecting another employee with a substantially similar compensation position as held by the previous median employee. In any case, a reporting company must still calculate the identified median employee's annual total compensation and use that figure in calculating its pay ratio every year.

Determination of Total Annual Compensation of the Median Employee

A reporting company is required to calculate the annual total compensation for its median employee using the same rules for calculating the PEO's annual total compensation as reported in the Summary Compensation Table of its proxy statement or information circular. The final rule allows reporting companies to use reasonable estimates when calculating any elements of the annual total compensation.

PEO Annual Compensation

Calculation of the annual total compensation of the PEO is made in accordance with existing requirements under Item 402(c)(2)(x) of Regulation S-K and is the number reported for the PEO in the reporting company's Summary Compensation Table disclosure. In situations where the reporting company has had more than one PEO during the course of the last completed fiscal year, the final rule provides two choices: (i) a reporting company may take the total compensation calculated pursuant to Item 402(c)(2)(x), and reflected in the Summary Compensation Table, provided to each person who served as PEO during the fiscal year and combine those figures, or (ii) a reporting company may look to the PEO serving in that position on the date it selects to identify the median employee and annualize that PEO's compensation.

Additional Disclosure Permitted But Not Required

Reporting companies are permitted, but not required, to supplement the required disclosure with a narrative discussion or additional ratios. Any additional discussion and/or ratios would need to be clearly identified, not misleading, and not presented with greater prominence than the required pay ratio.

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DORSEY

CORPORATE UPDATE

A PUBLICATION OF THE CORPORATE GROUP OF DORSEY & WHITNEY LLP

September 17, 2015

Do You Know Where Your Manually Signed Signature Pages Are?

Peter Skrief

On September 8, 2015, the Securities and Exchange Commission settled an enforcement action against a company for, among other violations, a failure to manually sign and retain signature pages, as required by Rule 302 of Regulation S-T under the Securities Exchange Act of 1934. The other violations include a failure to disclose certain related-party transactions with a major customer, accounting improprieties and issuances of the company's stock without an effective registration statement or exemption from registration. In light of the other violations, the failure to manually sign and retain signature pages may appear insignificant. The finding by the Commission, however, of a separate violation for such failure in this enforcement action is unusual, if not unprecedented, and should serve as a strong reminder of this requirement.

Rule 302 requires that (1) a signatory to an electronic filing manually sign the signature page either before or at the time of the electronic filing; (2) the filer retain the original executed document for five years; and (3) the filer provide the Commission staff with a copy of the document upon request. This includes Section 16 filings.

The company failed to maintain signed signature pages for most of its filings with the Commission from 2010 through 2013. Specifically, the company failed to receive or maintain any manually signed signature pages prior to December 2012. After December 2012, while the company had made over 23 filings with the Commission, it only received or maintained fully signed, original signature pages on eight filings.

This enforcement action should prompt all filers to confirm that they have procedures in place to obtain manually-signed signature pages for all electronic filings with the Commission and retain those pages for five years.

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CORPORATE UPDATE

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October 6, 2015

SEC and Amnesty International Seek *En Banc* Rehearing of Decision in Ongoing Conflict Minerals Court Battle

Kimberley R. Anderson

On Friday, the SEC and Amnesty International each filed petitions seeking a rehearing *en banc* of the August 2015 panel opinion of the U.S. Court of Appeals for the District of Columbia Circuit regarding the conflict minerals rules. The August 2015 panel decision reaffirmed the April 2014 decision, which concluded that the requirement that public companies report to the SEC and the public whether any of their products are "DRC conflict free," or have "not been found to be 'DRC conflict free,'" violates the First Amendment right to free speech.

In its petition, the SEC stated that it believed an *en banc* rehearing is warranted because the August panel opinion conflicts with both Supreme Court precedent as well as the recent *en banc* decision in American Meat Institute v. U.S. Department of Agriculture, which upheld country-of-origin labelling requirements for meat products.

While the future of the litigation is uncertain, these petitions do not impact the current guidance issued by the SEC's Division of Corporation Finance in response to the April 2014 decision. As a reminder, that guidance provides:

- No company is required to describe its products as "DRC conflict free," having "not been found to be 'DRC conflict free,'" or "DRC conflict undeterminable;" and
- An independent private sector audit will not be required unless a company voluntarily elects to describe a product as "DRC conflict free" in its Conflict Minerals Report.

Given the current status of the litigation, it seems unlikely that this guidance will change for the 2015 reporting period. As a result, we do not expect that companies will be required to obtain independent private sector audits for the filings due in 2016 unless a company voluntarily elects to describe a product as "DRC conflict free."

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October 6, 2015

SEC Proposes Schedule for Disclosure Rules Regarding Payments by Resource Extraction Issuers – Final Rules by June 27, 2016

Kimberley R. Anderson

On September 2, a federal judge held that the SEC had "unlawfully withheld" agency action by failing to promulgate final rules requiring disclosure of government payments by resource extraction issuers and gave the SEC 30 days to file with the court an expedited schedule to finalize the rules. On October 2, the SEC filed a notice with the court outlining a proposed schedule calling for a vote on the proposed rules by year-end and on the final rules by June 27, 2016.

The rules were mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act and would require natural resource companies that engage in the commercial development of oil, natural gas or minerals to disclose in their SEC annual report payments to the U.S. government or foreign governments for the purpose of the commercial development of oil, natural gas, or minerals. The original rules were vacated by the U.S. District Court for the District of Columbia in 2013, but have not yet been re-proposed. The litigation was brought by Oxfam America, Inc. in an effort to expedite the long-delayed rules.

Even while asking the court to approve its proposed schedule, the SEC outlined a number of reasons that the schedule may not be met, including the "unprecedented volume of enforcement, rulemaking, and other regulatory work" currently under way at the SEC, the difficult policy issues raised by the rules, and exigencies such as a potential government shut

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CORPORATE UPDATE

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October 23, 2015

SEC Gets Off the Sidelines - Publishes Guidance on Shareholder Proposal Exclusions

Kimberley R. Anderson

Yesterday, just in time for the start of the proxy season, the Securities and Exchange Commission published its eagerly-awaited guidance on two shareholder proposal exclusions – Rule 14a-8(i)(9) (“directly conflicts” exclusion) and Rule 14a-8(i)(7) (“ordinary business operations” exclusion). Both exclusions have been under review and the subject of much debate over the past year. The guidance significantly narrows the scope of 14a-8(i)(9) and reaffirms the Staff’s interpretation of 14a-8(i)(7). Staff Legal Bulletin No. 14H (“SLB 14H”) can be found at http://www.sec.gov/interps/legal/cfslb14h.htm.

Rule 14a-8(i)(9) – Permits exclusion of a shareholder proposal that "directly conflicts" with a management proposal

In January 2015, following questions about the Staff’s interpretation of 14a-8(i)(9) in the *Whole Foods* no-action letter, Chair White directed the Division of Corporation Finance to review the scope and application of the exclusion. Shortly thereafter, the Staff announced that they would express no view on no-action requests relying on 14a-8(i)(9) during the 2015 proxy season. This created significant frustration and uncertainly for a number of companies. Although companies may be relieved that the Staff is no longer sitting on the sidelines with respect to 14a-8(i)(9) no-action requests, the Staff’s new requirements will be difficult to satisfy. Therefore, we expect far fewer shareholder proposals will be excluded on this basis.

Under the Staff’s prior interpretation, as expressed in numerous no-action letters, a shareholder proposal could be excluded if the shareholder proposal and the management proposal presented “alternative and conflicting decisions for the shareholders” which might have “inconsistent and ambiguous results.”

Under the new and much more strict interpretation announced in SLB 14H, the Staff believes “that any assessment of whether a proposal is excludable under this basis should focus on whether there is a direct conflict between the management and shareholder proposals. For this purpose, we believe that a *direct conflict would exist if a reasonable shareholder could not logically vote in favor of both proposals*, i.e., a vote for one proposal is tantamount to a vote against the other proposal.” (emphasis added) In other words, the new test becomes: are the shareholder proposal and the management proposal “mutually exclusive”?

Staff's Examples of Proposals Which Conflict and May Be Excluded

Shareholder Proposal	Management Proposal
Proposal asks shareholders to vote against a merger	Proposal seeks approval of a merger
Proposal requiring separation of the company's chairman and CEO	Proposal seeks approval of a bylaw provision requiring the CEO to be the chair at all times

Staff's Examples of Proposals Which Do Not Conflict and May Not Be Excluded

Shareholder Proposal	Management Proposal	Staff's Explanation
Proxy access proposal permitting a shareholder or group of shareholders holding at least 3% of the company's outstanding stock for at least 3 years to nominate up to 20% of the directors	Proxy access proposal permitting shareholders holding at least 5% of the company's stock for at least 5 years to nominate up to 10% of the directors	Both proposals have similar objectives. Proposals do not present shareholders with conflicting decisions such that a reasonable shareholder could not logically vote in favor of both proposals
Proposal asking the compensation committee to implement a policy that equity awards would have no less than four-year annual vesting	Proposal to approve an incentive plan that gives the compensation committee discretion to set the vesting provisions for equity awards	A reasonable shareholder could logically vote for a compensation plan that gives the compensation committee the discretion to determine the vesting of awards, as well as a proposal seeking implementation of a specific vesting policy that would apply to future awards granted under the plan

Under the Staff's more strict interpretation in SLB 14H, we expect fewer shareholder proposals will be able to be omitted under 14a-8(i)(9). As a result, in the event that both of the shareholder and management proposals are approved, the board of directors will be required to determine how, or whether, to implement either or both proposals.

Rule 14a-8(i)(7) – Permits exclusion of a shareholder proposal that relates to company's "ordinary business operations"

Rule 14a-8(i)(7) allows a company to exclude proposals relating to a company's ordinary business operations. However, the Staff has recognized a "significant social policy" exception to the exclusion "in those cases in which a proposal's underlying subject matter transcends the day-to-day business matters of the company and raises policy issues so significant that it would be appropriate for a shareholder vote."

In light of the opinion in *Trinity Wall Street v. Wal-Mart Stores, Inc.* by the U.S. Court of Appeals for the Third Circuit, the Staff reaffirmed its prior interpretation of 14a-8(i)(7). The Staff's interpretation differs from the new, two-part, "significant social policy" test outlined in the majority opinion in *Trinity*. The two-part test in *Trinity* asks first if the proposal focuses on a significant policy and if so, whether the significant policy issue transcends the company's ordinary business operations. Most significantly, the Third Court's majority opinion noted that the Court believed that the SEC used the term "transcend" "to refer to a policy issue that is

divorced from how a company approaches the nitty-gritty of its core business." Therefore, if a proposal related to the "nitty-gritty" of the company's business, it could *never* pass the two-part test.

The Staff disagreed with this interpretation and noted in SLB 14H that the concurring judge in *Trinity* endorsed the Staff's interpretation of Rule 14a-8(i)(7). The Staff does not view the issues of "significance" and "transcendence" independently, and does not agree that a proposal must be divorced from a company's business in order to "transcend the day-to-day business matters." The Staff noted in SLB 14H that "a proposal may transcend a company's ordinary business operations even if the significant policy issue relates to the 'nitty-gritty of its core business'."

It is worth noting that the majority opinion in *Trinity* suggested that the SEC issue new interpretive guidance on 14a-8(i)(7). In fact, the Staff (i) rejected the articulation of the social policy exception in *Trinity*, (ii) stated that it will continue to apply 14a-8(i)(7), in a manner consistent with their past practice, and (iii) provided no fresh interpretive guidance regarding 14a-8(i)(7) in SLB 14H.

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