Capital Markets & Public Companies Quarterly: 2016 Goes Out with a Bang

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Summary

As 2016 drew to an end, the US Securities and Exchange Commission (SEC) kept up its pace to close out a busy year. In addition to issuing proposed rules for universal proxies, the SEC released several new Compliance & Disclosure Interpretations (C&DIs) addressing issues ranging from pay ratio disclosures to registration statement filing fees. The fourth quarter also saw the first two Schedule 14N filings by shareholders seeking to add shareholder nominees to a company's proxy materials, perhaps signaling a proxy access trend that could generate additional activity in 2017. Also included in this quarter's publication is a high-level summary of Institutional Shareholder Services Inc. and Glass Lewis' updated 2017 proxy voting guidelines.

In Depth

The First Schedule 14N Filings

On November 10, 2016, GAMCO Asset Management Inc. and Gabelli Funds, LLC, (together, GAMCO) filed a Schedule 14N in connection with GAMCO's nomination of a candidate for election to the board of directors of National Fuel Gas Company (NFG). This marks the first time that a shareholder has made a filing under Regulation 14N to nominate its own director candidate pursuant to a company's proxy access bylaw for inclusion in the company's proxy materials.

GAMCO's nomination was rejected by NFG after NFG's board determined that GAMCO did not satisfy NFG's proxy access bylaw. Specifically, in a letter dated November 23, 2016, and filed with the SEC, NFG stated that not only did GAMCO not comply, but it also was unable to comply with

NFG's proxy access bylaw requirement that a nominating shareholder must have acquired its shares "in the ordinary course of business and not with the intent to change or influence control of the Corporation, and does not presently have such intent[.]" NFG's letter notes that among the factors leading to the board's determination to reject GAMCO's nomination was the fact that GAMCO's ownership filings with respect to NFG were made on Schedule 13D (as opposed to Schedule 13G), as well as several statements by GAMCO executives that tended to show an intent to influence the policies and management of NFG. The letter specifically references a statement by one GAMCO executive that using the proxy access mechanism could reduce the costs of activism by allowing activists to "piggyback on someone else's proxy." GAMCO filed an amendment to its Schedule 13D on November 28, 2016, announcing that its director nominee had decided to withdraw his name as a candidate for NFG's board.

Following close on the heels of the GAMCO saga, on December 2, 2016, well-known microcap investor Barry C. Honig filed a second Schedule 14N in connection with his nomination of four candidates for the board of directors of Bioptix, Inc. In a letter filed as an amendment to a Current Report on Form 8-K filed January 6, 2017, Bioptix acknowledged that Honig had also commenced an action against the company in Colorado to compel Bioptix to hold a special meeting of the shareholders to remove three of the company's directors. The targeted directors resigned as of January 6, 2017. Honig has not yet made a filing withdrawing his director nominees.

One lesson to take away from the GAMCO nomination is that a passive investment requirement in a company's proxy access bylaw appears to be an effective means of preventing activists from using proxy access as a back door tool to avoid the costs of a true proxy contest, particularly when there is an ample public record to back up the board's determination that the nominating shareholder is not in compliance. We will continue to follow proxy access proposals as the year moves forward.

SEC Proposes Amendments to Proxy Rules to Require Use of Universal Proxies in Contests

On October 26, 2016, the SEC proposed amendments to the proxy rules that would require the parties in a proxy contest to use universal proxy cards. The practical effect of the amendments would be to require that all parties in a contested election use a universal proxy card that includes all nominees to the board of directors (*i.e.*, management and dissident nominees).

The proposed rule changes would allow shareholders to vote by proxy for the directors of their choice, whether that be a management slate, a dissident slate or a combination of the two. In addition, a dissident would be required to disclose to the company the names of the dissident's nominees no less than 60 days prior to the anniversary of the prior year's annual meeting, and management would be required to disclose its nominees to the dissident no fewer than 50 days prior to the anniversary of the prior year's annual meeting.

To ensure that dissidents are willing to bear the full costs of a proxy contest, the rule changes would also require dissidents to solicit shareholders representing at least a majority of the votes entitled to be cast on the election of directors. Dissidents would also be required to file their definitive proxy statements with the SEC by the later of 25 calendar days prior to the meeting date or five calendar days after the issuer files its definitive proxy statement.

Under the proposed amendments, each party to a proxy contest would be required to refer shareholders to the other party's proxy statement for information about the nominees included on the universal proxy card and inform shareholders that both parties' proxy statements are available for free on the SEC's website.

Outgoing SEC Chair Mary Jo White said of the proposed amendments: "This change would allow shareholders through the proxy process to more fully exercise their vote for the director nominees they prefer."

ISS and Glass Lewis Update Proxy Voting Guidelines for the 2017 Proxy Season

Proxy advisory firms Institutional Shareholder Services Inc. (ISS) and Glass, Lewis & Co., LLC, (Glass Lewis) issued their respective annual updates to proxy voting guidelines on November 21, 2016.

The Glass Lewis update applies to meetings held on or after January 1, 2017, and the updated ISS policies will take effect with respect to annual meetings held on or after February 1, 2017. As revised, these policies have important implications for companies preparing for the 2017 proxy season.

Key Changes to ISS Proxy Voting Guidelines

IPOs with Multi-Class Capital Structures

In 2016, ISS bifurcated its policy on unilateral board adoptions of bylaw and charter provisions by establishing separate methodologies for established public companies versus those newly public.

The updated policy expands the instances where ISS generally will recommend "withhold" or "against" votes on individual directors in newly public companies to include situations where the company implements a multi-class capital structure where the classes have unequal voting rights. The updated ISS policy also rejects ISS's prior position that shareholder approval within three years following a newly public company's initial public offering (IPO) would be sufficient to alleviate an adverse voting recommendation for any unilateral board adoptions of bylaw and charter provision or multi-class capital structure implemented in connection with the IPO. The voting recommendations issued in response to such unilateral charter or bylaw amendment, or multi-class capital structure with unequal voting rights, considers the following factors, among others:

- The level of impairment of shareholder rights
- The ability to change the governance structure (*e.g.*, supermajority vote requirements to amend the charter or bylaws or limitations on shareholders' right to amend the charter or bylaws)
- The disclosed rationale for the multi-class capital structure or adopted charter or bylaw provision
- The ability of shareholders to hold directors accountable by annual director elections or the existence of a classified board structure
- Any reasonable sunset provision that terminates the significant shareholder restriction or multi-class capital structure

Shareholder Ability to Amend Bylaws

ISS introduced a new policy related to director accountability in order to address restrictions on the ability of shareholders to amend the bylaws of a company. Under this policy, adverse vote recommendations will generally be warranted regarding members of a board's governance committee if the company's charter imposes undue restrictions on shareholders' ability to amend the bylaws. Restrictions that would trigger such adverse vote recommendation by ISS include the outright prohibition on the submission of binding shareholder proposals, or minimum share ownership thresholds or time holding period requirements for such shareholder proposals in excess of those set forth in SEC Rule 14a-8. The updated policy seeks to eliminate the use of the exclusion currently found in Rule 14a-8(i)(2) in connection with certain binding shareholder proposals. It appears from ISS's most recent survey that ISS is specifically targeting Maryland real estate investment trusts (REITs) with this policy change.

Overboarding

ISS considers a director who sits on an excessive number of public company boards to be overboarded, because such director may be unable to devote sufficient time and energy to attend to board responsibilities to effectively represent shareholders' interests. With respect to annual meetings held on or after February 1, 2017, ISS will generally recommend voting "against" or "withhold" regarding individual directors who sit on more than five public company boards. ISS has not revised its director overboarding guidelines with respect to directors who are sitting public company CEOs, and thus ISS will continue to recommend voting against or withholding from such directors who sit on the boards of more than two additional public company boards. Such withhold vote recommendation will continue to apply at the CEO's outside boards only.

Non-Employee Director Compensation

In light of a number of high-profile shareholder lawsuits regarding excessive non-employee director compensation, some companies have put forth shareholder advisory proposals seeking ratification of their non-employee director pay programs. In response, ISS adopted a recommendation that a company's shareholders evaluate whether to approve the company's proposed director compensation based on a number of qualitative factors, including (among others) a review of director compensation in comparison to that at similar companies, director stock ownership guidelines, meaningful limits on director compensation and the quality of proxy disclosure on director compensation.

ISS continues to recommend that shareholders consider three factors in determining whether to vote for non-employee director equity plans: the cost of equity plans relative to industry peers, the company's three-year burn rate relative to peers and the presence of egregious plan features. Where equity plans exceed the relative burn rate, ISS recommends shareholders consider the same qualitative factors described in the preceding paragraph. These changes introduce additional factors to ISS's recommendations (in particular, relative pay and meaningful pay limits) and simplify certain existing factors.

Equity Plan Scorecard

In addition to minor changes to various factor weightings, the updated policy includes an evaluation of the payment of dividends on unvested awards. Full points will be earned under the Equity Plan Scorecard "plan feature" category only if the equity award plan expressly prohibits, for all award types, the payment of dividends before the vesting of the underlying award. No points will be earned if the prohibition is missing or applicable only to some award types, even if the company has a general practice of not paying dividends that is not enumerated in the plan document. A company that has such a practice might consider amending its equity award plan to specifically provide that no dividends are payable under awards until vesting. Accrual of dividends on awards prior to vesting remains acceptable.

Modifications were also made to the minimum vesting factor. To receive full points, an equity award plan must specify a minimum vesting period for all award types. No points will be earned if the plan allows for individual award agreements that reduce or eliminate the one-year vesting requirement. Currently, the ISS scorecard awards full points for the minimum vesting requirement factor if a plan provides for minimum one-year vesting with respect to plan awards. ISS provides several exceptions to that rule, including a plan provision that up to 5 percent of the total number of shares authorized under a plan can be granted without a one-year vesting requirement. ISS has become concerned that the exceptions may result in more than 5 percent of a plan's share reserve being used for awards with a vesting schedule of less than a year. ISS reviews will likely focus on plan language that permits exceptions to the vesting schedule (such as "except as otherwise provided under the plan") and director awards that have a vesting requirement that is less than a single anniversary (*e.g.*, 357 days instead of 365 days).

Section 162(m) Tax Deductibility

ISS revised its policy with respect to proposed amendments to cash and/or equity plans presented to shareholders solely for 162(m) compliance purposes versus those requesting both 162(m) approval and approval of additional shares, or that may otherwise increase the transfer of shareholder value to employees. ISS will recommend approving proposals that only seek approval for 162(m) purposes as long as the plan administering committee consists entirely of "independent outside directors." ISS will evaluate on a case-by-case basis proposals "bundling" 162(m) amendments with other amendments that request additional shares or may otherwise increase the transfer of shareholder value.

Key Changes to Glass Lewis Proxy Voting Guidelines

Governance Following a Spin-Off or IPO

Glass Lewis generally refrains from making vote recommendations on the basis of governance standards during the one-year period following a company's IPO. However, under its 2017 guidelines, if a company has gone public within the past year, Glass Lewis will generally recommend voting against directors or members of the corporate governance committee of a board who served at the time of the governing documents' adoption if the directors or members approved governing documents that significantly restrict or subvert shareholders' rights and interests. In making this determination, Glass Lewis plans to review specific governance areas including, without limitation, supermajority voting requirements, anti-takeover mechanisms, whether shareholders can remove directors without cause, voting standards applicable to director elections and various other provisions affecting shareholders' rights.

Board Evaluation and Refreshment

In its 2017 guidelines, Glass Lewis has clarified its approach to board evaluation, succession planning and refreshment. Rather than relying on age or tenure limits, Glass Lewis focuses on a board evaluation process that ties to the assessment and alignment of company strategy with director skills. However, Glass Lewis cautioned companies against waiving existing term or age limits. Generally, waivers of established limits will result in voting recommendations adverse to directors unless there is a sufficient explanation for the need of such waiver, such as consummation of a corporate transaction.

Overboarding

Like ISS, Glass Lewis revised its policy on directors who sit on what is considered to be an excessive number of public company boards. For the 2017 proxy season, Glass Lewis will generally recommend voting against a director who either (i) serves on more than five public company boards or (ii) is an executive officer of a public company and serves on more than two public company boards, in which case Glass Lewis will recommend votes against only the director's outside boards. Under the revised Glass Lewis policy, when deciding whether a director's service on an excessive number of boards limits the ability of such director to devote time to company board duties and therefore warrants an adverse vote recommendation, the following factors should be considered:

- The director's board duties and roles at the companies in question
- The size and geographic location of the other companies on which the director serves
- The director's board attendance record at all companies on which such director serves
- Whether the director additionally serves on the board of any large privately held companies
- The director's tenure on the boards in question (with tenure being a factor to sway Glass Lewis towards not issuing a negative vote recommendation)

If the company provides sufficient rationale for the director's board service, such as a unique perspective and background that the director provides, Glass Lewis may refrain from issuing a negative vote recommendation against such director. Moreover, Glass Lewis will not issue a negative vote recommendation on the basis of the director overboarding policy against (i) a director who serves on an excessive number of boards within a consolidated group of companies or (ii) a director who represents a firm whose sole purpose is to manage an investment portfolio that includes the company.

Gender Pay Equity Shareholder Proposals

Shareholders are increasingly asking companies to report on their efforts to ensure gender pay equity. In response, Glass Lewis codified a new policy in its 2017 shareholder initiatives guidelines indicating that it will review such shareholder proposals on a case-by-case basis, considering the following factors:

- The company's current policies, efforts and disclosure with regard to gender pay equity
- The practices and disclosure of company peers
- The company's industry
- Any relevant regulatory and legal actions at the company

Under its 2017 guidelines, Glass Lewis will consider recommending in favor of shareholder proposals requesting greater disclosure in favor of gender pay equity in cases where a company has not adequately addressed the issue and there is evidence that such inattention poses a risk to the company's shareholders or operations.

Use of Non-GAAP Metrics in Incentive Compensation Disclosures

Many companies use non-GAAP financial measures as part of their incentive compensation plans. Glass Lewis cautions these companies to disclose and reconcile non-GAAP financial measures against GAAP measures and to provide clear explanations regarding any non-GAAP adjustments, aligning its policy with recent SEC guidance. Existing proxy disclosure rules require companies that use non-GAAP financial measures as performance goals to include disclosure as to how such measures are derived from the company's audited financial statement.

SEC Issues Final Rules Designed to Modernize Regulation of Intrastate and Regional Securities Offerings

On October 26, 2016, the SEC issued a final rule adopting amendments to Rule 147 under the Securities Act of 1933, establishing a new intrastate offering exemption as Securities Act Rule 147A, amending Securities Act Rule 504 to increase the amount of capital companies can raise in Regulation D offerings under Rule 504, and repealing Securities Act Rule 505. Taken together, these changes will give companies more flexibility to raise capital through unregistered offerings, facilitating capital formation without subjecting smaller companies to the regulatory burdens associated with registered offerings of securities.

Amended Rule 147 and New Rule 147A

Section 3(a)(11) of the Securities Act exempts wholly intrastate offerings of securities from the registration requirements of the Securities Act. Securities Act Rule 147 has long provided a safe harbor for the intrastate exemption. However, under Securities Act Rule 147, companies are limited to making offers (i) only in their state of incorporation and (ii) only to residents of that state. With the advent of the internet, these restrictions severely limit the utility of Rule 147's safe harbor for most issuers. For example, the limitation on only making offers to residents of a company's state of incorporation generally prohibits the use of the internet to distribute information about an unregistered intrastate offering.

Although the amended Securities Act Rule 147 may still be of limited value as a safe harbor because of the requirements that an issuer be incorporated and have its principal place of business in the state where the offering is made, the other amendments to the rule make the safe harbor somewhat more accessible for issuers, while new Securities Act Rule 147A provides more lenient standards. Generally, the new Rule 147A is substantially identical to amended Rule 147, with the following exceptions:

- It allows an issuer to make offers that are accessible to out-of-state residents (*i.e.*, generally accessible over the internet).

- It allows an issuer to make offers in a state other than its state of incorporation provided it can demonstrate that its "principal place of business" is located in that state and the issuer is "doing business" in the state.

Both the new Securities Act Rule 147A and the amended Securities Act Rule 147 include the following provisions:

- **Revised Definition of "Doing Business."** An issuer is considered to be "doing business" in a state where it meets any one of four requirements, such as having a majority of its employees based in the state.

- **"Reasonable Belief" Standard for Purchaser Residency Requirement.** An issuer is limited to making sales to those persons it "reasonably believes" are residents of the state in which the offering is being made. This is a substantial liberalization of the standard in the former Rule 147, which provided only that an issuer was limited to making offers and sales to residents of the state in which the offering was being made—a prohibitive strict?liability standard.

- **Residency Attestation.** The issuer must obtain from each purchaser a written representation as to the purchaser's residence. Although it may be tempting to rely on this representation to satisfy the "reasonable belief" standard described above, the instructions to the rule provide that obtaining a written representation as to residency "will not, without more, be sufficient to establish a reasonable belief that such purchasers are in-state residents."

- **Six-Month Restriction on Resales.** Securities sold in reliance on amended Rule 147 or new Rule 147A are subject to a six-month restriction on resales. This restricted period is coupled with a requirement that the issuer issue stop transfer instructions to its transfer agent with respect to the subject securities.

- **Integration Safe Harbor.** Both rules provide an integration safe harbor to ensure exempt intrastate offerings are not integrated with prior or subsequent offerings of the issuer's securities. Specifically, sales pursuant to amended Rule 147 or new Rule 147A will not be integrated with offers and sales made prior to the commencement of the intrastate offering or with certain enumerated offers and sales made after the completion of the intrastate offering.

- **Legend.** All securities sold under the amended Rule 147 or New Rule 147A must bear a prominent legend indicating to offerees and purchasers that sales will only be made to residents of the state or territory in which the offering is being made and providing information about the restriction on resales.

Amended Rule 504

In addition to amending Rule 147 and creating new Rule 147A, the SEC amended Rule 504 and repealed Rule 505 of Regulation D. The amendments to Rule 504 include an increase in the aggregate offering threshold from $1 million to $5 million, as well as the application of the Rule 506(d) "bad actor" disqualifiers to exempt offerings conducted pursuant to Rule 504. Because the changes to Rule 504 limit the utility of Rule 505, the SEC simultaneously repealed Rule 505. Amended Rule 504 became effective on January 20, 2017, and the repeal of Rule 505 will become effective on May 22, 2017.

The changes to Rules 147 and 504 along with the addition of Rule 147A will make it significantly less burdensome for smaller companies to effectively raise capital through exempt offerings. Importantly, these changes indicate that the SEC is willing to account for the practical realities of the modern marketplace when considering new rules and amendments to existing rules. If you have any questions or would like to explore your options under the new exempt offering safe harbors, please feel free to contact one of the lawyers in McDermott's Capital Markets & Public Companies Group.

A Flurry of New C&DIs to End the Year

During the fourth quarter of 2016, the SEC published several new C&DIs covering a wide variety of topics. The new guidance includes but is not limited to the following:

- Reporting companies no longer need to mail hard copies of their annual reports to the SEC. Instead, a reporting company can satisfy the notice requirements of Rules 14a-3(c) and 14c-3(b) under the Securities Exchange Act of 1934 as well as the requirements of Form 10-K by posting an electronic version of the required materials to its website and keeping those materials available for one year from the date of posting. This is a welcome change from the prior physical mailing requirement and represents yet another example of the SEC's willingness to modernize its rules and guidance in response to technological advances.

- In November 2016, the SEC published two revised and two new C&DIs with respect to registration fees for Form S-8 registrations. Revised C&DIs 126.06 and 126.42 as well as new C&DIs 126.43 and 126.44 can be accessed here.

- In December 2016, the SEC published 35 new C&DIs addressing Foreign Private Issuers, Qualified Institutional Buyers and Offshore Offerings. These new C&DIs address a range of relevant issues and can be accessed here.

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