Matters To Consider for the 2020 Annual Meeting and Reporting Season

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Companies have important decisions to make as they prepare for the 2020 annual meeting and reporting season.

We have compiled the following overview of key corporate governance, executive compensation and disclosure matters on which we believe companies should focus as they plan for the upcoming season. As always, we welcome any questions you have on any of these topics or other areas related to annual meeting and reporting matters.

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Comply With Updated SEC Filing Requirements

Over the past year, the U.S. Securities and Exchange Commission (SEC) amended various disclosure requirements that impact annual reports, proxy statements and other SEC filings. A number of these changes are described below.

FAST Act Amendments to Regulation S-K

The SEC adopted various amendments to Regulation S-K to modernize and simplify disclosure requirements, as mandated by the Fixing America's Surface Transportation Act (FAST Act).[1] The amendments impact a number of documents required to be filed with the SEC. When preparing annual reports on Form 10-K companies should note the following:

- **Risk Factors.** Risk factor disclosure requirements are located in new Regulation S-K Item 105, which favors a principles-based approach that encourages companies to focus on their own specific circumstances. Other considerations regarding risk factor disclosures are discussed in the section titled "Assess Impact of SEC Staff Comments and Guidance."
- **Description of Property.** Regulation S-K Item 201, which requires a description of a company's principal physical properties, was amended to add a materiality qualifier. As a result, a company must describe its properties only to the extent they are material. Companies also may describe their properties on a collective basis, when appropriate.
- **Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A).** Companies with financial statements covering three years in a filing may omit discussion about the earliest of the three years in the MD&A section if they already have included such discussion in a prior filing (*e.g.*, in the prior year's Form 10-K or another prior SEC filing).[2] If electing to omit a discussion of the earliest year, companies must include a statement identifying the location in the prior filing of the omitted discussion.
- **New "Description of Securities" Exhibit.** Regulation S-K Item 601(b)(4) was amended to require, as an exhibit to Form 10-K, a description of a company's registered securities in accordance with Regulation S-K Item 202.[3]
- **Material Contract Exhibits.** Only newly reporting companies are subject to the two-year look back of Regulation S-K Item 601(b)(10)(i), which requires the inclusion of all material contracts that were entered into during the last two years of the applicable registration statement or report.[4] All companies still must file as an exhibit contracts not made in the ordinary course of business that are material to the company and to be performed in whole or in part at or after the filing of the registration statement or report.
- **Modified "Executive Officers" Caption.** For companies that include executive officer biographies in Part I of Form 10-K, Regulation S-K Item 401 now requires such disclosure under the caption titled "Information about our Executive Officers," which replaces the previously required "Executive officers of the registrant" caption.[5]

[1] See our client alert "SEC Modernizes and Simplifies Disclosure and Compliance Requirements" (March 26, 2019).

[2] See Regulation S-K, Instruction 1 to Item 303(a).

[3] The exhibit should include information required by paragraphs (a) through (d) and (f) of Item 202, but not paragraph (e), which pertains to market information pursuant to Item 201(a) of Regulation S-K. See Regulation S-K Item 601(b)(4)(vi).

[4] See Regulation S-K Item 601(b)(10)(i)(A).

[5] See Regulation S-K, Instruction to Item 401.

Form 10-K Cover Page Changes

Recent SEC rulemaking has resulted in the following changes to the cover page of Form 10-K and other SEC forms:

- **Trading Symbol Disclosure.** Consistent with changes to the cover pages of Forms 10-Q and 8-K, the cover page of Form 10-K now requires disclosure of the ticker symbol for securities registered under Section 12(b) of the Exchange Act.[6]
- **Delinquent Section 16(a) Reports.** The Form 10-K cover page no longer includes a checkbox indicating that late Section 16 filing disclosure will be included in the Form 10-K or annual proxy statement. For additional information regarding the related changes to Regulation S-K Item 405, see the section titled "Prepare for Hedging Policy Disclosures."

Redacted Exhibits and Streamlined Confidential Treatment

As discussed in our May 17, 2019, client alert "A Guide to Redacting Commercially Sensitive Information From Exhibits Filed With the SEC," the FAST Act amendments eased certain exhibit filing requirements and streamlined the process for confidential treatment of commercially sensitive terms in agreements filed as exhibits with the SEC.

Omission of Schedules and Other Attachments From Exhibits. Companies may omit schedules and similar attachments from any exhibit filings (including material contracts), so long as the omitted information is not material and is not otherwise disclosed in the exhibit or the SEC filing.[7] In lieu of including such schedules and similar attachments in an exhibit, companies must file with the exhibit a list briefly identifying the contents of the omitted schedules, although this can be satisfied by the agreement itself (*e.g.*, by the table of contents).

Confidential Treatment Request (CTR) Process. The FAST Act amendments have significantly simplified the process for redacting commercially sensitive terms from certain agreements filed as exhibits to SEC filings.[8] Companies seeking to redact or omit commercially sensitive terms from exhibits may now file a redacted exhibit without concurrently submitting a written CTR to the SEC staff.[9] However, companies still are permitted to submit a traditional CTR under the existing process.

Companies also should note that the substantive requirements applicable to exhibit redactions have not changed. Accordingly, information may be redacted from exhibits *only* if it (i) is not material and (ii) likely would cause competitive harm to the company if publicly disclosed.[10] The amendments also codify the prior practice of permitting companies to omit personally identifiable information (such as social security numbers, residential addresses and similar information) without any confidential treatment request or other conditions.[11]

When preparing a redacted exhibit for filing, the first page of the exhibit should include a prominent statement indicating that certain information has been excluded from the exhibit because it is not material and likely would cause competitive harm to the company if publicly disclosed. The exhibit also should reflect the redactions with brackets (*e.g.*, "[***]") to indicate where information has been omitted. In addition, the exhibit index of the applicable SEC filing should include a notation indicating that portions of the exhibit have been omitted.[12]

Given that redactions from exhibits remain subject to SEC staff review, companies should be prepared to provide redacted materials to the SEC staff upon request. Although not required, it may be prudent for companies to memorialize the basis for confidential treatment at the time redactions are determined. In addition, companies should continue to take care to prevent other public disclosure of omitted terms, such as by requesting that counterparties do not make such terms public, whether in their own SEC filings or otherwise.

Confidential Treatment Order Extensions. If a previously granted confidential treatment order is due to expire and a company wishes to continue to protect the unredacted version of an agreement from being subject to public release under the Freedom of Information Act (FOIA), the company still must file an extension application under Securities Act Rule 406 or Exchange Act Rule 24b-2, as applicable. The SEC staff now accepts a simple, one-page extension request.[13]

Inline XBRL

Large accelerated filers that prepare their financial statements in accordance with U.S. GAAP (generally accepted accounting principles) already are required to tag their financials in Inline eXtensive Business Reporting Language (iXBRL). Accelerated filers will be required to comply with iXBRL in reports for fiscal periods ending on or after June 15, 2020. All other filers will be

[6] See our client alert "SEC Modernizes and Simplifies Disclosure and Compliance Requirements" (March 26, 2019).

[7] See Regulation S-K Item 601(a)(5).

[8] Note that unlike the amendments allowing the omission of schedules to any exhibit filings, the ability to redact commercially sensitive terms without a CTR is limited to exhibits filed under Items 601(b)(2) and 601(b)(10).

[9] See Regulation S-K Items 601(b)(2)(ii) and (10)(iv).

[10] See Regulation S-K Items 601(b)(2)(ii) and 601(b)(10)(iv).

[11] See Regulation S-K Item 601(a)(6).

[12] See Regulation S-K Items 601(b)(2)(ii) and 601(b)(10)(iv).

[13] See the SEC's press release "New Streamlined Procedure for Confidential Treatment Extensions" (April 16, 2019). A blank version of the short-form extension request may be found here.

required to comply in reports for fiscal periods ending on or after June 15, 2021.

In addition, companies that use iXBRL are subject to updated exhibit index requirements:

- The exhibit index should reference the Exhibit 101 required for Interactive Data Files and include the word "Inline" within the title description for XBRL-related exhibits.[14]
- A new Exhibit 104 is required for cover page iXBRL data and should be included in the Interactive Data File covered by Exhibit 101.[15]

As a result, a typical exhibit index for a company using iXBRL in its Form 10-K should have an Exhibit 101 that refers to "Inline" XBRL and a reference to Exhibit 104 along the following lines:

> 104 Cover Page Interactive Data File — the cover page XBRL tags are embedded within the Inline XBRL document.

Section 16 Compliance

Regulation S-K Item 405 was amended in the following ways:

- Disclosure of non-compliance with the securities ownership reporting requirements of Exchange Act Section 16(a) is now required under the caption "Delinquent Section 16(a) Reports" (previously titled "Section 16(a) Beneficial Ownership Reporting Compliance").
- A new instruction encourages companies to exclude the "Delinquent Section 16(a) Reports" caption when such disclosure is not required.
- As noted above, the Form 10-K cover page no longer includes the checkbox indicating that late Section 16 filing disclosure will be included in the Form 10-K or annual proxy statement.
- Item 405 also was amended to clarify that in complying with this Item, companies may rely solely on the filings made on EDGAR. Relatedly, persons subject to Section 16 are no longer required to provide the applicable company with copies of such filings.

[14] See Regulation S-K Item 601(b)(101).

[15] See Regulation S-K Item 601(b)(104). See the SEC staff's Compliance and Disclosure Interpretations (C&DIs) "Interactive Data" (August 20, 2019). While this requirement applies to Form 8-K, there is no requirement to reference Exhibit 104 in a Form 8-K that otherwise would not include an exhibit list.

Updated Mining Property Disclosure Requirements

Companies with material mining operations should note that the SEC adopted rules to modernize the mining property disclosure requirements applicable to registration statements and annual reports.[16] The amendments rescind Industry Guide 7 and consolidate the mining disclosure requirements in a new subpart 1300 of Regulation S-K.[17] Companies are required to begin complying with the new rules in their first fiscal year beginning on or after January 1, 2021. The SEC staff also has stated that early voluntary compliance is permitted so long as a company satisfies all of the provisions of the new rule and any required technical report is filed as an exhibit that meets existing EDGAR technical specification requirements.[18]

As part of aligning disclosure requirements with the Committee for Mineral Reserves International Reporting Standards (CRIRSCO), the rules require companies with material mining operations to disclose, among other things:

- information concerning mineral resources (the definition of which tracks CRIRSCO standards more closely and excludes oil and gas resources resulting from oil and gas producing activities, gases and water), which was previously only permitted in limited circumstances;
- material exploration results and related exploration activity; and
- summary information concerning properties in the aggregate as well as more detailed information about individually material properties.

Further, under the new rules, companies' disclosure of exploration results, mineral resources or mineral reserves must be substantiated with supporting documentation prepared by a "qualified person."[19] The new rules also require companies to obtain a technical report summary prepared by the qualified person, summarizing their review and conclusions about mineral resources or reserves on each material property.[20] Such report must be filed as an exhibit to a relevant SEC filing when mineral reserves or resources are disclosed for the first time or when there is a material change in the disclosure.

[16] See the SEC's adopting release "Modernization of Property Disclosures for Mining Registrants" (October 31, 2018).

[17] Regulation S-K Items 1300 through 1305.

[18] See the SEC's press release "Voluntary Compliance with the New Mining Property Disclosure Rules Prior to Completion of EDGAR Reprogramming" (May 7, 2019).

[19] Defined in Regulation S-K Item 1300 as a mineral industry professional with at least five years of relevant experience in the type of mineralization and type of deposit under consideration and in the specific type of activity that person is undertaking on behalf of the registrant and an eligible member or licensee in good standing of a recognized professional organization at the time the technical report is prepared.

[20] Regulation S-K Item 601(b)(96).

Prepare for Critical Audit Matters

Audit reports for large accelerated filers with fiscal years ending on or after June 30, 2019, must now include a new section addressing critical audit matters (CAMs).[21] The Public Company Accounting Oversight Board (PCAOB), which governs audit report content, expects that most companies required to comply will disclose at least one CAM in their audits. As a result, most large accelerated filers — companies with calendar year-end fiscal years — soon will be required to file their first set of audited financial statements accompanied by an audit report likely to identify one or more CAMs. Fortunately, audit reports already filed with the SEC that have disclosed CAMs provide a glimpse into what companies generally can expect.

Background. As we explained in our June 7, 2017, client alert "Accounting Oversight Board Adopts New Model for Auditor Reports," a CAM is a matter communicated or required to be communicated to the audit committee that (i) relates to accounts or disclosures that are material to the financial statements and (ii) involved especially challenging, subjective or complex auditor judgment. If an auditor determines that a CAM exists from the current period audit, the auditor is required to provide certain information about the CAM in its audit report accompanying the audited financial statements. Such information, intended to make the audit report more relevant to investors, includes identification of the CAM, a description of the principal considerations that led the auditor to determine the matter is a CAM, a description of how the CAM was addressed in the audit, and a reference to the relevant financial statement accounts or disclosures.

CAMs disclosures thus far reveal that, consistent with the PCAOB's expectations, companies average one CAM per audit report. Reported CAMs to date generally have not been surprising, tending to cover issues that often involve significant management judgment. According to Audit Analytics, between July 1, 2019, and November 11, 2019, just over 200 CAMs were disclosed in the audit reports of more than 100 different companies.[22] More than 75% of those CAMs related to asset impairment and recoverability (22%), revenue recognition (20%), acquisitions and disposal topics (17%), income taxes (13%) and contingent liabilities (6%), with the balance relating to valuations, accounting changes and error corrections, and industry-specific matters.

Preparing for CAMs Disclosures. To ensure a smooth implementation process and fewer potential surprises, companies should be working closely with their auditors to determine the methodology the auditor plans to use to identify potential CAMs and to identify as early as possible which matters may be considered CAMs. Completing "dry runs" with the auditors helps in this regard and is highly recommended. Such dry runs, according to Deloitte, often entail the auditors evaluating matters that might qualify as CAMs, considering how CAMs should be drafted and discussing potential CAMs with management and audit committees to help them understand and prepare for the disclosures.[23]

Companies considering the dry-run process should allot adequate time for doing so. In an Accounting Today/SourceMedia Research survey, 81% of large accelerated filers indicated that company personnel met with the auditor at least three times during the dry-run process, and nearly two-thirds of companies surveyed took more than four months to complete the

[21] Such requirement will become effective for all other nonexempt companies for fiscal years ending on or after December 15, 2020. Nonexempt companies include emerging growth companies; brokers and dealers; investment companies other than business development companies; and employee stock purchase, savings and similar plans.

[22] See Audit Analytics' "An Update on Critical Audit Matters (CAMS)" (October 17, 2019) and "More to Discover with CAMS" (November 12, 2019).

[23] See Deloitte's "Critical Audit Matters Make Their Debut!" (August 30, 2019).

process.[24] More than 40% of companies surveyed also indicated that the audit committee identified additional controls that required implementation as part of the dry-run process.

Companies also should determine what, if any, additional disclosure should be included in their SEC filings in light of any anticipated CAMs disclosures. Outside of the notes to the financial statements, the management's discussion and analysis section is mostly likely to be revisited as a result of CAMs disclosures. According to an Intelligize survey of companies, for example, nearly half of respondents are considering updating their MD&A to address potential issues raised by the auditor's identification of a CAM.[25]

[24] See Accounting Today's "Dry Runs for CAMs Show They'll Bring Extra Work" (September 10, 2019).

[25] See Intelligize's "New Intelligize Report Digs Into CAM Preparations" (September 10, 2019).

Incorporate Lessons Learned From the 2019 Say-on-Pay Votes and Compensation Disclosures

Companies should consider their recent annual say-on-pay votes and disclosure best practices when designing their compensation programs and communicating about their compensation programs to shareholders. This year, companies should understand key say-on-pay trends, including overall 2019 say-on-pay results, factors driving say-on-pay failure (*i.e.*, those say-on-pay votes that achieved less than 50% shareholder approval), say-on-golden-parachute results and equity plan proposal results, as well as recent guidance from the proxy advisory firms Institutional Shareholder Services (ISS) and Glass Lewis.

Overall Results of 2019 Say-on-Pay Votes

Below is a summary of the results of the 2019 say-on-pay votes from Semler Brossy's annual survey[26] and trends over the last eight years since the SEC adopted its say-on-pay rules. Overall, say-on-pay results in 2019 were similar to those in 2018.

- Approximately 97.3% of companies received at least majority support on their say-on-pay proposal, with approximately 91% receiving above 70% support. On an aggregate level, these results are largely consistent with results for 2018.
    - However, the average say-on-pay approval rates declined for certain industries in 2019 compared to 2018, with at least one half of 1% decreases for the pharmaceuticals, biotechnology and life sciences, insurance, and media and entertainment industries. Other industries experienced year-over-year say-on-pay approval increases of at least one half of 1%, such as the banking, diversified financials and retail industries.[27]
- Companies received an average vote result of 90.5% approval in 2019, slightly higher than the average vote result of 90.2% in 2018.[28]
- Approximately 2.7% of say-on-pay votes for Russell 3000 companies failed in 2019 as of October 2019, which is the same as for October 2018 but higher than year-end failure rates for the three years preceding 2018. In addition, approximately 10% of Russell 3000 companies and 8% of S&P 500 companies surveyed have failed to receive a majority support for say-on-pay at least once during the preceding eight years.
- One-third of S&P 500 companies and 28% of Russell 3000 companies surveyed have received less than 70% support at least once during the preceding eight years. However, companies frequently have recovered, with 63% of companies that received an "Against" ISS recommendation in 2018 receiving a "For" recommendation in 2019.
- ISS approval continues to sway say-on-pay votes, which, on average, yield 30% lower approval for companies that received an ISS "Against" recommendation in 2019, which is near the high end of the historical average range of 24% to 32% but consistent with 2018. This may suggest an increasing alignment between institutional shareholder voting and ISS recommendations. Moreover, ISS' "Against" recommendation rate has decreased from 13.9% in 2018 to 12.7% in 2019, which borders the historical average of 12.8% since 2011.

Factors Driving Say-on-Pay Failure

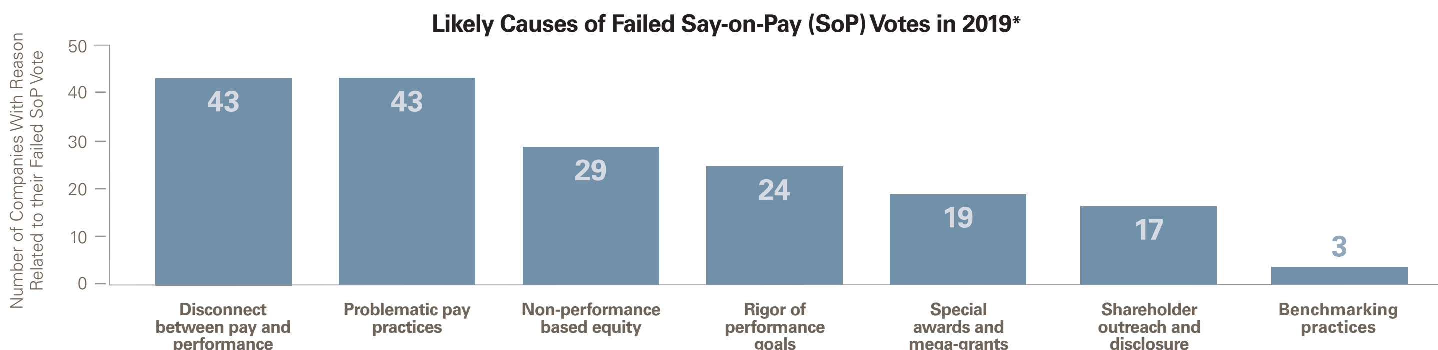
Overall, the most common causes of say-on-pay failure were a disconnect between pay and performance, problematic pay practices, use of nonperformance-based equity, the rigor of performance goals, special awards such as mega-grants (*i.e.*, front-loaded awards intended

[26] See Semler Brossy's report "2019 Say-on-Pay and Proxy Results" (October 3, 2019).

[27] See Aon's report "Preparing for the 2020 Proxy Season and a Lookback at 2019 Say-on-Pay Voting in the U.S." (September 2019).

[28] See Semler Brossy's report "2018 Say on Pay and Proxy Results: End of Year Report" (January 24, 2019).

to cover several years of compensation in lieu of long-term incentive grants), shareholder outreach and disclosure issues, and challenged benchmarking practices, as summarized in the chart below.



*56 companies that failed on SoP were included in this survey. The same company may be counted towards multiple cases of failure.

Notably, an increasing number of failed say-on-pay votes is attributed to the rigor of performance goals, which in 2019 was ranked the fourth most frequently cited likely cause of say-on-pay vote failure, compared to sixth in 2018. However, companies appear to have improved their shareholder outreach and disclosure efforts. In 2019, shareholder outreach and disclosure efforts were the sixth most frequently cited likely cause of say-on-pay vote failure, compared to fourth in 2018. Otherwise, the likely causes of say-on-pay failure remained largely consistent between 2018 and 2019, with a disconnect between pay and performance and problematic pay practices as the continuing frontrunners.

Another study noted that companies are reporting increased investor attention on their executive compensation practices, and that over the past three years, executive bonuses and benefits have drawn the most attention from shareholders based on their responses to a 2019 survey.[29] Therefore, companies should carefully communicate the link between performance and executive bonuses and benefits to their shareholders.

ISS Guidance

When evaluating pay practices, proxy advisory firms tend to focus on whether a company's practices are contrary to a performance-based pay philosophy. In December of each year, ISS publishes Frequently Asked Questions (FAQ) to help shareholders understand changes to ISS compensation-related methodologies. In December 2018, ISS published its most recent FAQ[30] summarizing which problematic practices are most likely to result in an adverse ISS vote recommendation. These practices are expected to remain problematic in 2020, including the following:

- repricing or replacing of underwater stock options/SARs without prior shareholder approval (including cash buyouts and voluntary surrender of underwater options);
- extraordinary perquisites or tax gross-ups, likely including gross-ups related to a secular trust or restricted stock vesting, and home-loss buyouts, or any lifetime perquisites;
- new or extended executive agreements that provide for (i) termination or change in control payments exceeding three times the executive's base salary and bonus; (ii) change in control severance payments that do not require involuntary job loss or substantial diminution of duties; (iii) change in control payments with excise tax gross-ups, including modified gross-ups, multiyear guaranteed awards that are not at-risk due to rigorous performance conditions; (iv) a "good reason" termination definition that presents windfall risks, such as definitions triggered by potential performance failures, such as a company bankruptcy or delisting; or (iv) a liberal change in control definition combined with any single-trigger change in control benefits; and
- any other egregious practice that presents a significant risk to investors.[31]

Other issues contributing to low say-on-pay support include:

- inadequate disclosure around incentive goals and lowered incentive goals without explanation;
- high-target incentives for companies that are underperforming relative to their industries;
- special bonuses and mega equity grants without sufficient rationale or risk-mitigating design features;
- targeting compensation above the 50th percentile of peer compensation groups, especially when using outsized peers; and

[29] See Toppan Merrill's "Market Pulse: Executive Compensation" (September 11, 2019).

[30] See ISS' Frequently Asked Questions (FAQ) "U.S. Compensation Policies" (December 20, 2018).

[31] See *id.* FAQ #47 and FAQ #48.

- insufficient shareholder outreach and disclosure, including inadequate response to compensation-related concerns raised by shareholders.

Glass Lewis Guidance

Glass Lewis also recently released its 2020 Proxy Paper Guidelines for the United States,[32] which included the following updates for 2020:

- For the first time, Glass Lewis made clear that it expects companies to defer to their shareholders' opinion on the frequency of the say-on-pay vote. If a company's board of directors adopts a frequency for its say-on-pay vote that diverges from the frequency approved by the plurality of a company's shareholders, Glass Lewis generally will recommend against all compensation committee members.
- Glass Lewis created a new expectation that companies correct for certain unfavorable pay practices when amending or renewing employment agreements. Such pay practices include: excessive severance payments, new or renewed single-trigger change-in-control arrangements, excise tax gross ups and multiyear guaranteed awards. Glass Lewis historically has deemed such pay practices as concerning.
- Glass Lewis may consider change-in-control arrangements to be single-trigger or modified single-trigger arrangements if they do not explicitly require both a change in control and a termination or constructive termination to be effective. It also continued to emphasize its disfavor of excessively broad change in control definitions, which could contribute to windfalls for executives who did not recognize meaningful changes in their status or duties.
- Glass Lewis set a new expectation that companies disclose the threshold awards that can be achieved under short-term bonus or incentive (STI) plans. Companies also should continue to disclose the target and potential maximum awards. Additionally, Glass Lewis newly made clear that it expects companies to offer a robust disclosure of their rationale for exercising upward discretion with respect to STI awards, such as lowering performance goals mid-year or increasing STI plan payouts.
- Glass Lewis elaborated on its expectations for companies that received low say-on-pay support from their shareholders. Specifically, it will review such companies' shareholder engagement efforts, implementation of changes that address shareholder concerns where reasonable and disclosures regarding shareholder engagement activities. Failure to disclose such shareholder engagement activities or insufficient responses to low shareholder support (80% or less) may contribute to a negative Glass Lewis vote recommendation. Glass Lewis also made explicit that it will consider the magnitude of opposition in a single year and the persistence of shareholder discontent over time when gauging the adequacy of the board's responsiveness to low shareholder support.
- When reviewing say-on-pay proposals, Glass Lewis stated that it will now consider post-fiscal year-end changes and one-time awards.
- Glass Lewis continues to use its proprietary pay-for-performance model to evaluate the link between a company's pay and its performance. Although this analysis is primarily quantitative, Glass Lewis now specifies certain qualitative factors that may influence its voting recommendations, such as overall incentive structure, significant forthcoming changes to a company's compensation program or reasonable long-term payout levels.

Recommended Next Steps

Overall, executive compensation remains in the spotlight, with companies facing pressure from proxy advisory firms, institutional investors, the news media, activist shareholders and other stakeholders. This year's proxy season is an opportunity for all companies to clearly disclose the link between pay and performance and efforts to engage with shareholders about executive compensation. These disclosures should explain the company's rationale for selecting particular performance measures for performance-based pay and the mix of short-term and long-term incentives. Companies also should carefully disclose the rationale for any increases in executive compensation, emphasizing their link to specific individual and company performance.

Companies should consider including executive summaries, charts, graphs and other reader-friendly tools. For example, many companies provide a summary near the beginning of the proxy that highlights, among other things, the company's business accomplishments and key compensation elements, features and decisions.

In the year following a say-on-pay vote, proxy firms conduct a thorough review of companies whose say-on-pay approval votes fall below a certain threshold: 70% approval for ISS and 80% for Glass Lewis. ISS' FAQ explain that this review involves investigating the breadth, frequency and disclosure of the compensation committee's stakeholder engagement efforts, disclosure of specific feedback received from investors who voted against the proposal, actions taken by the board to address the low level of support, other recent compensation actions, whether the issues raised were recurring and the company's ownership structure.

[32] See Glass Lewis' "2020 Proxy Paper Guidelines, An Overview of the Glass Lewis Approach to Proxy Analytics, United States" (November 2019).

Looking ahead to 2020, companies that received say-on-pay results below the ISS and Glass Lewis thresholds should consider enhancing disclosures of their shareholder engagement efforts in 2020 and actions they took to address concerns. Companies that fail to conduct sufficient shareholder engagement efforts and to make these disclosures may receive negative voting recommendations from proxy advisory firms on say-on-pay and compensation committee member reelection.

Recommended actions for such companies include:

- Assess results of the most recent say-on-pay vote. As part of this analysis, identify which shareholders were likely the dissenting shareholders and why.
- Engage key company stakeholders by soliciting and documenting their perspectives on the company's compensation practices. Analyze stakeholder feedback, determine recommended next steps, and discuss findings with relevant internal stakeholders, such as the compensation committee and the board of directors.
- Review ISS and Glass Lewis guidance to determine the reason for their vote recommendation in 2019. Carefully consider how shareholders and proxy advisory firms will react to planned compensation decisions for the remainder of the current fiscal year and recalibrate as necessary.
  - For example, consider compensation for new hires, leadership transitions and any special one-time grants or other arrangements.
- Determine and document which changes will be made to the company's compensation policies in response to shareholder feedback.
- Disclose specific shareholder engagement efforts and results in the 2020 proxy statement. Such disclosures should include information about the shareholders engaged, such as the number of them, their level of ownership in the company and how the company engaged them. They also should reflect actions taken in response to shareholder concerns, such as a company's decision to offer more robust disclosures or to adjust certain compensation practices.
  - Companies that have not changed their compensation plans or programs in response to major shareholder concerns should consider disclosing: (i) a brief description of those concerns, (ii) a statement that the concerns were reviewed and considered and (iii) an explanation why changes were not made.

Say-on-Golden Parachute Proposal Results

Say-on-golden parachute votes historically have received lower support than annual say-on-pay votes. According to Willis Towers Watson's annual report,[33] average support for golden parachute proposals dropped slightly from 78% in 2018 to 76% from January 1, 2019 through July 12, 2019. Companies should beware of including single-trigger benefits (*i.e.*, automatic vesting upon a change in control) in their parachute proposals, because stakeholders cite single-trigger vesting as a primary source of concern, with tax gross ups, performance awards vesting at maximum and excessive cash payouts as significant secondary concerns.

ISS' impact on say-on-golden parachute votes is also more substantial than in previous years, with approximately 37% less support for proposals where ISS issued an "Against" recommendation in 2019, compared to 33% less support in 2018. This is consistent with proxy advisory firms' increasing influence over say-on-pay votes.

Equity Plan Proposal Results

Equity plans continue to be widely approved, with less than 1% of equity plan proposals receiving less than a majority vote in 2019. Average support for equity plan proposals as of October 2019 is 88.5%, which is higher than the 88.1% average support observed in October 2018.

Most companies garner strong equity plan proposal support from shareholders, regardless of the say-on-pay results. As of October 2019, companies with less than 70% say-on-pay approval that presented an equity plan proposal still received 85% support for the equity plan proposal. On average, companies that received more than 90% say-on-pay support also received similar support for their equity plan proposal.

However, equity plan proposals are becoming increasingly rare. The decrease in equity plan proposals may be driven by the elimination of the performance-based compensation deduction under Section 162(m) of the Internal Revenue Code of 1986, which diminished the need for regular shareholder approval of performance goals in incentive plans.

2019 marked the fifth year in which ISS applied its Equity Plan Scorecard (EPSC). ISS' application of the EPSC changed in important ways for meetings on and after February 1, 2019, and will continue to evolve in 2020:[34]

- In 2018, the change in control vesting factor was simplified, scoring companies on a basis of full or no credit. A company earned full credit if its equity plan contained both of the following provisions: (i) for performance-based awards,

[33] See Willis Towers Watson's report "U.S. Executive Pay Votes—2019 Proxy Season Review" (August 2019).

[34] See ISS' Frequently Asked Questions "U.S. Equity Compensation Plans" (December 19, 2018).

acceleration is limited to actual performance achieved, a pro rata of the target based on the performance period or a combination of both; and (ii) for time-based awards, acceleration upon a change in control cannot be discretionary or automatic single-trigger. However, starting in 2019, equity plans that disclose with specificity the change in control vesting treatment for both performance- and time-based awards earn full credit. Credit is earned based on quality of disclosure, rather than based on actual vesting treatment of awards. Plans that fail to address change in control vesting treatment for either type of award or provide merely for discretionary vesting earn no credit.

- In 2019, ISS began applying a new negative overriding factor relating to excessive equity dilution when a company's equity compensation program is estimated to dilute shareholders' holdings by over 20% for S&P 500 companies or 25% for Russell 3000 companies.
- Certain factor scores were adjusted for 2019. The plan duration factor was increased to encourage companies to submit their equity plans for shareholder approval more frequently.
- Effective for meetings on and after February 1, 2020, ISS will now consider "evergreen" funding provisions a negative overriding factor in equity plan proposals. "Evergreen" funding provisions provide for automatic share increases on a periodic basis without requiring shareholder approval for those increases.[35]

Companies should continue to pay careful attention to the EPSC. A company that pursues an equity plan that conflicts with proxy advisory standards should conduct robust shareholder engagement efforts and make a persuasive case for the plan in the proxy statement to increase the chances of shareholder approval.

Other Proxy Advisory Firm Takeaways

In 2017, ISS provided guidance about its 2018 policy for evaluating whether nonemployee director (NED) pay is excessive. Under that policy, an ISS finding of excessive NED pay over two or more consecutive years without a compelling rationale or mitigating factors could result in an adverse vote recommendation starting in 2019. However, in November 2018, ISS announced it would revise its methodology for identifying NED pay outliers and delayed the first possible adverse vote recommendations under ISS' NED pay policy until meetings occurring on or after February 1, 2020.

ISS' most recent full set of FAQ[36] provides the following insights about the updated methodology for evaluating NED pay:

- Pay outliers will be those NEDs with pay that exceeds the top 2%-3% of all comparable directors (rather than the top 5%).
  - Individual NED pay totals will be evaluated within the context of a company's index (*e.g.*, S&P 500) and sector (two-digit Global Industry Classification Standard group).
  - Board leaders (limited to nonexecutive chairmen and lead independent directors) will be compared against other board leaders.
  - The lack of a pronounced difference in pay between the top 2%-3% of NEDs and the median director in a given sector-index grouping may be a mitigating factor.
- If ISS determines that an NED's pay is a quantitative pay outlier, it will perform a qualitative evaluation of the company's disclosed rationale to determine if concerns are adequately mitigated. The following fact patterns typically would mitigate concerns, provided they are within reason and adequately explained:
  - new director onboarding grants clearly identified as one-time in nature;
  - special payments related to corporate transactions or special circumstances (*e.g.*, special committee service); or
  - payments made for necessary, specialized scientific expertise.

Payments to reward general performance typically will not be considered a compelling mitigating factor, and payments made in connection with separate consulting agreements will be assessed on a case-by-case basis.

In its most recent full set of FAQ, ISS shared several updates for 2019, which are expected to carry through to 2020:[37]

- ISS confirmed that, while there were no changes to its quantitative pay-for-performance screens for 2019, it is continuing to explore the potential use of an economic value added (EVA) measure and begin to display EVA results in its research reports. As to the qualitative screens, ISS added a new consideration — the emphasis of objective and transparent metrics. ISS also expressly noted that, while investors prefer emphasis on objective and transparent metrics, it does not endorse or prefer the use of total shareholder return or any other specific metric.

[35] See ISS' "United States Compensation Policies for 2020: Preliminary Frequently Asked Questions" (November 13, 2019).

[36] See ISS' Frequently Asked Questions (FAQ) "U.S. Compensation Policies" (December 20, 2018).

[37] See *id.*

- ISS said that it is unlikely to support "front-loaded" award grants that cover more than four years and that a company's commitment not to grant additional awards over the covered period should be firm.
- ISS previously had made clear that if an automatically renewing/extending employment agreement is not materially amended, its automatic extension will not on its own result in a negative say-on-pay vote recommendation, even where the agreement contains a problematic pay practice. ISS subsequently made clear that an amendment is "material" for this purpose if it involves any change that is not merely administrative or clarifying.
- ISS reiterated that a company's CEO pay ratio will not at this time impact its vote recommendations but that its research reports will continue to display the company's median employee pay figure and the pay ratio for not only the current year but also, if available, the prior year as well.

In addition, according to ISS' Preliminary FAQ for Compensation Policies for 2020,[38] ISS' financial performance assessment (FPA) will be based on EVA metrics instead of the GAAP metrics that were used in 2019. The EVA metrics include EVA margin, EVA spread, EVA momentum vs. sales, and EVA momentum vs. capital. Although the GAAP metrics will no longer be incorporated into the pay-for-performance screens, they will continue to be displayed on ISS' research reports.

Companies should consider whether to make any updates to the compensation benchmarking peers included in ISS' database. ISS uses these company-selected peers when it determines the peer group it will use for evaluating a company's compensation programs. ISS will accept these updates through Friday, December 6, 2019.[39]

[38] See ISS' "United States Compensation Policies for 2020: Preliminary Frequently Asked Questions" (November 13, 2019).

[39] See ISS' article "Company Peer Group Feedback" (2019).

Prepare for Hedging Policy Disclosures

Most companies will be required to disclose their hedging policies in proxy or information statements for the first time in 2020.[40] New Regulation S-K Item 407(i) requires companies to describe their policies or practices regarding the ability of their employees, officers, directors or any of their designees to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange funds) or otherwise engage in transactions designed to hedge or offset decreases in the market value of the company's equity securities.[41] For purposes of the rule, a company's equity securities include those of the company and of its parents, its subsidiaries and subsidiaries of the company's parents.

A company may satisfy Item 407(i) either by disclosing its practices or policies in full or by providing a fair and accurate description of its hedging practices or policies, including the categories of people affected and types of hedging transactions specifically allowed or not allowed.[42] The rule does not require that companies adopt any such anti-hedging policies, but if a company does not have a hedging policy, it is required to state that fact or to state that hedging transactions generally are permitted.

Companies that have voluntarily disclosed their anti-hedging policies in past proxy statements should review their disclosure against the requirements of Item 407(i) and make adjustments as appropriate. Among other things, companies should give special consideration to the treatment of exchange funds as "hedging" instruments, notwithstanding that many companies and practitioners do not consider exchange funds as fitting within the plain meaning of that term. Looking further ahead, companies that disclose that they do not have anti-hedging policies (or that they have relatively permissive policies) should be aware that ISS, Glass Lewis and certain prominent institutional investors have indicated that they favor robust anti-hedging policies for executives and may support shareholder proposals to adopt such policies.

[40] Regulation S-K Item 407(i) applies to proxy and information statements regarding director elections in fiscal years beginning on or after July 1, 2019, except for smaller reporting companies and emerging growth companies, for which the new rules apply to proxy and information statements regarding director elections in fiscal years beginning on or after July 1, 2020. Listed closed-end funds and foreign private issuers are not subject to the new rule.

[41] See our client alert "SEC Adopts Hedging Policy Disclosure Requirements" (January 8, 2019).

[42] Companies also should consider their disclosure pursuant to Regulation S-K Item 402(b)(2)(xiii)—the compensation discussion and analysis concerning policies regarding hedging the economic risk under equity or other security ownership requirements or guidelines applicable to named executive officers—to coordinate or distinguish the two items as appropriate.

Prepare for 2020 Pay Ratio Disclosures

2020 marks the third year that SEC rules require companies to disclose their pay ratio, which compares the annual total compensation of the median company employee to the annual total compensation of the CEO.[43] This section helps companies prepare for the third year of mandatory pay ratio disclosures by considering the following:

- What were the key findings from the 2019 pay ratio disclosures?
- Can the same median employee be used this year?
- What else do companies need to know for 2020?

Key Findings From the 2019 Pay Ratio Disclosures

In an era when executive compensation draws close attention from shareholders, proxy advisory firms and the media, the SEC's pay ratio rules require companies to be transparent about their pay practices.

Based on Semler Brossy's quantitative analysis of 2019's proxy season through October 3, 2019,[44] pay ratios disclosed in 2019 were slightly higher than those disclosed in 2018, primarily driven by increases in CEO pay, as summarized in the table below:

Changes Between 2018 and 2019:	S&P 500	Russell 3000	Independent Study[45]
CEO Pay Ratio (50th Percentile)	Ratio increase from 165:1 to 169:1	Ratio increase from 72:1 to 77:1	Ratio increase from 144:1 to 173:1
Median CEO Compensation	4% increase	6% increase	—
Median Employee Compensation	3% increase	3% increase	—

Key trends from pay ratio data include:

- The use of seasonal or part-time workers continues to impact pay ratios in certain industries. The consumer discretionary and consumer staples sectors both rely heavily on seasonal and part-time workers and were the sectors with the highest median pay ratios, at 483:1 and 355:1 for S&P 500 companies, respectively.
- The utilities and energy sectors continue to have relatively low pay ratios and a low variance between median, minimum and maximum pay ratios. In 2019, the utilities sector had a median pay ratio of 53:1 for the Russell 3000 and 91:1 for the S&P 500, representing the sector with the second lowest and the lowest median pay ratio for the Russell 3000 and the S&P 500, respectively. The private sector industry with the highest unionization rate is the utilities industry,[46] suggesting that union activity could be correlated with lower pay ratios.

[43] Emerging growth companies, smaller reporting companies and foreign private issuers are exempt from the pay ratio disclosure requirement. Transition periods are also available for newly public companies.

[44] See Semler Brossy's report "2019 Say-on-Pay and Proxy Results" (October 3, 2019). Unless otherwise noted, Semler Brossy's report is the source of pay ratio and say-on-pay statistics in this annual checklist.

[45] See Pearl Meyer's Research Report "The CEO Pay Ratio: Data and Perspectives from the 2018 Proxy Season" (September 2018). See also Pearl Meyer's 2019 CEO Pay Ratio page. This study analyzed data from 2,021 companies through June 24, 2019.

[46] Union membership data comes from the Bureau of Labor Statistics Economic News Release "Union Members Summary" (January 18, 2019).

- Although pay ratios do not generally drive say-on-pay vote results, companies should tread cautiously if their pay ratios are in the top quartile of their index. Russell 3000 companies with pay ratios above 150:1, and S&P 500 companies with pay ratios above 300:1 are nearly twice as likely to generate below 90% approval on their say-on-pay vote.

Companies continue to take varying approaches to their pay ratio disclosures and calculations, as permitted by SEC guidance:

- The *de minimis* exception remains the most commonly used exemption, which allows a company to exclude non-U.S. employees when identifying their median employee, if excluded non-U.S. employees constitute 5% or less of their workforce.[47]
- The most common reasons that companies elect to disclose alternate pay ratios is to highlight the influence of the following factors on the pay ratio: one-time awards to the CEO, use of only U.S. employees, or use of only full-time or corporate employees.
- Few companies made robust disclosures about changes in their pay ratios between 2018 and 2019. One study noted that only 14% of its 2,021 respondents included disclosures comparing their 2019 pay ratio against their 2018 pay ratio and only 3% disclosed changes in their consistently applied compensation measure (CACM).[48]
- Although few companies disclose details about their median employee, such as the individual's role or location, such disclosures are slightly increasing. One study of the first 201 proxy statements filed in 2019 found that 16% of companies provided additional details about their median employee in 2019, up from 12% in 2018.[49] The study also found that 35% of the companies sampled used the same median employee in both 2018 and 2019.

Determining Whether To Use the Same Median Employee

As a reminder, under Regulation S-K Item 402(u), companies only need to perform median employee calculations once every three years, unless they had a change in the employee population or compensation arrangements that could significantly affect the pay ratio. This requires companies to assess annually whether their workforce composition or compensation arrangements have materially changed.

Even if a company uses the same median employee in its proxy statement filed in 2020 as in 2019, it must disclose that it is using the same median employee and briefly describe the basis for its reasonable belief that no change occurred that would significantly affect the pay ratio.

To determine whether a material change occurred, companies should continue to evaluate the following:

- How has workforce composition evolved over the past year?
  - Review hiring, retention and promotion rates.
  - Consider the applicability of exceptions under the pay ratio rules:
    - Determine whether to incorporate employees from recent acquisitions or business combinations into the CACM. For example, a company may exclude employees from a 2018 business combination from its 2019 pay ratio calculations, but those excluded employees should probably factor into the company's 2020 median employee calculations.
    - Determine whether the *de minimis* exception applies within the context of the company's 2019 workforce composition. Under this exception, non-U.S. employees may be disregarded if the excluded employees account for less than 5% of the company's total employees or if a country's data privacy laws make a company's reasonable efforts insufficient to comply with Item 402(u).
  - Analyze how the workforce used for the CACM is distributed across the pay scale and how the distribution has changed since last year.
- How have compensation policies changed in the past year, compared to the workforce composition? For example, an across-the-board bonus that benefits all employees may not materially change the pay ratio, while new special commission pay limited to a company's sales team would do so.
- Have the median employee's circumstances changed since last year? Consider changes to the employee's title and job responsibilities alongside any changes to the structure and amount of the employee's compensation, factoring in the company's broader workforce composition. Additionally, if the median employee was terminated, companies must identify a new median employee.

[47] See CAPintel's "A Deep Dive into the Second Year of CEO Pay Ratio Disclosures" (April 10, 2019).

[48] See Pearl Meyer's 2019 CEO Pay Ratio page.

[49] See CAPintel's "A Deep Dive into the Second Year of CEO Pay Ratio Disclosures" (April 10, 2019).

Other Points To Keep in Mind

In addition to determining whether to select a new median employee, companies should continue to consult Item 402(u) and carefully consider whether their CACM will reflect the following:

- Annualized pay for new hires (but not seasonal or part-time workers).
- Personal benefits that amount to less than $10,000 per employee, such as health or retirement benefits, derived from nondiscriminatory benefit plans.
- Cost-of-living adjustments.
- A new date for identifying the median employee.

Although the SEC provides companies substantial flexibility in calculating their pay ratios, to satisfy the SEC staff and engage with investors, employees and other stakeholders, companies should continue to diligently document and disclose their pay ratio methodology, analyses and rationale.

Companies also should recognize that state and local governments are increasingly viewing pay ratios as a tax revenue generating opportunity. In 2016, the city of Portland, Oregon, passed an ordinance that imposes a surtax on the amount of city of Portland business license tax that publicly traded companies owe if their pay ratio (as calculated in their proxy statements) equals or exceeds 100:1. Specifically, if a company's pay ratio equals or exceeds 100:1 but less than 250:1, it owes a 10% surtax on its existing business license tax. If the pay ratio equals or exceeds 250:1, the surtax is 25%.[50]

San Francisco is attempting to implement a similar measure. Under its proposed November 2019 ballot initiative, which was deferred, San Francisco could impose an additional gross receipts tax and administrative office tax on businesses with a pay ratio between a company's highest-paid employee to the median worker in the city (San Francisco Executive Pay Ratio) that exceeds 100:1 to fund a mental health program for San Francisco, with the tax rate depending on the degree to which the company's San Francisco Executive Pay Ratio exceeds 100:1 and whether the business is an administrative or a non-administrative business.[51] Washington state and at least five other states are considering following Portland's lead.[52] As part of his presidential campaign, Sen. Bernie Sanders (I-Vt.) also proposed implementing a form of pay ratio tax nationally, which provides momentum for state and local-based initiatives.

[50] See city of Portland's Pay Ratio Surtax Administrative Rule (ARB-LIC-5.02).

[51] See San Francisco's Initial Initiative Ordinance for an Additional Tax on Businesses with Disproportionate Executive Pay and the Corresponding Mental Health Gross Receipts Tax Ordinance.

[52] See *Bloomberg Law*'s "Taxing CEO-Worker Pay Gap Catches on in San Francisco, Elsewhere" (October 28, 2019).

Assess Impact of SEC Staff Comments and Guidance

A recent study by Ernst & Young (EY)[53] observed that the SEC Division of Corporation Finance staff issued approximately 34% fewer comment letters on company filings during the 12-month period ended June 30, 2019, compared to the prior-year period. However, this decrease is not surprising in light of the SEC's two-month closure during the most recent federal government shutdown, as well as the SEC staff's continued focus on larger companies and materiality of comments in their reviews of annual report filings. Of the comments issued, the EY survey reveals that revenue recognition and non-GAAP financial measures were, once again, the most common topics covered by the SEC staff. In particular:

- **Revenue Recognition.** Revenue recognition became the top area of focus in SEC staff comment letters after the first year of compliance following implementation of the new recognition accounting standard, Accounting Standard Codification (ASC) Topic 606, "Revenue From Contracts With Customers," which went into effect in December 2017. The SEC staff's comments primarily focused on areas of judgment, including how companies identified performance obligations, determined timing of satisfaction of performance obligations, estimated variable consideration and determined the amortization period of capitalized contract costs. The SEC staff also has asked companies to provide an analysis for certain judgments and estimates made in their application of the standards.
- **Non-GAAP Financial Measures.** The SEC staff also continues to focus on non-GAAP financial measures and compliance with the SEC staff's non-GAAP guidance.[54] Although most of these comments have focused on the use of non-GAAP measures in earnings releases and SEC filings, companies should note that the SEC staff also reviews non-GAAP measures disclosed outside of SEC filings, including on company websites and in investor presentations. Companies should continue to ensure that any public disclosures of non-GAAP financial measures comply with applicable SEC rules and staff guidance. For a discussion on recent developments regarding non-GAAP disclosures, see the section titled "Remain Vigilant With Existing SEC Disclosure Requirements."

Considerations for Risk Factors and Other Disclosures

The SEC has observed that principles-based disclosure encourages companies "to provide risk disclosure that is precisely calibrated to their particular circumstances and therefore more meaningful to investors."[55] This approach is echoed throughout the SEC staff guidance and statements covering the following disclosure topics:[56]

- **Cybersecurity.** Companies should keep in mind the SEC's February 2018 interpretive guidance relating to disclosures of cybersecurity risks and incidents, disclosure controls and procedures and insider trading policies.[57] In particular, companies should consider discussing material cybersecurity risks and/or incidents in their disclosures, such as the MD&A, risk factors, descriptions of business or legal proceedings, as well as financial statements and accompanying notes. In addition, companies may want to revisit their proxy statement disclosures regarding board oversight of risk and consider addressing cybersecurity or otherwise enhancing their disclosures. For additional information, see our February

[53] See EY's SEC Reporting Update "SEC Comments and Trends: An analysis of current reporting issues" (September 18, 2019).

[54] See the SEC staff's C&DIs "Non-GAAP Financial Measures."

[55] See Section II.B.4.b of the SEC's adopting release "FAST Act Modernization and Simplification of Regulation S-K" (April 2, 2019).

[56] The SEC staff has acknowledged that the Office of Risk and Strategy in the Division of Corporation Finance is monitoring company disclosures in certain areas, including Brexit and LIBOR, among others.

[57] See the SEC's interpretive release "Commission Statement and Guidance on Public Company Cybersecurity Disclosures" (February 27, 2018).

23, 2018, client alert "SEC Issues Guidance on Cybersecurity Disclosures."

- **LIBOR Phase-Out.** Companies with financial instruments that rely on the London Interbank Offered Rate (LIBOR) as a benchmark should evaluate the implications of the LIBOR phase out that is expected to occur by the end of 2021. As discussed in our July 25, 2019, client alert "SEC Staff Encourages Proactive Approach to LIBOR Transition Issues," the SEC staff issued a statement[58] encouraging companies to proactively assess material risks as they transition away from LIBOR. For example, companies should disclose material risks and known trends, demands, commitments, events or uncertainties that will or are reasonably likely to result in a material change in liquidity, results of operation or financial condition relating to the discontinuation of LIBOR. The SEC staff's statement also notes companies should consider discussing LIBOR transition in other disclosures, such as risk factors, board risk oversight, as well as financial statements and accompanying notes.
- **Brexit.** Companies should assess the potential impact of the United Kingdom's anticipated exit from the European Union (Brexit). SEC Chairman Jay Clayton has directed the SEC staff to focus on Brexit-related disclosures and has urged companies to disclose how management is dealing with Brexit's impact on the company and its operations.[59] In a March 2019 speech, William Hinman, director of the SEC's Division of Corporation Finance, reminded companies to include tailored, rather than generic, Brexit disclosures in their annual reports, noting that "[g]iven the differences across industries and companies, there is no one specific data point or prescriptive piece of information that all companies could provide to disclose material information relating to their Brexit-related risks." Director Hinman also posed a number of potential questions for companies to consider in evaluating the materiality of their Brexit-related disclosures.
- **Sustainability.** In the same speech referenced above, director Hinman acknowledged the importance of flexible, principles-based disclosure requirements with respect to sustainability disclosures, a topic in which investors and other market participants continue to express a growing interest. He noted the importance of allowing investors to see the company through the eyes of management and encouraged companies to disclose all emerging issues, including risks that may affect their long-term sustainability and plans to mitigate these risks. He also reminded companies to evaluate their disclosure obligations concerning climate change matters by consulting the SEC's related interpretive release, which was published in 2010 but remains relevant.[60]

Companies should also assess any other significant risks to their business and industry, following a principles-based approach to their risk factor disclosures when preparing their annual report filings, in addition to assessing any material changes to existing risk factor disclosures on a quarterly basis.

SEC Disclosure Review Program 'Realignment'

On September 27, 2019, the SEC's Division of Corporation Finance announced an internal realignment "to promote collaboration, transparency and efficiency" in carrying out the SEC's mission to facilitate capital formation and protect investors.[61] Generally, the changes relate to internal staffing and are not expected to impact any ongoing filing reviews. As a result of the realignment, each reporting company is assigned to one of seven industry-focused "review offices," as indicated on the company's EDGAR profile page. Previously, companies were assigned to one of 11 industry-focused offices known as "Assistant Director" or "AD" groups. The seven review offices are:

- Energy & Transportation;
- Finance;
- Life Sciences;
- Manufacturing;
- Real Estate & Construction;
- Technology; and
- Trade & Services.

The consolidation of review offices reflects a decrease in the number of reporting companies.

[58] See the SEC staff's public statement "Staff Statement on LIBOR Transition" (July 12, 2019).

[59] See Jay Clayton's speech "SEC Rulemaking Over the Past Year, the Road Ahead and Challenges Posed by Brexit, LIBOR Transition and Cybersecurity Risks" (December 6, 2018).

[60] See the SEC's interpretive release "Commission Guidance Regarding Disclosure Related to Climate Change" (February 8, 2010).

[61] See the SEC staff's announcement "Disclosure Program Realignment" (September 27, 2019).

Assess Impact of Proxy Advisory Voting Guidelines by ISS and Glass Lewis

Proxy advisory firms ISS and Glass Lewis have updated their voting guidelines for the 2020 annual meeting season. There are a number of changes for which companies should assess the potential impact when considering changes to corporate governance practices, shareholder engagement and proxy statement disclosures.

ISS Updates

ISS announced updates to its proxy voting guidelines applicable for upcoming shareholder meetings held on or after February 1, 2020.[62] These updates include changes based on the results of ISS' 2019 Global Policy Survey and clarifying revisions, as summarized below.[63]

Board Gender Diversity.[64] ISS will generally recommend against the chair of the nominating committee (or other directors as appropriate) of an all-male board of directors. Glass Lewis has had a similar policy in place since January 1, 2019. In addition, ISS may consider proxy disclosure of a "firm commitment" to appoint at least one woman to the board within a year as a mitigating factor in the following circumstances:

- A company with an all-male board that previously included a woman at the preceding annual meeting. The related ISS commentary further states that a "company will need to acknowledge the current lack of a gender-diverse board, and provide a firm commitment to re-achieving board gender diversity by the following year. A 'firm commitment' will be considered to be a plan, with measurable goals, outlining the way in which the board will achieve gender diversity."[65]
- Any other company with an all-male board during the 2020 season, clarifying that ISS will no longer consider a "firm commitment" as a mitigating factor after February 1, 2021.

Exemptions for New Nominees. ISS clarifies that only new nominees who have served on the board for less than one year may be excluded from an adverse voting recommendation. Accordingly, "new nominees" will now exclude directors who are up for election by shareholders for the first time but have served for more than one year on a classified board or on the board of a newly public company since before its IPO.

Board Composition — Attendance. ISS revised its board and committee meetings attendance policy to exempt any nominees who served only part of the fiscal year, instead of any "new nominees." This change is intended to exempt a director for two consecutive years in the following example: a director who joined the board in April 2019 and was elected by shareholders at the May 2019 annual meeting would not be a "new nominee" at the May 2020 annual meeting but would be exempt from the attendance policy for both 2019 and 2020 as a nominee who served only part of those fiscal years.

Independent Board Chair Shareholder Proposals. ISS codified its existing approach when considering shareholder proposals requesting separation of the chair and CEO positions. While maintaining a "holistic approach," the update specifies six factors that will increase

[62] See ISS' "Proxy Voting Guidelines for 2020" (November 18, 2019). For a summary of ISS' 2020 updates for the U.S., Canada and Latin America, see ISS' "Americas Proxy Voting Guidelines Updates for 2020" (November 11, 2019). For an executive summary of all policy updates to ISS' global proxy voting guidelines, see "ISS Benchmark Policy Updates" (November 11, 2019). By mid-December 2019, ISS is expected to publish FAQ documents on its website.

[63] See "ISS 2019 Global Policy Survey — Summary of Results" (September 11, 2019).

[64] This policy applies to companies in the Russell 3000 or S&P 1500 indices.

[65] See page 6 of ISS' "Americas Proxy Voting Guidelines Updates for 2020" (November 11, 2019).

the likelihood of ISS giving a recommendation in support of these proposals, including a weak or poorly defined lead independent director role and a recent recombination of the role of chair and CEO.

Problematic Governance Structures — Newly Public Companies. The updates clarify and narrow the scope of what ISS considers as problematic governance structures for newly public companies that generally warrant adverse voting recommendations against director nominees:

- Supermajority vote requirements to amend the bylaws or charter, a classified board structure or any "[o]ther egregious provisions." ISS will consider a "reasonable" sunset provision as a mitigating factor.
- Multi-class capital structures with unequal voting rights. ISS will consider a "reasonable" time-based sunset provision as a mitigating factor. The sunset period must not last more than seven years from the IPO date, and ISS will consider whether a sunset provision is reasonable, based on the company's lifespan, its post-IPO ownership structure and the board's disclosed rationale for the sunset duration.

Share Repurchase Program Proposals. Although most U.S. companies do not require a shareholder vote to implement a share repurchase program, ISS codified its existing approach for those companies that do seek shareholder approval, such as certain financial institutions or certain U.S.-listed cross-market companies. ISS will generally support a management proposal for an open-market share repurchase program, in the absence of certain specified concerns.

Glass Lewis Updates

Glass Lewis also updated its proxy voting guidelines for shareholder meetings held on or after January 1, 2020. Several key updates, which focus on board committee performance and compensation, are summarized below.[66]

Nominating and Governance Committee. Glass Lewis will now generally recommend voting against the chair and/or members of the nominating and governance committee in the following circumstances:

- **Exchange Act Rule 14a-8 No-Action Relief.** As discussed in the section titled, "Consider Shareholder Proposal Trends and Developments," Glass Lewis may recommend votes against all committee members in the event that the company excludes a shareholder proposal from its proxy materials after submitting a no-action request and the SEC staff (i) declines to state a view on the no-action request, or (ii) verbally grants the request but the company does not provide any disclosure regarding the oral no-action relief.
- **Inadequate Disclosure of Director Attendance.** Glass Lewis may recommend a vote against the committee chair when the company's proxy disclosures: (i) do not discuss the directors' attendance at board and committee meetings; or (ii) indicate that at least one director attended less than 75% of board and committee meetings but the disclosure is too vague to identify which specific director's attendance was lacking. This update is not expected to impact most companies, given that such disclosure is required under Regulation S-K Item 407(b).

Audit Committee. Glass Lewis generally will recommend voting against the chair of the audit committee when fees paid to the company's external auditor are not disclosed, which Glass Lewis describes as crucial to shareholders' ability to make an informed judgment on the independence of the company's external auditor. This update is not expected to impact most companies, given that such disclosure is required under Schedule 14A Item 9.

Compensation Committee. Glass Lewis will now generally recommend against all members of the compensation committee when the board adopts a frequency for its say-on-pay vote other than that approved by a plurality of shareholders, which Glass Lewis views as an example of "the board ignoring the clear will of shareholders, for which all members of the compensation committee should be held responsible."

Responsiveness to Low Say-on-Pay Vote. As discussed in the section titled, "Incorporate Lessons Learned From the 2019 Say-on-Pay Votes and Compensation Disclosures," Glass Lewis may recommend against the upcoming say-on-pay proposal if the company does not provide robust disclosure of engagement activities and specific changes made in response to shareholder feedback following low shareholder support (80% or below) for the say-on-pay proposal at the previous annual meeting.

[66] See Glass Lewis' updated proxy voting guidelines "2020 Guidelines: An Overview of the Glass Lewis Approach to Proxy Advice — United States" (2019).

Consider Recent Director Compensation Litigation

On October 30, 2019, the Delaware Chancery Court issued its *Ultragenyx*[67] decision, whereby it dismissed an excessive director pay case and provided important guidance on the statutory hurdle to maintaining stockholder derivative claims. The opinion rejects a plaintiff-stockholder's use of a tactical, "stock form" letter to pressure a board to settle baseless nonemployee director compensation claims.

A stockholder of Ultragenyx Pharmaceutical Inc. claimed that the company's board of directors awarded its non-employee directors excessive pay. Under applicable Delaware law, a stockholder asserting such a claim has two mutually exclusive options: (i) make a pre-suit demand on the board or (ii) initiate litigation without making a pre-suit demand, whereby the stockholder may plead with particularity the reason it would have been futile to make a pre-suit demand on the board.

A stockholder who pursues the first path of making a pre-suit demand and ultimately escalates it to the court must make the claim that the board wrongfully refused the demand, which is more difficult for the stockholder to sustain than a demand futility claim.

In *Ultragenyx*, the stockholder's counsel sent a pre-suit letter to the company's board "suggesting" that the board take remedial action, while expressly stating that the letter was not a demand within the meaning of the applicable Delaware rule. Essentially, the stockholder attempted to take the first path while preserving the ability to subsequently make a demand futility claim. The company's board treated the stockholder's letter as a demand and conducted an investigation into the allegations and concluded not to pursue them on behalf of the company. In response, the stockholder-plaintiff commenced the *Ultragenyx* litigation, whereby the plaintiff argued that demand futility was the appropriate standard. The defendants (the company and its directors) subsequently moved to dismiss the stockholder's complaint because the stockholder had failed to plead wrongful demand refusal.

The court agreed with the defendants, because it found that the pre-suit letter was in fact a pre-suit demand, foreclosing the demand futility path. Specifically, when determining whether a communication is a pre-suit demand, the court is not constrained by "the subjective intent of the sender," and a communication that is substantively a pre-suit demand remains a pre-suit demand, regardless of whether it includes a disclaimer or other magic words that attempt to disguise it. Otherwise, Delaware's prohibition on stockholders both making a demand and pleading demand futility "would become a virtual nullity if a stockholder could avoid a judicial determination that pre-suit demand was made by simply stating 'this is not a demand' in [a] pre-suit communication to a board."[68]

As such, the court applied the business judgment standard and found that the board's determination that it would be in the best interests of the company not to authorize commencement of a civil action or changes in its board compensation practices was a proper exercise of its fiduciary duties. In reaching its finding, the court also noted that the company responded to the plaintiff's pre-suit letter by conducting an investigation with the aid of counsel, which included a review of pertinent documents and interviews of key individuals, such as the chairman of the company's compensation committee and the company's compensation consultant.

[67] *Solak ex rel. Ultragenyx Pharm. Inc. v. Welch*, No. 2018-0810-KSJM, 2019 WL 5588877 (Del. Ch. October 30, 2019). See also our client alert "A Pipe Is Indeed a Pipe: Delaware Court of Chancery Provides Important Guidance to Companies by Dismissing Excessive Director Pay Case" (November 4, 2019).

[68] See *Solak*, 2019 WL 558877, at *5.

Therefore, companies should:

- recognize that a communication from a stockholder that states that it is not a pre-suit demand may nevertheless be considered by a court to be a pre-suit demand, in which case the stockholder has a lower chance on prevailing on his or her claims in court; and
- thoroughly respond to and document responses to stockholder communications challenging director pay practices, regardless of whether the stockholder communications state that they are not a pre-suit demands.

An adequate response may include an investigation into the company's pay practices with the assistance of legal counsel and compensation consultants.

Note Recent SEC Actions Related to Proxy Advisory Firms

The SEC recently issued interpretive guidance relating to the proxy voting process and proposed a number of amendments to the federal proxy rules relating to the proxy voting advice business.

In August 2019, the SEC issued guidance addressing the proxy voting responsibilities of investment advisers, particularly with respect to their use of advice from proxy advisory firms such as ISS and Glass Lewis.[69] The SEC also issued an interpretation that proxy voting advice provided by these firms generally constitutes a "solicitation" under the federal proxy rules and related guidance about the application of the proxy anti-fraud rule to proxy voting advice.[70] In November 2019, the SEC proposed amendments with respect to the exemptions from the proxy filing requirements for a proxy advisory firm's voting recommendations.[71]

Applicability to Proxy Voting Advice

The August 2019 interpretation reiterated prior SEC statements to reinforce the view that proxy voting advice generally constitutes a "solicitation" within the meaning of the federal proxy rules. Then, in November 2019, the SEC expanded upon that interpretation to propose amendments to the federal proxy rules that would:

- Codify the SEC's interpretation that proxy voting advice generally constitutes a "solicitation";
- Condition the availability of the exemption from the proxy information and filing requirements for a firm's proxy voting recommendations on compliance with: (i) additional disclosure requirements concerning material conflicts of interest and (ii) new procedural requirements permitting an opportunity for companies to review the voting recommendations and provide feedback in advance of the firm's issuance of the recommendations and to include in the firm's voting recommendations a hyperlink to the company's views on those recommendations; and
- Provide examples of when the failure to disclose certain information in proxy voting advice may be considered misleading in violation of the federal proxy rules.

The proposed amendments would add three new requirements in order to exempt proxy voting advice from information and filing requirements.

- The first requirement under the proposed amendments would be inclusion in the firm's proxy voting advice, and in any electronic medium used to deliver the proxy voting advice, of "prominent" disclosure of material conflicts of interest. This includes any information material to assessing the objectivity of the proxy voting advice, as well as any policies and procedures used to identify any material conflicts of interest and steps taken to address any such conflicts. The proposing release notes that this disclosure should be sufficiently detailed and that boilerplate language would be insufficient.
- The second requirement under the proposed amendments would be the opportunity to review and provide feedback on the proxy voting advice in advance of the release of that

[69] See the SEC's press release "SEC Clarifies Investment Advisers' Proxy Voting Responsibilities and Application of Proxy Rules to Voting Advice" (August 21, 2019) and guidance, "Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers" (August 21, 2019).

[70] See the SEC's "Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules" (August 21, 2019). See our client alert "SEC Provides Guidance on Investment Advisers' Proxy Voting Responsibilities, Proxy Voting Rules" (August 26, 2019).

[71] See our client alert "SEC Proposes Amendments to the Proxy Rules Regarding Shareholder Proposals and Proxy Voting Advice" (November 7, 2019). Further to the November 2019 meeting at which the proposed rule amendments were adopted, SEC Chairman Jay Clayton stated that the SEC staff has been instructed to prepare recommendations regarding "proxy plumbing" and universal proxy cards. The timing of any proposed amendments on these topics is not known.

advice to clients. Specifically, the company and any other person conducting a non-exempt solicitation (*i.e.*, a competing solicitation) would receive a copy of the proxy voting advice prior to the distribution of that advice to the proxy advisory firm's clients, with the length of time provided for review and feedback dependent on how far in advance of the shareholder meeting the company or other soliciting person has filed its definitive proxy material. If the definitive proxy material is filed at least 45 days before the meeting date, the review and feedback period would be five business days, and if the definitive proxy material is filed less than 45 days, but at least 25 days, before the meeting date, the review and feedback period would be three business days. In addition to the review and feedback period, the proxy advisory firm must then provide the company and other soliciting persons with a final notice of voting advice. This final notice must be no earlier than the expiration of the applicable review and feedback period and no later than two business days prior to the delivery of the proxy voting advice to the firm's clients. This final notice must include a copy of the proxy voting advice that will be delivered to clients, including any revisions made by the proxy advisory firm after the review and feedback period.

- The third requirement under the proposed amendments is that, if requested by the company or other person conducting a non-exempt solicitation prior to the expiration of the two business-day period between the final notice of voting advice and delivery of the proxy voting advice to clients, the proxy advisory firm must include in the proxy voting advice, and in any electronic medium used to deliver the proxy voting advice, an active hyperlink that leads to the company's or other soliciting person's statement regarding the proxy voting advice. The proposing release observes that any such statement also would have to be filed by the company or other soliciting person with the SEC as additional soliciting material.

There would be no proxy voting advice review and feedback period, no final notice of voting advice and no opportunity to request inclusion of a hyperlinked statement regarding the proxy voting advice for a company or other soliciting person that filed a proxy statement less than 25 days prior to the meeting date.

Anti-Fraud Provisions. The proposed amendments would modify Exchange Act Rule 14a-9 to include examples of when the failure to disclose certain information in the proxy voting advice could, depending upon the particular facts and circumstances, be considered misleading. The examples include failure to disclose material information, such as the proxy advisory firm's methodology, sources of information or conflicts of interest.

ISS' Litigation Against the SEC. In October 2019, ISS filed a lawsuit in federal district court seeking to overturn the guidance set forth in the August 2019 interpretation stating the SEC's view that the advice provided by proxy advisory firms generally constitutes a solicitation under the federal proxy rules. ISS asserts that the interpretation inappropriately alters the regulatory regime applicable to proxy voting advice by exceeding the SEC's statutory authority under the federal proxy rules and should be invalidated because it was issued without a notice-and-comment period as required under federal regulations.[72]

[72] For additional detail, see ISS' press release "ISS Files Suit Over August SEC Guidance" (October 31, 2019).

Consider Shareholder Proposal Trends and Developments

A number of trends and developments related to shareholder proposals have occurred since the beginning of the 2019 proxy season. Following is a summary of the most noteworthy items.

2019 Proxy Season Recap

While the number of proposals submitted to companies last year remained relatively flat, the overall volume of shareholder proposals that went to a vote in 2019 was at its lowest level in recent history, down from 473 in 2018 to 447 in 2019. The drop may be attributed to proactive engagement between companies and shareholders, increased company disclosure and the adoption by many companies of market-standard governance practices. Large-cap companies, which tend to be more proactive on all of these fronts, however, continue to be the primary focus of shareholder proposals, with the S&P 500 accounting for roughly three out of every four proposals that went to a vote in 2019.

Social-Oriented Proposals. For the second straight year, social-oriented proposals eclipsed the number of governance proposals submitted. The largest number of those proposals during the 2019 proxy season focused on corporate political contributions and/or lobbying activities, although the overall number of such proposals declined to 102 since their peak of 125 in 2015. Average support for those proposals increased from approximately 30% during each of the last five years to more than 34% during 2019, and four such proposals achieved majority support in 2019. A similar, if not higher, volume of those proposals and average level of support are expected during the 2020 proxy season, in light of the upcoming election cycle.

Another large portion of social-oriented proposals comprised a variety of diversity and human capital management topics. There were 17 calls for increased diversity of employees, compared to nearly twice as many of those proposals last year. Two of the eight proposals that went to a vote received majority support, including one that sought a report on the diversity of the company's executive leadership team and plans to increase such diversity, receiving nearly 57% support, and another seeking a report on plans to increase the workforce diversity more broadly, receiving close to 51% support. Human capital management proposals submitted to companies spanned a variety of topics, including, among others, gender pay equity gap (29 proposals), "inequitable employee practices" (10 proposals) and sexual harassment (10 proposals). Average support for such proposals ranged from the low teens to mid-30s.

In addition, 29 of the 51 board diversity proposals, which generally called for adopting policies or disclosing steps taken, were withdrawn following company engagement with the proponent. Of those, 12 were voted on and generally did not receive majority support, averaging support of 19%. Two proposals, however, received majority support, including one unopposed by management that received 78% support and the other, at a company with only one woman on the board, receiving 65% support.

Governance Proposals. Governance proposals continue to represent a significant portion of the proposals that go to a vote, with over 220 out of just shy of 450 shareholder proposals proceeding to a vote in 2019 concerning some governance topic. Calls for an independent board chair (approximately 60) represented the greatest number of governance proposals submitted to and voted on during the 2019 proxy season, yet with average support hovering just below 30%, such proposals rarely have passed, absent special circumstances. Otherwise ranking high among governance proposals submitted to a vote in 2019 were shareholder requests to provide for, or make easier, the ability of shareholders to act by written consent or call a special meeting, to reduce or remove supermajority voting provisions from charters and bylaws, to permit shareholders proxy access rights and adopt majority voting in the uncontested election of directors. Of these other popular governance topics, the only one to average

more than majority support in 2019 was shareholder calls to eliminate supermajority voting provisions, averaging slightly more than 62%. In fact, excluding controlled companies, significant insider ownership and ISS "against" recommendations, all 18 proposals to eliminate supermajority-voting obtained majority support in 2019. In addition, although only four requests to declassify a company's board of directors went to a vote in 2019, all of those proposals received majority support.

Environmental Proposals. Although more than 90 environmental proposals were submitted last season, only a small percentage of those proposals (29%) made their way to a shareholder vote, averaging around 25% support. Many of those proposals requested that companies adopt goals to achieve reduced greenhouse gas (GHG) emissions or similar environmental footprints or report on efforts to mitigate environment-related risks. The low percentage of proposals that went to a vote in 2019 represents companies' successful attempts to negotiate withdrawals from proponents or obtain no-action relief from the SEC staff to exclude the proposals. Of those that went to a vote, requests for climate change reporting or steps to achieve GHG emissions goals garnered the highest levels of support 32% support. Further, unlike in the past two proxy seasons, no environmental-related proposal passed in 2019.

Executive Compensation Proposals. Only 50 proposals addressing executive compensation matters were submitted during the 2019 proxy season, down from 55 in the 2018 season. The number of proposals and the average level of support also declined from 40 proposals that received average support of 24% during the 2018 proxy season to 36 proposals that averaged 20% in the 2019 season. As in prior seasons, the proposals covered a range of topics within the realm of executive compensation. Unlike in the last three seasons, however, in which no executive compensation-related proposals obtained majority support, two proposals — both requesting adoption of a clawback policy — received majority support in the 2019 season.

Staff Legal Bulletin 14K

In October 2019, the SEC's Division of Corporation Finance published Staff Legal Bulletin No. 14K (SLB 14K), providing updated guidance concerning shareholder proposals.

SLB 14K reiterated for a third straight season the staff's view that a well-developed discussion of the board's analysis of the significance of a proposal can assist the staff in evaluating certain no-action requests under the "ordinary business" exclusion of Exchange Act Rule 14a-8. The staff emphasized that no-action requests featuring a robust discussion of the board's analysis are helpful even when the staff does not explicitly reference the board analysis in its response letter. The staff also noted that if a no-action request in which significance is an issue does not include a board analysis, the staff may be unable to state a view regarding exclusion. SLB 14K also provided additional guidance on two factors previously suggested by the staff as potentially helping to form a "well-developed discussion" of a board's analysis: (i) the "delta" between a proposal's specific request and the actions the company has already taken, and (ii) prior voting results on a particular issue.

In addition, SLB 14K discussed the scope and application of the micromanagement prong of the ordinary business exclusion. Among other things, the staff suggested that when making micromanagement arguments, companies should include an analysis of how the proposal may unduly limit the ability of the board and/or management to manage complex matters with the level of flexibility necessary to fulfill their fiduciary duties to shareholders.

Finally, SLB 14K endorsed a "plain meaning" approach to analyzing proof of ownership letters submitted by shareholders seeking to demonstrate eligibility to submit a shareholder proposal. While recognizing that the proof-of-ownership requirements can be highly technical, the staff encouraged companies to not seek to exclude a shareholder proposal for a failure to prove ownership if the proof offered by the proponent "is clear and sufficiently evidences the requisite minimum ownership requirements."

For additional information about SLB 14K, including a discussion of the staff's suggested "delta" analysis, prior voting results analysis, framework for analyzing micromanagement arguments and other guidance, please refer to our October 18, 2019, client alert "SEC Staff Issues Additional Shareholder Proposal Guidance."

Change in Staff Review of No-Action Requests

In September 2019, the staff announced two potentially significant changes to its Exchange Act Rule 14a-8 no-action request review process. In particular, beginning with the 2019-20 shareholder proposal season:

- **Responses May Not Be Issued at All.** The Staff may decline to weigh in on certain no-action requests. The staff noted that if it does not take a view on any particular request, "the interested parties should not interpret that position as indicating that the proposal must be included," and that the company may indeed have a valid legal basis to exclude the proposal. The staff also reminded parties that "as has always been the case, the parties may seek formal, binding adjudication on the merits of the issue in court."
- **Responses May Be Oral:** The staff may respond orally rather than in writing to some no-action requests. The staff noted that it "intends to issue a response letter where it believes doing so would provide value, such as more broadly applicable guidance about complying with Rule 14a-8."

Importantly, the changes announced do not eliminate a company's obligation to notify the SEC staff (which nearly always would come in the form of a no-action request) of the company's intention to exclude a proposal from its proxy statement.

In cases when the staff does not issue any response to a company's no-action request, the company generally will want to consider the potential reaction of investors and proxy advisory firms before deciding to include or exclude a proposal. Glass Lewis, for example, has expressed its intention to recommend a vote against all members of the governance committee when a shareholder proposal is excluded from a meeting agenda under those circumstances.

Glass Lewis also indicated that in instances where the SEC verbally permitted a company to exclude a shareholder proposal, and there is no written record provided by the SEC about such determination, the proxy advisory firm expects the company to provide some disclosure concerning the verbal no-action relief or risk a vote recommendation against the members of the governance committee. Subsequent to Glass Lewis' guidance, however, the staff publicly stated that it would post chart on the SEC's website tracking the staff's no-action positions, including those communicated orally. As of the date of this publication, it is unclear whether Glass Lewis will continue to expect additional company disclosures in instances where the SEC provides an oral response.

SEC Proposed Exchange Act Rule 14a-8 Changes

On November 5, 2019, the SEC proposed changes to certain procedural requirements relating to the submission of shareholder proposals and changes to the provision regarding the ability to exclude resubmitted proposals. The proposed changes would (i) replace the current ownership requirements with a tiered approach combining the number of shares owned and the length of ownership, (ii) require certain documentation when a proposal is submitted by a representative on behalf of a proponent, (iii) require a proponent to provide information regarding the proponent's availability for engagement with the company, (iv) amend the one-proposal rule to apply to a proponent's representative, (v) raise the levels of support that a proposal must receive to be resubmitted at future shareholder meetings and (vi) add a new provision that would allow exclusion of certain resubmitted proposals that have experienced declining shareholder support.

Additional detail regarding the proposed amendments is provided in our November 7, 2019, client alert "SEC Proposes Amendments to the Proxy Rules Regarding Shareholder Proposals and Proxy Voting Advice." Because these proposed changes remain subject to a public comment period, calendar year-end companies currently receiving shareholder proposals for 2020 annual meetings should continue to analyze those proposals under the existing rules.

Reevaluate Board Risk Oversight Process

Two Delaware decisions in 2019 highlight the continued importance of the board's risk oversight process. In *Marchand v. Barnhill*,[73] the Delaware Supreme Court reversed the Court of Chancery's dismissal of a stockholder derivative suit alleging *Caremark* claims[74] — that the board failed to provide adequate oversight of a key risk area and thus breached its duty of loyalty.[75] The case arose out of a listeria outbreak in ice cream made by Blue Bell Creameries USA Inc. that sickened many consumers, caused three deaths and resulted in a total product recall.

In *In re Clovis Oncology, Inc. Derivative Litigation*,[76] the Delaware Court of Chancery issued a decision denying a motion to dismiss breach of fiduciary duty claims against a board of directors under a *Caremark* theory of liability. The complaint alleged that, notwithstanding receiving multiple reports regarding issues with the clinical trials for a key drug in the FDA approval process, the board did not take steps to address the issues. When the revised trial results were eventually reported, the FDA did not approve the drug and the company's stock price dropped 70%.

Although these decisions do not signal changes to Delaware law, they are noteworthy because, for purposes of denying a motion to dismiss by the company, the facts alleged by the plaintiffs were sufficient to satisfy the high *Caremark* standard for establishing that a board breached its duty of loyalty by failing to make a good faith effort to oversee a material risk area, thus demonstrating bad faith. Normally, companies do not expect to fail to meet this standard. The Delaware Supreme Court in *Marchand* explained that "[a]s with any other disinterested business judgment, directors have great discretion to design context- and industry-specific approaches," but "*Caremark* does have a bottom-line requirement that is important: the board must make a good faith effort — *i.e.*, try — to put in place a reasonable board-level system of monitoring and compliance."[77]

We recommend that companies reevaluate their board risk oversight process. To demonstrate their good faith efforts to implement and monitor a risk oversight system, boards need to focus on their companies having in place — and continually monitoring, updating (as necessary) and periodically reporting to the board about — systems reasonably designed to identify, monitor and mitigate material risks to their companies. Boards and their advisors, of course, should also not ignore information that comes to their attention. These compliance efforts should continue to be documented in minutes and other meeting materials.

[73] 212 A.3d 805 (Del. 2019).

[74] *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

[75] For additional information, please see our client alert "Director Independence and Oversight Obligation in *Marchand v. Barnhill*" (July 6, 2019).

[76] C.A. No. 2017-0222-JRS (Del. Ch. Oct. 1, 2019).

[77] 212 A.3d at 821.

Remain Vigilant With Existing SEC Disclosure Requirements

As discussed in the section titled "Comply with Updated SEC Disclosure Requirements," there have been a number of changes to SEC disclosure requirements over the past year that companies should consider as they prepare year-end reports and other filings. In addition, companies should continue to comply with existing SEC disclosure requirements and related SEC staff guidance.

Companies should remain vigilant with regard to SEC rules, regulations and guidance, notwithstanding the recent decrease in SEC comment letters discussed in the section titled "Assess Impact of SEC Staff Comments and Guidance." The absence of SEC comment on a particular disclosure practice does not necessarily indicate staff approval of such practice. For example, while SEC comment letters on non-GAAP matters have decreased in quantity, the SEC nevertheless remains focused on compliance with Regulation G and Regulation S-K Item 10(e). This focus has even manifested in enforcement actions, as discussed below. Companies wishing to discuss non-GAAP results should carefully review their disclosures for compliance with the applicable requirements.[78]

Unfortunately, there are plaintiffs' law firms that recently have submitted stockholder demand letters to companies for alleged failures to comply with certain SEC disclosure requirements. These letters have cited Regulation G, Item 10(e) and other provisions of Regulation S-K in making their demands. Some of these letters even have resulted in monetary settlements. Consequently, companies should perform thorough form checks for all SEC filings and redouble efforts to avoid complacency with regard to all applicable SEC disclosure requirements and related SEC staff guidance.

Reassess Disclosure Controls and Procedures

In 2019, the SEC continued its enforcement focus on "detecting, remedying, and punishing misconduct by issuers and financial institutions."[79] In its annual report, the SEC's Division of Enforcement noted that "accurate financial and other disclosures are the bedrock of our capital markets" and highlighted that during the year the SEC "brought actions against public companies involving a wide range of alleged misconduct, including fraud, deficient disclosure controls, misleading risk factor disclosures, and misleading presentation of non-GAAP metrics." These actions involved a number of high-profile companies that were ordered to pay significant multimillion dollar penalties,[80] and in many of the actions, senior members of management also settled charges.[81]

It has been more than 15 years since the SEC adopted the requirements for public companies to establish disclosure controls and procedures and for CEOs and CFOs to quarterly certify that such disclosure controls and procedures have been designed to ensure that material information is made known to them and that they have evaluated the effectiveness of the company's disclosure controls and procedures and presented their conclusions. The SEC has not provided specific guidance on how best to establish those controls and procedures, but its continued focus on disclosure controls and misleading disclosures are important reminders for companies to remain vigilant about these requirements.

[78] See our client alert "The Use of Non-GAAP Financial Measures – A Disclosure Guide" (July 7, 2016) for details on how to comply with these rules.

[79] See SEC enforcement annual report.

[80] Facebook, Mylan N.V. and Fiat Chrysler.

[81] Comscore and Volkswagen.

Companies should reassess their disclosure controls and procedures to ensure that they are designed to address, not only the specific SEC line item disclosure requirements, but also the broader impact of evolving events on the prior and current disclosures of the company. The company's key risks should be monitored and analyzed by company personnel responsible for SEC disclosure decisions and particular attention should be paid to longstanding disclosures that may need to be updated to address current events.

Consider Recent Requests Regarding Environmental, Social and Governance (ESG) Disclosure and Reporting

Whether the primary purpose of a corporation is to generate profits for its stockholders or to operate in the interests of all of its stakeholders has been widely discussed in the corporate community. Some stakeholders and institutional investors recently have begun to openly question the decades-long corporate principle that corporations only should focus on maximizing stockholder value in response to increasing requests and demands from various ESG constituents for enhanced corporate reporting, disclosure and oversight, arguing instead that corporations should be furthering the interests of all stakeholders. Although the broader stakeholder view of a corporation's purpose has been endorsed by some in the ESG constituency, the investor community is not uniformly aligned on this question. As a result, boards of directors and management continue to be confronted with challenges in determining how to better integrate ESG into their business strategy, risk management processes and public disclosures.

Matters To Consider

Boards of directors and management should be aware of the growing prominence of ESG investing, their respective company's environmental and social (E&S) profile and vulnerabilities (putting aside the "G" — the governance issues with which boards are likely to be familiar), and the emerging trend for targeted and specific E&S disclosure. E&S matters are numerous and varied, and include, in particular, sustainability, climate change, human capital management, gender pay equity,[82] board and workforce diversity, supply chain management, political and lobbying expenditures, the opioid crisis, gun control, and even cybersecurity and data privacy, to some extent.

Investor and Corporate Commentary. In January 2019, in his annual letter to CEOs, BlackRock CEO Laurence Fink called for companies to focus on their "purpose" and not just profits.[83] Mr. Fink opined that "purpose is not a mere tagline or marketing campaign; it is a company's fundamental reason for being — what it does every day to create value for its stakeholders. Purpose is not the sole pursuit of profits but the animating force for achieving them" and that "when a company truly understands and expresses its purpose, it functions with the focus and strategic discipline that drive long-term profitability." The letter also noted that BlackRock's Investment Stewardship team has begun to speak with companies about corporate purpose over the last year in an effort to understand how a company's purpose informs its strategy and culture.

More recently, in August 2019, The Business Roundtable (BRT), an association of CEOs of some of the largest companies in the U.S., issued a Statement on the Purpose of a Corporation (Statement on Purpose)[84] that some interpreted as departing from the prevailing model of maximizing stockholder value. The Statement on Purpose stated the signatories' fundamental commitment to all stakeholders, and each signatory committed to: delivering value to its customers; investing in its employees; dealing fairly and ethically with its suppliers; supporting the communities in which it works; and generating long-term stockholder value.

Following BRT's announcement, the Council of Institutional Investors (CII)[85] released a statement expressing concern and disagreement with the Statement on Purpose. CII stated that "[t]o achieve long-term shareholder value, it is critical to respect stakeholders, but also to have clear accountability to company owners." CII argued BRT's statement undercuts

[82] See the section titled "Consider Shareholder Proposal Trends and Developments."

[83] See BlackRock, Larry Fink's 2019 letter to CEOs titled "Purpose and Profit" (January 2019).

[84] See The Business Roundtable's "Statement on the Purpose of a Corporation" (August 2019).

[85] See CII's "Council of Institutional Investors Responds to Business Roundtable Statement on Corporate Purpose" (August 19, 2019).

managerial accountability to stockholders, stating "[a]ccountability to everyone means accountability to no one." In response to CII's statement, BRT published a statement in a Q&A format to provide greater clarity and context, noting, among other points, that the Statement on Purpose "is not a repudiation of shareholder interests in favor of political and social goals" and that while "different stakeholders may have competing interests in the short term, it is important to recognize that the interests of all stakeholders are inseparable in the long term."[86]

ESG Ratings. A number of organizations are engaged in collecting, aggregating, synthesizing and rating companies based on ESG data, including, Bloomberg, ISS, MSCI and Sustainalytics. Companies should understand that they may receive conflicting ratings from different organizations due to the fact that each ESG ratings organization uses different combinations of data sources other than company disclosures, even where companies may not agree with the veracity or accuracy of those data sources. When reviewing ESG ratings, companies should consider their risk exposure to their most significant ESG issues and the specificity of any ESG disclosures. Depending upon the facts and circumstances, a company may consider engaging with ESG rating providers to provide targeted data verification prior to publication of their ESG ratings report. In addition, if a company decides to disclose favorable ESG ratings it should be prepared for scrutiny should the ratings become less relevant or less positive over time and potential criticism and inquiry for not similarly disclosing other less favorable ESG ratings, if any.

SEC Statements Regarding Human Capital Management. In February 2019, SEC Chairman Jay Clayton, in a public statement to the SEC Investor Advisory Committee, stated that disclosure requirements must be rooted in principles of materiality, comparability, flexibility, efficiency and responsibility.[87] Chairman Clayton acknowledged that current SEC disclosure requirements date back to a time when plant, property and equipment typically were the significant value drivers, whereas today, for some companies, human capital is a resource and significant driver of value. Although noting the difficulties of looking at human capital across different industries, Chairman Clayton stated: "I think investors would be better served by understanding the lens through which each company looks at their human capital. Does management focus on the rate of turnover, the percentage of their workforce with advanced degrees or relevant experience, the ease or difficulty of filling open positions, or some other factors? I have heard this and similar questions on earnings conference calls and in other investor settings. I am interested in hearing from those on the Investor Advisory Committee who manage investment capital — what is it that you are looking for as an investor and what questions do you ask the issuers when it comes to human capital?"

In response to the Investor Advisory Committee's recommendation on human capital management disclosure in March 2019,[88] Chairman Clayton emphasized that the "disclosure framework should not attempt to impose rigid standards or metrics for human capital on all public companies" and that "investors would be better served by understanding the lens through which each company looks at its human capital."[89] He reasoned that "disclosure should focus on the material information that a reasonable investor needs to make informed investment and voting decisions" and the "historical approach of disclosing only the costs of compensation and benefits often is not enough to fully understand the value and impact of human capital on the performance and future prospects of an organization."

Most recently, in August 2019, the SEC announced proposed amendments to modernize the rules requiring description of business, legal proceeding and risk factor disclosures, which would require, to the extent material to an understanding of a company's business, a description of the company's human capital resources, including any human capital measures or objectives that management focuses on in managing the business.[90]

Disclosure Considerations. In light of the increasing and continued demand for ESG information, boards of directors and management must consider disclosures, whether in annual reports, proxy statements, sustainability or corporate social responsibility reports, or other public statements, in managing business strategies and risk oversight functions. In the absence of a mandatory SEC disclosure framework, investors and companies may increasingly look to financial and operational performance metrics rooted in ESG initiatives to support more robust public disclosure.

In November 2019, the U.S. Chamber of Commerce (Chamber) published ESG reporting best practices intended to serve as guidelines to further inform voluntary ESG reports and disclosures.[91] The Chamber, like some other ESG stakeholders, believes that each company should exercise discretion in determining which ESG factors and related metrics are most relevant to its business and acknowledge that disclosure variability is a byproduct of ESG factors differing from industry-to-industry

[86] See The Business Roundtable's "Redefined Purpose of a Corporation: Welcoming the Debate" (August 25, 2019).

[87] See SEC's "Remarks for Telephone Call with SEC Investor Advisory Committee Members" (February 6, 2019).

[88] See Recommendation of the Investor Advisory Committee's "Human Capital Management Disclosure" (March 28, 2019).

[89] See the SEC's "Remarks to the SEC Investor Advisory Committee" (March. 28, 2019).

[90] See the SEC's adopting release "Modernization of Property Disclosures for Mining Registrants" (October 31, 2018).

[91] See U.S. Chamber of Commerce's "ESG Reporting Best Practices" (November 2019).

and company-to-company, and based on business model, geography, customer base and other variables.

If a company decides to add voluntary ESG disclosure, boilerplate and conclusory statements should be avoided and such disclosure should be accompanied by meaningful cautionary language and disclaimers so as not to inadvertently characterize any current or anticipated ESG plans as false or misleading.

Consider the Intersection of Executive Compensation and ESG Matters

In light of the current corporate climate, companies may want to consider integrating ESG goals into their compensation strategies. When doing so, companies should consider which ESG goals will impact short-term vs. long-term value, and integrate those goals as performance metrics into short-term or long-term incentive plans accordingly.[92]

To inform whether and how such goals impact compensation, companies also should note key trends among companies that are already beginning to integrate ESG metrics into their compensation plans. Important results from a recent survey of 135 companies (93 of which are publicly traded) from various industries in the U.S. and Canada[93] include the following:

- 30% of survey respondents currently use ESG metrics in at least one of their incentive plans and 21% are considering following suit.
  - Actual use of ESG metrics in U.S. companies is probably less frequent overall because 28% of companies participating in the survey were part of the energy or mining and metals sectors, which tend to have above-average adoption of ESG metrics in incentive plans due to environmental sustainability concerns.
- ESG metrics are more likely to be featured in short-term incentive plans than long-term incentive plans. Environmental metrics are the most prevalent in both types of plans. Metrics regarding employee engagement and culture are also very prevalent in long-term incentive plans and moderately prevalent in short-term incentive plans.
- Outside of the energy, metal and mining sectors, the most prevalent ESG metrics concern employee engagement and culture, followed by diversity and inclusion.
- ESG metrics tend to be quantitative and apply to all participants in an incentive plan, rather than only to key executives. However, diversity and inclusion metrics are more likely to be qualitative than quantitative, which means they are evaluated subjectively based on data such as policy implementation and employee surveys.
- ESG metrics that are used in incentive plans tend to be weighted at 5% or less.

Shell Oil Company is one company that is implementing ESG metrics in its compensation plans. Shell's Sustainability Report for 2018 announced that it planned for its 2019 long-term incentive plan (LTIP) grants to feature an energy transition condition, which aligns in part with Shell's first three-year target to reduce its net carbon footprint. The energy transition condition will apply to Shell's executive directors, executive committee members and approximately 150 of Shell's senior executives. In the coming years, Shell intends to expand the energy transition condition to performance share awards made to approximately 16,000 employees. Beginning in 2019, the energy transition condition is intended to be weighted at 10%, with Shell's other performance conditions, including the following, weighted equally at 22.5% each: total shareholder return, cash flow from operating activities growth, return on average capital employee growth and free cash flow.[94]

Moreover, as artificial intelligence and machine learning gain traction, companies are considering their link to human capital strategy and compensation. Technology-oriented incentive plans eventually could reflect performance metrics accordingly, such as accident rates for self-driving cars.[95]

Overall, we advise companies to remain ahead of the curve by determining which ESG goals are important to their various stakeholders and considering whether and how to incorporate such goals into their pay practices.

[92] See Harvard Law School Form on Corporate Governance and Financial Regulation article, posted by Janice Koors, Pearl Meyer & Partners LLC, "Executive Compensation and ESG" (September 10, 2019), as well as Semler Brossy's article by Seymour Burchman and Mark Emanuel "What a Stakeholder Approach Means for Executive Compensation" (September 24, 2019).

[93] See Mercer's North America Executive Rewards "Environmental, Social, and Governance (ESG) Incentive Plan Metrics: Spot Survey" (2019).

[94] See Shell's 2018 Sustainability Report, including its Executive Remuneration section (April 2, 2019).

[95] See Semler Brossy's article by Stephen Charlebois and Ross Perry "Comp Committees Should Broaden Tech-Ethics Scope" (May 1, 2019).

Consider Recommendations To Increase Board Diversity and Enhance Related Disclosures

Over the last several years, board composition has become subject to increasing scrutiny from investors and stakeholders. Although issues involving board refreshment, oversight and evaluation warrant careful consideration, mainstream investors and stakeholders have demonstrated a sustained effort to influence the composition of boards through engagement on diversity of thought, skills and experience, as well as other forms of traditional self-identified characteristics such as race, gender, ethnicity, religion, nationality, disability or sexual orientation.

As investors and other stakeholders continue to focus on board effectiveness in light of corporate strategy and financial performance, the expectation is that boardrooms will reflect diversity of thought and experiences. Although finding a right balance of skills and experiences in the boardroom may be considered a foundational element of board composition, many investors and stakeholders increasingly believe that requiring a variety of skills and experiences in the boardroom should not come at the expense of enhancing board diversity.

Institutional Investor Activism

The heightened focus on skills and diversity disclosure is perhaps best exemplified by the New York City Comptroller's "BoardRoom Accountability Project 2.0" campaign, launched in 2017, in which the comptroller sent letters to 151 public companies in the NYC Pension Funds' portfolios calling for the disclosure of a board "matrix" describing the skills, gender and race/ethnicity of individual directors on the board and requesting engagement with independent directors regarding the board's refreshment process and future plans to diversify the boardroom. The campaign pushes for disclosure in a standardized matrix format. According to the comptroller, the information provided in such matrix "would give a birds-eye view of the board as a whole, while spelling out the skills each director brings to the table, and highlighting their gender and race."[96]

More recently, in October 2019, the comptroller launched the third phase of the Boardroom Accountability Project with a new initiative challenging companies to adopt a policy requiring the consideration of women and people of color for every open board seat and for CEO appointments, premised on the "Rooney Rule" initiated by the National Football League.[97] The comptroller sent letters to 56 S&P 500 companies, regardless of the current diversity of their board or CEO, which do not currently have in place a Rooney Rule policy, and indicated that shareholder proposals will be initiated at companies that lack apparent racial diversity.

Some companies and other commentators have expressed concerns that attributing specific skills to specific directors in a matrix format could be used to argue for varying liability among directors based on the identified expertise or could otherwise encourage a check-the-box approach to board refreshment.

Institutional Investor Gender Diversity Concerns

BlackRock, State Street and Vanguard have all voiced concerns about the lack of gender diversity on public company boards, although only BlackRock has publicly stated that it would vote against board members on companies with insufficient gender diversity. Specifically, BlackRock expects at least two female members on a board (regardless of size) and will vote against the reelection of nominating committee members on companies where it sees shortfalls in board diversity. State Street announced that beginning in 2020, it will vote against the entire nominating committee of any company without at least one female direc-

[96] See Boardroom Accountability Project 2.0's "Comptroller Stringer, NYC Pension Funds Launch Boardroom Accountability Project Campaign - Version 2.0" (September 8, 2017).

[97] See Boardroom Accountability Project 3.0's "Comptroller Stringer Launches Boardroom Accountability Project 3.0, a First-in-the-Nation Initiative to Bring Diversity to Board and CEO Recruitment" (October 2019).

tor and which has not successfully engaged with State Street's gender diversity program for three consecutive years.[98] Vanguard is a member of the "30% Club," a group with a goal of achieving 30% female directors on S&P 100 boards by 2020, and has called for increased representation of women on public company boards.[99]

In addition, both ISS and Glass Lewis will generally recommend votes against the chair of the nominating and governance committee of a board with no female directors, as discussed in the section title "Assess Impact of Proxy Advisory Voting Guidelines by ISS and Glass Lewis."

While it is difficult to judge the precise impact of these policies, companies should be aware that institutional investors and proxy advisory firms are taking gender diversity into account when voting, or recommending voting, for directors.

Recent Diversity Trends

Skills and Experience Diversity. According to the EY Center for Board Matters, 75% of the *Fortune* 100 now use a "skills matrix to highlight the diversity of relevant director qualifications in an easily readable format" (without clarifying whether the disclosed skills are director-specific or non-director specific), up from 30% in 2016.[100] According to the same source, 46% of S&P 500 companies included a skills matrix in their 2018 proxy statement (29% director-specific; 17% non-director specific).[101]

As for investor voting policies, BlackRock believes that when identifying director candidates, "boards should take into consideration the full breadth of diversity including personal factors, such as gender, ethnicity, and age; as well as professional characteristics, such as a director's industry, area of expertise, and geographic location."[102] Similarly, CII believes "that boards should be diverse, including such considerations as background, experience, age, race, gender, ethnicity, and culture."[103] Vanguard, on the other hand, explains that although it is "directionally supportive" of skills matrix or similar disclosures to allow stockholders to make better-informed voting decisions, companies may have sufficient disclosures, and some stockholder proposals on these matters can be overly prescriptive.[104]

Gender, Racial and Ethnic Diversity. According to the EY Center for Board Matters, a majority of S&P boards (56%) now have at least three female directors, up from 37% in 2016.[105] According to the Spencer Stuart 2019 Board Index, 26% of S&P 500 directors are women, a new milestone and increase from 24% in 2018 and 16% in 2009, and one-third of boards have three female directors and 23% have four or more.[106] As of July 2019, there are no longer any all-male boards at S&P 500 companies. As for board leadership roles, Spencer Stuart reports that progress is mixed: women chair 24% of board committees, including 24% of audit committees (versus 20% in 2018), 24% of compensation committees (versus 19% in 2018) and 25% of nominating/governance committees (versus 24% in 2018). However, only 5% of independent board chairs are women, a decline from 7% in 2018, as are 10% of lead/presiding directors, the same as last year.

Further, according to Spencer Stuart, minority women (defined as African-American/Black, Hispanic/Latino or Asian) represented 10% of new directors, up slightly from 9% in 2018, and of the top 200 S&P 500 companies (by annual revenue), 93% have minority directors, an increase from 85% a decade ago, and 70% of these companies have two or more minority directors, compared with 65% in 2018.

As for investor voting policies, BlackRock and Vanguard, for example, have continued strong engagement with companies. Blackrock encourages companies to have at least two women directors on their boards,[107] and Vanguard's 2019 Investment Stewardship Annual Report included an in-depth discussion of board diversity. In the report, Vanguard identified the following four board diversity expectations for public companies: (i) publish perspectives on board diversity; (ii) disclose board diversity measures, (iii) broaden search for director candidates and (iv) make progress on this front.[108]

Although proxy advisory firms have voting polices concerning gender diversity,[109] they do not have voting guidelines concerning diversity of thought more generally or skills matrix disclosures.

[98] See State Street's "State Street Global Advisors Reports Fearless Girl's Impact: More Than 300 Companies Have Added Female Directors" (September 27, 2018).

[99] See Vanguard's "Investment Stewardship" (August 29, 2019).

[100] See EY Center for Board Matters' "Five Takeaways From the 2019 Proxy Season" (July 23, 2019).

[101] See EY Center for Board Matters' "2018 Proxy Season Review" (July 2019).

[102] See BlackRock's "Proxy Voting Guidelines for U.S. Securities" (January 2019).

[103] See CII's "Policies on Corporate Governance" (October 24, 2018).

[104] See Vanguard's "Proxy Voting Guidelines for U.S. Portfolio Companies" (April 1, 2019).

[105] See EY Center for Board Matters' "Five takeaways from the 2019 proxy season" (July 23, 2019).

[106] See Spencer Stuart's "2019 United States Spencer Stuart Board Index" (November 2019).

[107] See BlackRock's "Proxy Voting Guidelines for U.S. Securities" (January 2019).

[108] See Vanguard's "Investment Stewardship 2019 Annual Report" (August 2019).

[109] See the section titled "Assess Impact of Proxy Advisory Voting Guidelines by ISS and Glass Lewis."

SEC Staff Guidance on Board Diversity Disclosures

As discussed in our February 12, 2019, client alert "SEC Staff Issues Interpretive Guidance on Board Diversity Disclosures," the SEC staff published interpretive guidance providing that where director nominees have self-identified diversity characteristics and consented to their disclosure, the company's disclosures should identify those characteristics, along with other qualifications or attributes, to the extent they were considered by the board or nominating committee in evaluating board membership. The guidance focuses on the requirements of Regulation S-K Items 401(e)(1) and 407(c)(2)(vi). Item 401(e)(1) requires a brief discussion of the specific experience, qualifications, attributes or skills that led to the conclusion that the person should serve as a director in light of the company's business and structure. Item 407(c)(2)(vi) requires a description of the nominating committee's process for identifying and evaluating nominees for director, including whether, and if so how, the nominating committee (or the board) considers diversity in identifying director nominees.

Given that the enhanced disclosure hinges on directors' willingness to self-identify, and the fact that some directors may choose not to do so for personal reasons, it is not clear whether the SEC guidance will have a discernable impact in the future. Nevertheless, companies preparing their annual meeting proxy statements should consider what, if any, changes should be made to enhance their disclosures regarding director qualifications and nomination processes.

According to The Conference Board, approximately 50% of S&P 500 boards have a formal, written policy on diversity for the selection of board candidates, and approximately 52% of S&P 500 companies disclose that they consider gender diversity as part of their process for assessing and selecting board candidates.[110] While some companies are specific about the notion of diversity extending to gender, race, ethnicity, geography and professional experience, others use more generic language.

[110] See The Conference Board's "Corporate Board Practices in the Russell 3000 and S&P 500: 2019 Edition" (April 2019).

Review Insider Trading Policies and Consider Recent Developments

Although 2019 did not see any dramatic developments in insider trading law, a trio of noteworthy enforcement actions should remind companies that compliance continues to deserve meaningful attention and should not be taken for granted. The circumstances that gave rise to those proceedings — each involving senior in-house attorneys — were ripe for undesirable media attention. Also, reflecting a broader interest in (and perhaps skepticism of) insider trading practices, multiple bills under consideration in Congress in 2019 may alter insider trading practices or disclosure requirements, if they become law.

In the first several months of the year, the SEC filed insider trading charges against senior in-house attorneys at two household-name companies, in each case alleging that the attorneys traded company stock shortly before the public announcement of news that had a meaningful effect on the respective companies' stock prices, allowing the defendants to profit or avoid losses on the basis of then non-public material information. In one case the defendant is said to have been responsible for ensuring compliance with the company's insider trading policy, and in both cases the defendants were experienced corporate attorneys who would be expected to regularly have advance access to news of key company developments. One of the defendants quickly settled with the SEC, while the other has been indicted and litigation is pending.

Another insider trading claim brought and settled by the SEC this year involved a defendant who exploited his personal relationship with a company's general counsel to access material non-public information, with no knowledge by the general counsel. The defendant was apparently a guest at the general counsel's home during a period when the general counsel's company was considering a merger, and the guest came across related materials that the general counsel had brought home to review. On the basis of the transaction materials, the defendant bought company stock in accounts belonging to two other associates and tipped two associates who also bought company stock, which in all cases became worth significantly more when the transaction was announced.

In the complaints against the attorneys in the first two cases mentioned above, the SEC made it clear that it believed that the defendants knowingly breached the applicable company insider trading policy. While it may be impossible for companies to stamp out all intentional insider trading violations, appropriate policies and practices demonstrate that such violations are explicitly in contravention of company requirements and can in no way be characterized as tolerated by the company. Beyond mere policy, perhaps emphasizing the SEC's continued focus on and success in bringing insider trading complaints will dissuade some insiders from trying to break the rules.

While the general counsel in the third case mentioned above has not been prosecuted in connection with his guest's insider trading and there has been no suggestion of any wrongdoing on his part, the tale certainly emphasizes the need to treat company confidentiality obligations with the utmost seriousness, even with those persons whom insiders might implicitly trust with their own personal information.

Watch for Potential Legislative Developments

Congress has shown some interest in insider trading issues this year, and, regardless of whether existing bills ever become law, coming years may see legislative developments in an area that has largely been left to the judiciary and administrative agencies in the recent past.

Although it failed to attract bipartisan support in the House Committee on Financial Services, in September 2019 the majority of that committee approved H.R. 2534 (Insider Trading Prohibition Act), which sets out to codify and clarify the standards for finding criminal insider trading. The bill, which has yet to go before a vote of the full House, may be characterized as

lowering the bar for scienter, expressly criminalizing trading on the basis of stolen information and seemingly setting aside any requirement that a person must realize a personal benefit to be guilty of criminal insider trading.

Relatedly, early in 2019, the House passed H.R. 624 (Promoting Transparent Standards for Corporate Insiders Act), which would require the SEC to examine the impact of a number of potential changes to Exchange Act Rule 10b5-1. That rule provides for an affirmative defense against claims of trading on the basis on non-material information, so long as the trading was made pursuant to certain plans or delegations established at a time when the trader had no material non-public information, and other non-interference requirements are satisfied. The House bill (which is in committee in the Senate) is designed to curtail the potential for insiders to abuse Rule 10b5-1 plans to obscure insider trading violations or impair prosecution thereof. Among other changes, the bill asks the SEC to consider the impact of requiring insiders to publicly disclose their Rule 10b5-1 plans.

Review Insider Trading Policies

Although companies would be wise to stay attuned to potential developments (and Skadden will address any relevant significant developments that may occur), even in the absence of any major changes, it is advisable to periodically review existing policies and practices to see that they best serve the company's interest. Even when the law is unchanged, casting an eye back on any issues that arose in connection with the company's insider trading policy in the past couple of years may suggest room for improvement. Although company circumstances will vary, many companies should consider:

- whether the insider trading policy aligns with company anti-hedging policies, especially in light of new SEC requirements to disclose such policies (see the section titled "Prepare for Hedging Policy Disclosures");
- Rule 10b5-1 practices;
- implementing or revising training to illustrate the seriousness of illegal insider trading and the substantial likelihood of being caught;
- formalizing company practices regarding violations of insider trading policies;
- whether peer group insider trading policies have evolved;
- if the company's policy is sufficiently clear in addressing gifts and estate planning transactions; and
- the appropriateness of the timing of recurring closed- or open-trading windows.

Consider Providing or Enhancing Disclosures of the Board Evaluation Process

With investors increasingly focused on the performance of boards of directors, boards have come to rely upon an annual evaluation process as an important tool to assess their performance and to identify areas for improvement. Further, in recent years, regulators, such as the Federal Reserve Board, and other stakeholders are increasingly seeking greater board effectiveness, in part through the board evaluation process and disclosures regarding the board evaluation process. Earlier this year, the CII, for example, emphasized that "[r]obust evaluation processes provide an important conduit for change as companies require new skills, perspectives and strategies over time," and as a result, "investors increasingly regard the review process and its disclosure as key opportunities to enhance board effectiveness and shareholder value."[111] In response, an increasing number of companies have voluntarily disclosed their board evaluation processes in their annual proxy statements. According to a recent EY survey of proxy disclosures by *Fortune* 100 companies:

- 92% included board evaluation disclosures in the most recent proxy statement;
- 49% disclosed subjects addressed in their evaluations; and
- 25% disclosed measures taken in response to the results of evaluations.[112]

In light of the increased focus on this area, we recommend that companies consider whether additional disclosures related to their board evaluation processes should be made. Although it is important for the results of annual board evaluation surveys to remain confidential in order to, among other things, solicit and obtain candid director feedback, companies may want to consider providing some additional disclosure in the proxy statement to better inform investors about the company's board evaluation process and the steps the board has taken in response to the feedback received.

[111] See CII's "Board Evaluation Disclosure" (January 2019).

[112] See EY's "How Companies Are Evolving Board Evaluations and Disclosures" (September 17, 2019).

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