Governance Round-Up

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SEC Adopts Final Pay Ratio Rule

On August 5, the SEC adopted a final pay ratio rule, mandated under Dodd-Frank, requiring companies to disclose the median of the annual total compensation of all employees of the company and the ratio of that median to the annual total compensation of its CEO. The final rule introduces a small number of important changes designed to address concerns that compliance costs of the proposed rule were too high, including (i) the exclusion of certain non-U.S. based employees from the pool from which the median employee is selected, (ii) the ability to use the same median employee for up to three years, and (iii) the ability to select the median employee as of any date within the three-month period ending on the last day of the registrant's fiscal year. See the Debevoise Client Update at:

http://www.debevoise.com/insights/publications/2015/08/minding-the-gap.

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Proxy Access: The Devil in the Details

Proxy access shareholder proposals were relatively successful during the 2015 proxy season: reports indicate that of 82 proxy access shareholder proposals going to vote, 48 have passed with average 54.4% support. ISS recommended a vote "for" all of the shareholder proposals, most of which included thresholds mirroring the SEC's vacated 2010 proxy access rule: an ownership threshold of 3% of the company's stock for three or more years, and the right to nominate up to 25% of the company's board. Pressure from investors and governance organizations for companies to adopt proxy access will continue during the 2016 proxy season. Many companies will receive proxy access shareholder proposals or will decide to address proxy access on their own initiative. These companies must carefully consider strategies for engaging with investors and whether, and if so, in what form, to adopt proxy access bylaws.

While supporters are proclaiming that proxy access will inevitably become a mainstream governance practice such as majority voting and annual election of directors, proxy access market practices are evolving. Two recent developments indicate that the devil may be in the details, as companies and proxy access proponents continue to debate what restrictions on shareholders' rights to access the company's proxy statement for director nominations are acceptable.

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CII Guidance on Proxy Access Best Practices

On August 5, the Council for Institutional Investors (CII) issued guidance on what it deems to be "best practices" for proxy access provisions. Among other things, CII discourages:

- ownership thresholds of 5% or more;
- the right to nominate fewer than two directors;
- limiting the number of shareholders who can aggregate to form a group;
- prohibiting loaned shares from counting toward ownership thresholds;
- requiring continued share ownership after the annual meeting; and
- limitations on third-party compensation.

A recent report in The Wall Street Journal looked at the proxy access bylaws adopted during the 2015 proxy season and found that almost all of them failed to meet one or more of CII's criteria. See http://www.wsj.com/articles/investor-group-challenges-access-to-companies-boards-1438740001. Find the CII guidance at http://www.cii.org/.

ISS Survey Focus on "Material Restrictions" in Proxy Access Bylaws

ISS will generally recommend in favor of shareholder and management proxy access proposals with all of the following terms: ownership threshold of not more than 3% of voting power; holding period of no longer than three years; minimal or no limits on the number of shareholders that may form a nominating group; and a cap on seats of generally 25% of the board.

Indicating that ISS is focused on the details of proxy access bylaws beyond the primary ownership and cap thresholds, the ISS 2016 voting policy survey asked the following: in the event that a shareholder proxy access proposal receives majority support, and the board adopts proxy access with material restrictions not contained in the proposal, which types of restrictions implicate the board's responsiveness enough to potentially warrant "withhold" or "against" votes for directors?

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SEC Intends to Issue Rule 14a-8(i)(9) Guidance Soon; Interpretation of Rule 14a-8(i)(7) to Remain Unchanged

During the September meetings of the ABA Business Law Section, representatives of the SEC's Division of Corporation Finance confirmed two important points regarding exceptions to Rule 14a-8, the SEC proxy rule enabling shareholders to submit proposals for inclusion in a company's proxy materials: (1) the SEC intends to issue guidance or make an announcement before November addressing the application of Rule 14a-8(i)(9), which permits companies to exclude shareholder proposals that directly conflict with the company's own proposals, in order to provide clarity for the 2016 proxy season; and (2) the SEC will continue to apply current analysis and precedent with respect to no-action relief and guidance under Rule 14a-8(i)(7), which permits companies to exclude shareholder proposals relating to the company's ordinary business operations.

Rule 14a-8(i)(9) "Directly Conflicts" Exception

The SEC Staff took the unusual step of expressing no views on the application of the Rule 14a-8(i)(9) "directly conflicts" exception during the 2015 proxy season when Chair White, in reaction to the well-publicized debate surrounding a proxy access proposal received by Whole Foods, instructed the SEC Staff to review the application of the Rule.

Rule 14a-8(i)(7) "Ordinary Business" Exception

The interpretation of the Rule 14a-8(i)(7) "ordinary business" exception came under scrutiny as a result of the litigation in *Trinity Wall Street* vs. *Wal-Mart Stores, Inc*. In July, the U.S. Court of Appeals for the Third Circuit released its opinion permitting the exclusion of Trinity's shareholder proposal relating to the sale of high capacity assault rifles and other dangerous products. The Court's decision largely reinforced the SEC's interpretation of the exception and was welcome news to issuers and advisors who were concerned that proponents would submit "corporate governance" proposals to address issues that traditionally had been interpreted by the SEC as matters of day-to-day business. However, the Court's majority opinion differed from SEC precedent by permitting exclusion of proposals only if they both raise significant policy issues and also transcend day-to-day business. The court recommended that the SEC revise its regulations and issue new interpretive guidance in this area, leading to concerns that the SEC's interpretation of the Rule 14a-8(i)(7) exception could be in flux at a time when companies are preparing for the 2016 proxy season.

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Representatives of the SEC's Division of Corporation Finance have confirmed that they do not currently intend to change their interpretation of the Rule 14a-8(i)(7) exception. Consistent with the concurring opinion in the Third Circuit decision, the evaluation of whether a proposal raises an issue of significant social policy will not be separated from whether it transcends a company's day-to-day business; a proposal "is sufficiently significant 'because' it transcends day-to-day business matters."

For background on both of these issues, see the Debevoise client update at http://www.debevoise.com/insights/publications/2015/01/client-update-meyer-012015-got-no-acton-relief.

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BofA Stockholders Support Moynihan's Combined Chair/CEO Role

At a special meeting held on September 22, Bank of America stockholders voted in favor of the board's authority to combine the roles of chairman and CEO. The "yes" vote permits current CEO Brian Moynihan to keep his chairman title. The bank had faced a significant and well-publicized backlash from major proxy advisory firms and many institutional investors when it unilaterally recombined the chair and CEO roles in October 2014, reversing a bylaw separating these roles which was approved in 2009 in a binding stockholder vote. The bank gained 63% support despite negative recommendations from ISS and Glass Lewis and opposition from several influential investors, including CalSTRS and CalPERS.

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Conflict Minerals: Compliance and First Amendment Challenges

Compliance with Conflict Minerals Rules a Struggle

On August 4, The Wall Street Journal's "CFO Report" cited some telling statistics from the 2015 reporting cycle which reflect on the challenge many public companies face in trying to comply with the SEC's Conflict Minerals rules:

- of 1,262 reporting companies that filed conflict mineral reports:

- 90% couldn't determine whether their products are conflict free;

- only 314 (less than 24%) reached full compliance;

- 2/3 failed to describe the country of origin of their metals;

- 43% failed to disclose the diligence framework;

- Microsoft and Apple were among those reporting "conflict undeterminable" despite extensive supply chain examination; and

- aggregate cost of compliance was estimated to be $709 million and 6.5 million staff hours.

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The report argued that compliance costs and pressures will increase for the 2016 reporting cycle as the two-year phase-in expires and large companies are required to have outside auditors inspect their reports. See the WSJ article at http://blogs.wsj.com/cfo/2015/08/04/u-s-firms-struggle-to-trace-conflict-minerals/. However, as discussed below, the recent D.C. Circuit decision calls into question the conflict minerals rules audit requirement.

SEC Loses Challenge to First Amendment Ruling

On August 18, a three-judge panel of the D.C. Circuit, by a vote of two to one, reaffirmed its initial judgment in connection with a conflict minerals case, National Association of Manufacturers, Inc. v. SEC, that the requirements in the conflict minerals statute and related rule compelling companies to report to the SEC and to state on their website that any of their products have "not been found to be 'DRC conflict free'" violates companies' First Amendment rights. In April 2014, when the D.C. Circuit first issued its ruling, the SEC's Director of Corporation Finance Keith Higgins issued a statement directing that 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 that an independent private sector audit would not be required unless a company voluntarily elects to describe a product as "DRC conflict free" in its Conflict Minerals Report.

Form SD filings are next due on May 31, 2016. It seems likely that the SEC will issue additional guidance before this deadline as many are questioning how this recent decision will affect the SEC's conflict minerals rule and, in particular, the requirement that companies obtain an audit. In remarks at the September meeting of the ABA's Business Law Section, Director Higgins confirmed that the April guidance and stay on the requirement to obtain an audit will continue in force until the legal challenge is resolved. Director Higgins also indicated that, despite the lapse of the two-year phase-in period, companies should be permitted to continue to use the label "DRC conflict undeterminable."

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ISS 2016 Voting Policy Survey Closed September 4

The ISS 2016 proxy voting policy survey highlighted a continuing focus by ISS on, among other things, unilateral bylaw amendments, proxy access, over-boarding, and effective capital allocation. See the Debevoise Client Update at http://www.debevoise.com/insights/publications/2015/08/iss-2016-annual-policy-survey-open

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