



## GT Insights for Public Companies

January 9, 2017

A Bi-Weekly Update

### SEC Enforcement and Litigation

#### 10th Circuit Declares SEC Administrative Law Judges Unconstitutional and Creates Circuit Split

On Dec. 27, 2016, the United States Court of Appeals for the Tenth Circuit held in *Bandimere v. U.S. SEC* that the SEC's administrative law judges (ALJs) hold their positions in violation of the Appointments Clause of the United States Constitution. The court held that SEC ALJs are inferior officers, rather than mere employees of the agency, and that the ALJ in the *Bandimere* case held his office unconstitutionally. Because SEC ALJs preside over many SEC enforcement actions, the *Bandimere* holding potentially undermines the constitutionality of SEC ALJ proceedings and the rulings on a countless number of enforcement cases. The *Bandimere* ruling creates a circuit split with the D.C. Circuit's decision earlier this year in *Lucia v. SEC*.

A GT Alert regarding the *Bandimere* decision is available at:

<http://www.gtlaw.com/News-Events/Publications/Alerts/200579/The-10th-Circuit-Declares-SECs-Home-Courts-to-be-Unconstitutional-and-Creates-Circuit-Split>

The *Bandimere* decision is available at:

<http://www.ca10.uscourts.gov/opinions/15/15-9586.pdf>

### Securities Litigation – What to Watch in 2017

2016 was a banner year for securities-related litigation. As we noted in our Dec. 6, 2016 edition of *GT Insights*, SEC enforcement actions increased in 2016 and were the highest in any year based on available data. Also, securities class action lawsuit filings increased in 2016 to the highest level seen since 2001.

While it remains to be seen if 2017 will continue the trend of increased enforcement actions and class action litigation, there are significant issues pending before U.S. courts that may impact actions and decisions in 2017, including:

- > **Who can be a whistleblower under Dodd-Frank?**  
There is currently a split between the U.S. Circuit Courts as to the definition of a “whistleblower” under the Dodd-Frank Act. A narrow interpretation requires whistleblowers to bring their tips to the SEC before bringing a whistleblower claim in order to benefit from the protections of Dodd-Frank. The broader interpretation would not require prior reporting to the SEC. Cases are pending in other U.S. Circuit Courts regarding this and similar issues, including whether tips to a governmental agency other than the SEC (such as the FBI) would be sufficient to qualify as a whistleblower claim.

- > **Does the statute of limitation on civil penalties apply to the SEC's efforts to seek disgorgement?** Another issue that has produced split decisions in the U.S. Circuit Courts is whether the five-year limit on civil penalties also applies to disgorgement orders. The U.S. Supreme Court will consider the issue in 2017, and the impact could be significant with respect to the SEC's pursuit of older cases.
- > **How will *Salman v. U.S.* impact insider trading cases?** In the wake of the U.S. Supreme Court's decision in *Salman v. U.S.*, insider trading defendants and the government are using or distinguishing *Salman* in several pending cases and appeals. 2017 could bring answers to the questions raised by the narrow decision in *Salman*, such as what constitutes a "close relationship" and when a relationship is sufficient to create a "benefit".

<http://www.dandodiary.com/2017/01/articles/securities-litigation/2016-securities-lawsuit-filings-surge-record-levels/>

<https://www.cornerstone.com/Publications/Reports/SEC-Enforcement-Activity-Against-Public-Company-Defendants-2016>

## SEC Update

### Sullivan & Cromwell Partner Selected to be New Chairman of the SEC

President-elect Donald Trump has nominated Jay Clayton, a partner at Sullivan & Cromwell, to be chairman of the SEC. According to his profile at Sullivan & Cromwell, Mr. Clayton specializes in public and private mergers and acquisitions transactions, capital markets offerings and regulatory and enforcement proceedings. Trump still must fill two additional vacancies on the five-member commission.

## Governance

### ISS Releases White Paper regarding Pay-for-Performance Methodology

In December 2016, Institutional Shareholder Services, or ISS, released a white paper describing its quantitative and qualitative approach to pay-for-performance mechanics.

ISS has described its approach to evaluating pay-for-performance as consisting of two parts: an initial quantitative assessment and an in-depth qualitative review.

According to ISS, its initial quantitative screen is designed to identify outlier companies that have significant misalignment between CEO pay and company performance over time.

Following its quantitative screen, ISS performs qualitative evaluations, including a thorough review of the Compensation Discussion and Analysis (CD&A) section of a company's proxy statement, and highlights noteworthy issues to investors regardless of the results of the quantitative screen. If the quantitative screen results in an elevated concern level, the qualitative assessments are designed to uncover either the potential causes of a perceived long-term disconnect between pay and performance, or factors that mitigate the initial assessment. These in-depth qualitative evaluations are one of the most important parts of ISS' analysis and subsequent vote recommendation. If ISS identifies problematic incentive features for a company (e.g., multi-year guaranteed payments, discretionary pay components, inappropriate perquisites (including tax gross-ups), or lack of rigorous goals) as part of its qualitative analysis, it may issue a negative recommendation despite a "low" quantitative concern.

<https://www.issgovernance.com/file/policy/pay-for-performance-mechanics-dec-2016.pdf>

## ISS Releases Primer Regarding its Methodology for Evaluating Equity Compensation Plans in 2017

On Dec. 21, 2016, ISS published an updated overview of ISS's Equity Plan Scorecard methodology that will affect recommendations on proposals being voted on at meetings occurring on or after Feb. 1, 2017.

Although ISS continues to base its evaluation of a company's equity plan proposal on three distinct "pillars" (Plan Cost, Plan Features, and Grant Practices), there are a few changes to the pillars including the following:

- > ISS has formally introduced an additional qualitative review where an existing plan is being amended or restated. In this qualitative review, ISS will assess whether the proposed changes (on a collective basis) are detrimental to shareholders. If ISS determines that the proposed changes are sufficiently detrimental to shareholders, it may recommend against a plan that would have otherwise passed the more objective Equity Plan Scorecard;
- > Under the Plan Features pillar, full credit will be earned if the plan expressly prohibits, for all award types, the payment of dividends before the vesting of the underlying award (however, accrual of dividends payable upon vesting is acceptable). No points will be earned if this prohibition is absent or incomplete (i.e. not applicable to all award types) in the plan document.
- > There will be an increased emphasis on the granting of performance-based awards through slight reweighting of the CEO vesting and CEO equity pay mix factors.
- > There is also a slight modification to the valuation methodology of full value awards, as ISS will now value the number of time-based full-value awards reported in the Grants of Plan-Based Awards table by using the closing stock price on the date of grant.

## ISS Updates FAQs relating to Peer Groups, Equity Compensation Plans, and Executive Compensation Policies

In November and December 2016, ISS, released its updated Frequently Asked Questions relating to U.S. Equity Compensation Plans, U.S. Executive Compensation Policies, and U.S. Peer Group Selection Methodology and Issuer Submission Process.

The new or materially revised equity plan-related topics covered by the updated FAQs discuss:

- > how performance-based awards will be counted for the purposes of calculating burn rate;
- > how ISS evaluates an equity plan proposal seeking approval of one or more plan amendments;
- > how ISS evaluates proposals that include 162(m) reapproval along with plan amendments;
- > how ISS views a plan amendment to increase the tax withholding rate applicable upon award settlement;
- > changes made to the Equity Plan Scorecard, or EPSC, policy for 2017;
- > how ISS evaluates equity plan proposals at newly public companies;
- > what factors are considered in the EPSC, and why, including whether the factors are binary, or weighted equally; and
- > how ISS assesses a plan's minimum vesting requirement for EPSC purposes.

[https://www.issgovernance.com/file/policy/1\\_u.s.-equity-compensation-plans-faq-dec-2016.pdf](https://www.issgovernance.com/file/policy/1_u.s.-equity-compensation-plans-faq-dec-2016.pdf)

The new or materially revised compensation-related topics covered by the updated FAQs discuss:

- > how Total Compensation is calculated;

- > what factors ISS considers in conducting its qualitative review of the pay for performance analysis;
- > ISS' Relative Pay and Financial Performance Assessment included in research reports;
- > how ISS will use the Relative Pay & Financial Performance Assessment in its analysis;
- > whether the relevant quantitative pay for performance evaluation still applies if a company has not been publicly traded for at least three or five years, and if this affects whether a company would be used as a peer;
- > ISS' Problematic Pay Practices evaluation;
- > ISS' policy on say-on-pay frequency;
- > the vote recommendation implications in the event that a company does not present shareholders with a say-on-pay vote where one would otherwise be expected;
- > how ISS evaluates the treatment of equity awards upon a change-in-control;
- > how ISS evaluates management advisory proposals seeking shareholder approval of non-employee director pay; and
- > how ISS approaches U.S.-listed companies with multiple executive compensation proposals on the ballot as a result of the company's incorporation in a foreign country.

[https://www.issgovernance.com/file/policy/1\\_u.s.-executive-compensation-policies-faq-dec-2016.pdf](https://www.issgovernance.com/file/policy/1_u.s.-executive-compensation-policies-faq-dec-2016.pdf)

The FAQs relating to U.S. Peer Group Selection Methodology and Issuer Submission Process generally cover topics relating to (i) the methodology that ISS uses to identify peer companies that are reasonably similar to the subject company in terms of industry profile, size, and market capitalization, and (ii) updates to the subject company's peer group information, including means of communicating updated peer group to ISS.

[https://www.issgovernance.com/file/policy/uspeergroupfaq\\_nov2016.pdf](https://www.issgovernance.com/file/policy/uspeergroupfaq_nov2016.pdf)

### Financial Stability Board Task Force Issues Recommendations Regarding Climate Change-Related Disclosures

On Dec. 14, 2016, the Task Force on Climate-related Financial Disclosures issued an extensive report setting forth its recommendations for helping businesses disclose climate-related financial risks and opportunities. The Task Force was established in 2015 by the Financial Stability Board, an international body that monitors and makes recommendations about the global financial system, with the mandate to develop voluntary, consistent climate-related financial disclosures that would be useful to investors and others in understanding material risks.

The Task Force's report includes recommendations tied to four thematic areas – governance, strategy, risk management, and metrics and targets – which it believes should be implemented by all organizations that have public debt or equity outstanding. The general recommendations for applicable organizations are as follows:

- > Governance – Disclosure of their governance related to climate-related risks and opportunities, including the board of director's oversight, and management's role in assessment and management, of such risks and opportunities.
- > Strategy – Disclosure of actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning. Among other things, the Task Force recommends a description of the potential impact of different climate change scenarios, including the effect of a two degree Celsius increase in global average temperatures above pre-industrial levels.
- > Risk Management – Disclosure of the organization's processes for identifying, assessing, and managing climate-related risks,

and how these processes are integrated into the organization's overall risk management.

- > Metrics and Targets – Disclosure of the metrics and targets used by the organization to assess and manage climate-related risks and opportunities.

The Task Force recommendations are now subject to a 60-day consultation period that ends February 12. The final Task Force recommendations are to be presented to G20 leaders prior to their July summit in Hamburg, Germany. The Financial Stability Board has encouraged the Task Force to monitor and report on industry adoption of its final recommendations.

<https://www.fsb-tcf.org/wp-content/uploads/2016/12/TCFD-Recommendations-Report-A4-14-Dec-2016.pdf>

<http://www.fsb.org/2016/12/fsb-welcomes-task-force-consultation-on-recommendations-for-climate-change-disclosure/>

### Department of Labor Issues Guidance on Voting on ESG Proposals

On Dec. 28, 2016, the Department of Labor, or DOL, issued a new interpretive bulletin (IB 2016-01) to clarify that plan fiduciaries can exercise their proxy voting rights as part of their fiduciary duty to manage plan assets. The guidance also clarifies when plan fiduciaries can consider environmental, social, and governance (ESG) matters issues in connection with its shareholder engagement activities.

The DOL was concerned that its prior guidance had been broadly misunderstood by stakeholders to permit the exercise of shareholder rights only where the plan conducted a cost-benefit analysis and concluded that the proxy vote or action is more likely

than not to increase the economic value of the plan's investment.

In its updated guidance, the DOL noted that fiduciaries may engage in shareholder activities intended to monitor or influence corporate management if the fiduciary concludes that there is a reasonable expectation that such monitoring or communication with shareholders is likely to enhance the value of the plan's investment, after taking into account the costs involved. Active monitoring and communication activities include, among others:

- > governance issues including board independence and expertise, board composition, and executive compensation;
- > policies regarding mergers and acquisitions;
- > the extent of debt financing and capitalization;
- > long-term business plans including climate change preparedness and sustainability; and
- > policies and practices to address environmental or social factors that have an impact on shareholder value.

Active monitoring and communication may be carried out by various means, including correspondence and meetings with management and exercising shareholder rights.

The guidance also provides that a plan may include in its statement of investment policy voting guidelines as well as policies concerning economically targeted investments or ESG factors.

The new guidance became effective on Dec. 29, 2016.

<https://www.dol.gov/sites/default/files/ebsa/2016-31515.pdf>

Questions about topics covered in this newsletter should be directed to the GT attorney with whom you regularly contact or to the Executive Editor:

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