Small & Mid-Cap Public Company Update: 2018 Annual Report and Proxy Season Highlights

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With 2017 being another active year for regulators and governance activists, Small & Mid-Cap Public Companies should be aware of the following changes and trends for the upcoming reporting season.

Annual Report

Cover Page. Be sure to update the Form 10-K cover page to include additional required language and check boxes regarding filing status and other emerging growth company matters.

Exhibit Index. Present the exhibit index before the required signatures and include hyperlinks to all exhibits. Filers that are neither a *large accelerated filer* nor an *accelerated filer* have until September 1, 2018 to comply. (*See* ***Item 601(a)(2) of Reg. S-K***)

Non-GAAP Financial Measures. Continue to be attentive to prominence and reconciliation requirements when using non-GAAP financial measures. The SEC staff has issued numerous comment letters since updating its guidance in May 2016, and we expect that non-GAAP compliance will continue to be an area of staff focus. (*See* ***Non-GAAP CD&Is***)

Accounting Changes and Transition Disclosures. The new revenue recognition standards went into effect for fiscal years beginning after December 15, 2017, which means calendar year companies will need to report under the new standards in their Form 10-Q for the quarterly period ended March 31, 2018. For such companies, transition disclosures about the anticipated effects should be included in their Form 10-K for the year ended December 31, 2017. (*See* ***SAB Topic 11m***)

Also, if changes are made to internal controls in connection with the implementation of the new standards, companies will need to assess whether the changes are material and require disclosure in Item 9A of their Form 10-K.

2017 Tax Act. To assist with a company's accounting for income taxes under ASC Topic 740, the SEC issued SAB 118 on December 22, 2017 to express its views on the application of U.S. GAAP when assessing the impact of the Tax Cuts and Jobs Act of 2017 (the "Tax Act"). *(See* ***SAB 118****)* SAB 118 provides companies with an extended "measurement period" in which they must report (i) the effects of changes from the Tax Act where the calculations are complete and (ii) provisional effects where the calculations are not complete but reasonable estimates can be determined. If a reasonable estimate cannot be made, the company should continue to apply ASC 740 based on the tax law in effect immediately prior to the enactment of the Tax Act and must include disclosures in its financial statements about the incomplete accounting. The SAB 118 "measurement period" ends when the company has obtained, prepared, and analyzed the information necessary to comply with ASC 740 and, in any event, no later than December 22, 2018. In the absence of this guidance, ASC 740 could require companies to analyze the Tax Act in a compressed time frame with potentially insufficient information.

At the same time, the SEC issued a new CD&I to clarify that (i) the re-measurement of deferred tax assets because of changes in the Tax Act is not an impairment that triggers a requirement to file Form 8-K under Item 2.06 and (ii) if, during the "measurement period," a company concludes that an impairment has occurred as a result of the Tax Act, the company may rely on the instruction to Item 2.06 of Form 8-K and disclose the impairment in the company's next periodic report. *(See* ***Question 110.02****)*

Audit Report. Under new Auditing Standard No. 3101, the auditor's report must include: (i) the year the auditor began serving the issuer consecutively, (ii) a statement that the auditor is required to be independent and (iii) starting in fiscal years ending on or after December 15, 2020 (June 30, 2019 for large accelerated filers), disclosure of critical audit matters (CAMs) that arose during the audit. *(See* ***AS 3101****)* Audit Committees should consider asking auditors to discuss with them what CAMs would have been issued in connection with the audit so they can start planning for when CAM disclosure will be required. Also, Audit Committees of companies with long-tenured auditors should consider explaining the benefits of the long-term relationship in their audit reports.

Proxy Statement and Annual Meeting Matters

Governance Matters. Proxy Access continues to be a common shareholder proposal, and bylaws with the following provisions generally have been acceptable to investors: (i) a 3% ownership requirement for 3 years, (ii) nominating ability of up to 20% of the board, with a minimum of 2 nominees, (iii) a 20-shareholder aggregation limit to meet the 3% ownership requirement, and (iv) reasonably recallable loaned shares counting toward ownership.

Other shareholder proposal matters that continue to be prominent include: (i) requests for an independent board chair (ii) the elimination of supermajority voting, (iii) majority voting in uncontested elections, (iv) board declassification and (v) the right of shareholders to call a special meeting.

Environmental & Social Matters. Noteworthy proposals from 2017 include proposals on the following: (i) board diversity, (ii) climate change, (iii) political contributions and lobbying and (iv) gender pay equity. With the unmasking of many gender issues in 2017, we expect board diversity and gender pay equity to be even more prominent in 2018. BlackRock, State Street, Vanguard, CalPERS, the New York City Comptroller and others will continue their push for companies to have female directors and more gender balance. In addition, ISS will start identifying boards with no female directors, and, starting in 2019, Glass Lewis will generally recommend voting against a nominating committee chair with no female members on the board.

14a-8 Guidance. In November 2017, the SEC staff issued new guidance on the scope and application of two bases for excluding shareholder proposals under Rule 14a-8. *(See **Staff Legal Bulletin No. 14I**)* In particular, the staff advised that requests to exclude proposals under the “Ordinary Business” exception (Rule 14a-8(i)(7)) are expected to include the board’s analysis of the policy raised in the proposal and its significance. The staff also broadened the availability of the “Economic Relevance” exception (Rule 14a-8(i)(5)). Historically, the staff would not exclude a proposal if it raised “broad social or ethical concerns” and the company conducted *any* business related to the issue. Going forward, the staff has indicated that it will focus on the proposal’s significance to the company’s business when it otherwise relates to operations that account for less than 5% of total assets, net earnings and gross sales. That being said, the staff denied Apple’s request, which was the first request under the new guidance.

The staff also clarified that graphs and images in proposals do not violate the 500-word limit in Rule 14a-8(d), but noted that words contained in the graph or image would be counted toward the limit. The staff confirmed that graphs and images still may be excluded under Rule 14a-8(i)(3) where they are, for instance, materially false or misleading, inherently vague or impugn character.

CEO Pay Ratio Disclosure. Despite the hopes of many, companies will be required to disclose (i) the median of the annual total compensation of all employees, excluding the CEO, (ii) the annual total compensation of the CEO, (iii) the ratio of these totals and (iv) a brief description of the methodology used to determine these amounts. The SEC did not specify where this disclosure must be made, and we suggest that it not be part of the CD&A (unless it is considered when determining executive compensation) so that it is not required to be approved by the compensation committee. We also expect many companies to keep the disclosure to a minimum, without the addition of supplements to the required disclosure, and to utilize the staff’s guidance that the pay ratio may be disclosed as a reasonable “estimate.” If you plan to communicate directly with employees regarding the pay ratio, the communication should be reviewed to determine whether it constitutes additional solicitation materials required to be filed with the SEC.

162(m). The Tax Act made significant changes to the executive compensation deduction rules in Section 162(m). More specifically, as of January 1, 2018, the Tax Act eliminated the performance-based exception to the $1 million per-executive annual limit on compensation deductibility for certain public company executives. This change will result in a significant increase in disallowed tax deductions, which could result in substantial changes to executive compensation design that may need to be reflected in the proxy statement. Moreover, you should carefully review disclosures relating to Section 162(m) to ensure that they remain accurate.

Say-on-Pay Frequency Votes. A say-on-pay frequency vote is required every six years, and many companies included a frequency vote in their 2017 proxy, because they were subject to the initial rules when they became effective for shareholders' meetings occurring on or after January 21, 2011. If you didn't hold a frequency vote last year, which would be the case for smaller reporting companies that were not subject to the requirement until a later date, you should determine whether a frequency vote is required this year.

Issuers that formerly qualified as "emerging growth companies" (EGCs) also should review their say-on-pay requirements as issuers that no longer qualify as EGCs lose their exemption from these requirements within one year of losing EGC status (or no later than three years after selling securities under an effective registration statement if an issuer was an EGC for less than two years). Typically, such companies will also hold say-on-pay frequency votes when they hold their first say-on-pay vote as a non-EGC.

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