Matters To Consider for the 2021 Annual Meeting and Reporting Season

Skadden

12 / 14 / 20

Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates

The Americas
Boston
Chicago
Houston
Los Angeles
New York
Palo Alto
São Paulo
Toronto
Washington, D.C.
Wilmington

Europe
Brussels
Frankfurt
London
Moscow
Munich
Paris

Asia Pacific
Beijing
Hong Kong
Seoul
Shanghai
Singapore
Tokyo

Companies have important decisions to make as they prepare for the 2021 annual meeting and reporting season.

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

Checklist of Matters To Consider for the 2021 Annual Meeting and Reporting Season

SEC Disclosure Requirements

- ☐ **Comply With Updated SEC Filing Requirements**
  page 1
- ☐ **Prepare for New Human Capital Disclosure Requirements**
  page 3
- ☐ **Note Status of Recent and Pending SEC Rulemaking Matters**
  page 5

Recent SEC Guidance

- ☐ **Revisit COVID-19-Related Disclosures in Light of SEC Staff Guidance**
  page 8
- ☐ **Assess Impact of SEC Staff Comments**
  page 10
- ☐ **Reassess Disclosure Controls and Procedures**
  page 12
- ☐ **Revisit Internal Procedures Relating to Company Share Repurchases**
  page 14

Executive Compensation Considerations

- ☐ **Review Executive Compensation in Light of COVID-19 and Related Guidance From ISS and Glass Lewis**
  page 16
- ☐ **Confirm Approach to Perquisites and Note Recent SEC Enforcement Actions**
  page 21
- ☐ **Incorporate Lessons Learned From the 2020 Say-on-Pay Votes and Compensation Disclosures and Prepare for 2021 Pay Ratio Disclosures**
  page 24
- ☐ **Consider Trends and Developments on Employee, Environmental, Social and Governance Metrics in Executive Compensation**
  page 30

Annual Meeting and Corporate Governance Trends

- ☐ **Consider Recommendations To Increase Board Diversity and Enhance Related Disclosures**
  page 32
- ☐ **Note Calls for Action and Disclosure Related to Environmental and Sustainability Concerns**
  page 35
- ☐ **Assess Impact of Proxy Advisory Voting Guidelines by ISS and Glass Lewis**
  page 37
- ☐ **Consider Shareholder Proposal Trends and Developments**
  page 41
- ☐ **Plan for Another Year of Virtual Shareholder Meetings**
  page 45

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 and other SEC filings. A number of these changes are described below.

Amendments to Regulation S-K

As discussed in our August 31, 2020, client alert "SEC Modernizes Business Description, Legal Proceedings and Risk Factors Disclosure Requirements," the SEC adopted amendments to Regulation S-K Items 101, 103 and 105, effective November 9, 2020. The amendments update the rules in line with more recent market developments, improve the readability of disclosures for investors and simplify compliance requirements for companies. As a general matter, the amendments reflect a principles-based approach to disclosure requirements, shifting away from a prescriptive approach, as summarized below.

General Development of Business. Regulation S-K Item 101(a) was amended to, among other things, make clear that companies need to disclose only information material to an understanding of the general development of the business. Thus, a company is not required to address all topics listed in Item 101(a) if it determines that one or more of those topics are not material to an understanding of the general development of the company's business. Although the amendments also eliminated the lookback periods applicable to the discussion, companies should note that Form 10-K (Part I, Item 1) retains the one-year lookback period requiring a discussion of developments since the beginning of the fiscal year covered by the annual report.

Business Description. Regulation S-K Item 101(c) previously required a narrative description of the company's business with specific enumerated topics. Consistent with the principles-based approach described above, the amendments to Item 101(c) replace the previously prescribed list of topics with disclosure topic examples and a requirement to disclose information that is material to an understanding of the company's business as a whole. The rules also require disclosure of the material impact of compliance with all government regulations, expanding the scope from the prior requirement limited to environmental regulations. In addition, the amendments introduce a new requirement to provide human capital disclosures to the extent material to an understanding of the company's business. For additional information on the new human capital disclosure requirements, see the section titled "Prepare for New Human Capital Disclosure Requirements."

Legal Proceedings. The amendments to Regulation S-K Item 103 implement a modified disclosure threshold for certain governmental environmental proceedings resulting in monetary sanctions that increases the existing quantitative threshold for disclosure of those proceedings from $100,000 to $300,000 but also affords some flexibility by allowing companies to select a different threshold. If a company chooses its own dollar threshold, the threshold must:

- be reasonably designed, as the company determines, to result in disclosure of any material proceeding;
- not exceed the lesser of $1 million or 1% of the current assets of the company and its subsidiaries on a consolidated basis; and
- be disclosed (including any changes to the threshold) in each annual and quarterly report.

The amendments also explicitly permit hyperlinks or cross-references to legal proceedings disclosure elsewhere in the document (such as in the management's discussion and analysis of financial condition and results of operations (MD&A), risk factors or notes to the financial statements) to avoid duplication.

Risk Factors. The amendments replace the previous requirement in Regulation S-K Item 105 to disclose the "most significant" risk factors with "material" risk factors. In addition, if a company's risk factor disclosure exceeds 15 pages, those risk factors should be preceded by a new summary of the principal factors that cause an investment in the company or offering to be speculative or risky. The summary must consist of concise, bulleted or numbered statements on no more than two pages. The amendments also require risk factors to be organized under relevant headings, including a new requirement that generic risk factors appear at the end of the risk factor section under a separate caption, "General Risk Factors."

Changes to Exhibit Filing Requirements

Companies should be aware of amendments to the following exhibit filing requirements in Regulation S-K Item 601 in connection with certain rulemakings discussed below in the section titled "Note Status of Recent and Pending SEC Rulemaking Matters":

Redacted Exhibits. The SEC updated the standard for redacting confidential information in exhibit filings pursuant to Regulation S-K Items 601(b)(2) and 601(b)(10) to align with a recent United States Supreme Court interpretation of the Freedom of Information Act.[1] The amendments remove the "competitive harm" standard and permit information to be redacted if it is not material and is the type that the company both customarily and actually treats as private or confidential. The SEC adopted these changes as part of its amendments to the exempt offering framework, and the new rules are effective 60 days after publication in the *Federal Register*.

Registered Debt Exhibit. In connection with certain registered debt offerings, companies that comply with the streamlined requirements under amendments to Regulation S-X Rules 3-10 and 3-16 are required to file an Exhibit 22 pursuant to new Regulation S-K Item 601(b)(22) listing (i) each affiliate whose securities are pledged as collateral for the company's debt securities; and (ii) the securities pledged. This new exhibit requirement applies to Forms 10-K and 10-Q, among others. Early compliance with the new rules is permitted before they are effective on January 4, 2021.

New Cover Page Checkbox

As part of the amendments to the accelerated filer and large accelerated filer definitions under Exchange Act Rule 12b-2, effective April 27, 2020,[2] the following checkbox was added to the cover pages of Forms 10-K, 20-F and 40-F:

> Indicate by check mark whether the registrant has filed a report on and attestation to its management's assessment of the effectiveness of its internal control over financial reporting under Section 404(b) of the Sarbanes-Oxley Act (15 U.S.C. 7262(b)) by the registered public accounting firm that prepared or issued its audit report. ☐

Other New Requirements

In November 2020, the SEC adopted amendments to the MD&A and other financial disclosure requirements, as well as the requirements concerning the use of electronic signatures in connection with SEC filings. These new amendments are discussed in the section titled "Note Status of Recent and Pending SEC Rulemaking Matters."

[1] See *Food Marketing Institute v. Argus Leader Media*, 139 S.Ct. 2356 (2019).

[2] For additional detail, see the section titled "Note Status of Recent and Pending SEC Rulemaking Matters."

Prepare for New Human Capital Disclosure Requirements

As discussed above, the SEC introduced a new human capital disclosure requirement in the amendments to Regulation S-K Item 101(c) relating to the business description in Form 10-K. Below is a summary of key considerations in preparing such disclosures in upcoming filings.

Overview of Final Rules. New Item 101(c)(2) requires, to the extent material to an understanding of the company's business as a whole (or to a particular segment), a description of (i) the company's human capital resources, including the number of employees; and (ii) any human capital measures or objectives that the company focuses on in managing the business. The rules note — as potential examples — measures or objectives that address the development, attraction and retention of personnel, depending on the nature of the company's business and workforce. Other than the number of employees (retained from the prior rules), the new rules do not specifically require disclosure of additional quantitative measures.

Practical Considerations. Companies should consider the following guidance and recommendations when preparing human capital disclosures in upcoming filings:

- Assess the company's existing human capital disclosures in prior SEC filings (such as the proxy statement); environmental, social and governance (ESG) reports; the corporate website; and other publicly available sources. In addition, companies should consider any updates to corresponding human capital disclosures in upcoming proxy statements and/or ESG reports, which companies typically file or publish after filing the Form 10-K. Companies should ensure that the discussion in the Form 10-K aligns with any corresponding disclosures in other reports and communications.
- Engage with relevant internal stakeholders early in the process to identify the key strategic objectives and measures and to determine the scope of material human capital topics. Internal coordination may be required to monitor, collect and verify data for any metrics and other quantitative measures. Such discussions would typically involve members of the legal, human resources and investor relations teams, as well as senior management and the disclosure committee.
- Note that the new rules reflect a principles-based approach to provide companies flexibility in discussing human capital to the extent material to an understanding of the company's business. In addition, companies that follow specific ESG reporting frameworks, such as the Sustainability Accounting Standards Board (SASB), should be aware materiality may be defined differently under such frameworks versus the SEC rules and also consider any relevant guidance published by the relevant ESG reporting framework.[3]
- Determine whether any quantitative measures — such as full-time employees, part-time employees, independent contractors and contingent workers, as well as employee turnover — would be material to an understanding of the company's business and should be disclosed. The SEC generally expects companies to define any metrics consistently from period to period and to describe any changes to the metrics used or the definitions of those metrics.[4]

Potential Areas of Focus. A nonexclusive list of example topics pertaining to human capital, based on a review of recent filings and potential topics suggested in relevant commentary,[5] is provided below. In determining the scope of topics to be disclosed in the Form 10-K, companies

[3] See, *e.g.*, SASB's "Human Capital Bulletin" (November 2020).

[4] Jay Clayton's statement, "Modernizing the Framework for Business, Legal Proceedings and Risk Factor Disclosures" (August 26, 2020).

[5] See, *e.g.*, the SEC's proposing release "Modernization of Regulation S-K Items 101, 103, and 105" (August 8, 2018).

should also consider disclosing any progress that management has made with respect to any objectives it has set regarding its human capital resources.

- *Workforce composition*: number and types of employees, including the number of full-time, part-time, seasonal and temporary workers; workforce demographics by location, position, gender or race/ethnicity;
- *Diversity, equity and inclusion*: programs and initiatives to recruit, retain and promote diverse candidates; board diversity policies (such as the "Rooney Rule");
- *Compensation and benefits*: gender pay equity; incentives and benefits;
- *Recruiting and retention*: voluntary and involuntary turnover rates, internal rates of hiring and promotion; succession planning for management roles; relations with labor unions;
- *Health, safety and training*: loss of productivity due to illnesses or workplace injuries; average hours of training per employee per year; professional development opportunities;
- *Corporate culture*: employee engagement surveys; and work-life initiatives.

Early Disclosure Trends. As a preview to the evolving disclosure landscape, early filings indicate a wide range of approaches to addressing the new human capital rules, according to FW Cook's survey of the first 50 Form 10-K filings by large companies (with a market capitalization of greater than $1 billion) since the new rules became effective on November 9, 2020.[6] For example, the word length ranged from nine words to 1,582 words, with a median of 369 words, and most filings providing between 205 words and 601 words. The survey also notes the following topics that companies most frequently discussed (with more than a brief mention and sufficient detail so that the discussion is more than generic): extensive headcount data (60%), diversity and inclusion (54%), employee development/training (50%) and competitive pay/benefits (36%).

Other Considerations. In addition to the SEC, investors and other stakeholders have been focused on how companies address human capital in their business and disclosures. Human capital-related and broader ESG proposals have continued to gain increasing attention and support in the past several years, as discussed in the section titled "Consider Shareholder Proposal Trends and Developments." Large investors also have been focused on how their portfolio companies address human capital management. For example, BlackRock identifies human capital management as an engagement priority, and starting in 2021, BlackRock will expect companies to disclose workforce demographics (such as gender, race and ethnicity) as well as the steps that they are taking to advance diversity, equity and inclusion.[7] Similarly, Vanguard has increasingly focused on human capital management in its engagement with companies, noting that "[a]s companies reflect on how they approach diversity, equity, and inclusion in their own workforce, they will likely be held to higher standards — and challenged by shareholders who seek action and greater disclosure to demonstrate a commitment to progress."[8] In addition, State Street's letter to board chairs sets forth expectations focusing on diversity, requesting companies to articulate their risks, goals and strategies as related to racial and ethnic diversity, and to make relevant disclosure available to shareholders.[9] Companies should be prepared to discuss their human capital management strategies in engagement sessions with investors and consider the appropriate location of any related disclosures in the Form 10-K, proxy statement, ESG report and other forms of disclosures.

[6] See FW Cook's "10-K Filings Show a Variety of Approaches to the New Human Capital Resources Disclosure Rules" (November 27, 2020).

[7] See BlackRock's "Proxy Voting Guidelines for U.S. Securities" (December 2020).

[8] Vanguard's "Investment Stewardship 2020 Annual Report" (September 2020).

[9] State Street's letter, "Diversity Strategy, Goals & Disclosure: Our Expectations for Public Companies" (August 27, 2020).

Note Status of Recent and Pending SEC Rulemaking Matters

The year 2020 saw a flurry of final rulemakings and several notable SEC proposed rulemakings. Outlined in the section titled "Consider Shareholder Proposal Trends and Developments" are the recent amendments to Exchange Act Rule 14a-8 governing shareholder proposals. Other prominent newly adopted final rules include:

MD&A and Selected Financial Data. Final amendments to certain financial disclosure requirements of Regulation S-K, including those applicable to the MD&A.[10] The final rule changes move from a prescription-based disclosure framework toward a principles-based one that emphasizes a company-specific assessment and discussion of material information. Under the new rules, certain disclosure requirements have been eliminated, such as the requirement to provide selected financial data under Item 301 and to include tabular disclosure of contractual obligations under Item 303(a)(5), while others have been streamlined, clarified or reorganized. The SEC also adopted conforming amendments applicable to foreign private issuers, including to disclosures on Forms 20-F and 40-F.

The amendments will become effective 30 days after publication in the *Federal Register*, and compliance will be required upon the first fiscal year ending on or after the date that is 210 days after publication of the amendments in the *Federal Register*. Thus, for calendar year-end companies, the new rules will likely apply to annual reports for the fiscal year ending December 31, 2021. Voluntary compliance, however, is permitted at any time after the amendments become effective, so long as the disclosure provided is responsive to an amended item in its entirety.

Electronic Signatures. Final amendments to Regulation S-T Rule 302(b) to conditionally permit registrants and others to use electronic signatures in documents authenticating typed signatures used in electronic filings.[11] The final rules also amend certain rules and forms under the Securities Act, the Exchange Act and the Investment Company Act of 1940 to allow signatories to use electronic signatures in connection with certain other filings. The final rules permit the use of electronic signatures in connection with, among others, annual reports on Form 10-K; quarterly reports on Form 10-Q; current reports on Form 8-K; Exchange Act Section 16 forms; registration statements on Forms S-1, S-3 and S-8; and foreign private issuer filings such as Form 20-F.

Business Acquisitions and Dispositions. Final amendments to Regulation S-X Rule 3-05 and Article 11 that ease the disclosure requirements for financial information related to acquisitions and dispositions of businesses.[12] The final rules change the significance tests registrants use to determine what to disclose, the periods the financial statements must cover and the form of *pro forma* financial information that must be included in certain reports. The changes impact the requirements that registrants provide audited annual and unaudited interim financial statements and *pro forma* financial information for significant acquired businesses in reports on Form 8-K and in certain Securities Act registration statements (*e.g.*, Forms S-1 and S-3) and probable acquisitions of businesses in registration statements. The final rules are effective January 1, 2021; however, early compliance is permitted.

Financial Disclosures in Registered Debt Offerings. Final amendments to Regulation S-X Rules 3-10 and 3-16 (and adoption of new Article 13) that simplify the financial disclosure requirements applicable to registered debt offerings for guarantors and issuers of guaranteed

[10] See our client alert "SEC Amends MD&A and Other Financial Disclosure Requirements" (November 25, 2020).

[11] See our client alert "SEC Adopts Rules To Allow Use of Electronic Signatures" (November 20, 2020).

[12] See our client alert "SEC Adopts Changes to Financial Disclosure Requirements for Acquisitions and Dispositions" (May 28, 2020).

securities, as well as for affiliates whose securities collateralize a registrant's securities.[13] The final rules narrow the circumstances that require separate financial statements of subsidiary issuers and guarantors and replace the current relief requiring condensed consolidating financial information with the ability to provide summarized financial information and narrative disclosures. The final rules also eliminate the separate financial statement requirement for affiliates whose securities are pledged as collateral and replace it with disclosure requirements similar to those proposed for subsidiary issuers and guarantors. The final rules are effective January 4, 2021; however, early compliance is permitted.

Accelerated and Large Accelerated Filer Definitions. Final amendments to the accelerated filer and large accelerated filer definitions under Exchange Act Rule 12b-2 to reduce burdens and compliance costs for certain smaller registrants. As a result of changes to the smaller reporting company (SRC) definition in June 2018, some issuers previously were categorized as both SRCs and accelerated or large accelerated filers.[14] The final rules address this issue by excluding from the accelerated and large accelerated filer definitions issuers that are SRC-eligible and had no revenues or annual revenues of less than $100 million in the most recent fiscal year for which audited financial statements are available. SRCs benefitting from this change are able to avoid the costs and burdens of the Sarbanes-Oxley Act Section 404(b) auditor attestation requirement. The amendments add a checkbox to the cover pages of annual reports on Forms 10-K, 20-F and 40-F to indicate whether an auditor attestation on internal control over financial reporting is included in the filing. The final rules currently are effective.

Updated Mining Property Disclosure Requirements. Final amendments to Regulation S-K that consolidate and relocate the SEC's mining property disclosure requirements to a new subpart 1300.[15] Companies are required to begin complying with the new rules in their first fiscal year beginning on or after January 1, 2021. 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 individual 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."[16] 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.[17] 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.

Updated Disclosures for Banking Organizations. Final amendments that replace Guide 3, the industry guide for banking organizations.[18] The final rules eliminate a number of the requirements under Guide 3, which otherwise appear in the financial statements, and simplify many of those that remain. Many registrants already include the three "new" credit quality ratios in their disclosures, so these new requirements should not be significantly impactful. The rules will apply to fiscal years ending on or after December 15, 2021. Registrants filing initial registration statements will not be required to apply the final rules until an initial registration statement is first filed containing financial statements for a period on or after December 15, 2021. Voluntary compliance with the new rules will be accepted in advance of the mandatory compliance date. Guide 3 will be rescinded effective January 1, 2023.

Proxy Voting Advice. Final amendments to the federal proxy rules relating to proxy voting advice businesses (proxy advisors).[19] The final rules codify the SEC's position that voting advice issued by proxy advisors generally constitute a solicitation under the federal proxy rules and place additional conditions on these firms to qualify for exemptions from the information

[13] See our client alert "SEC Adopts Amendments to Rules 3-10 and 3-16 of Regulation S-X in Certain Registered Debt Offerings" (March 9, 2020).

[14] See our client alert "SEC Adopts Amendments to the Accelerated Filer and Large Accelerated Filer Definitions" (March 31, 2020).

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

[16] 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.

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

[18] See the SEC's adopting release "Update of Statistical Disclosures for Bank and Savings and Loan Registrants" (September 11, 2020).

[19] See our client alert "SEC Adopts Proxy Rule Amendments Relating to Proxy Voting Advice Businesses" (July 27, 2020).

and filing requirements under the proxy rules.[20] Proxy advisors are not required to comply with the new requirements to qualify for exemptions from the information and filing requirements of the proxy rules until December 1, 2021, so these amendments will not directly impact the 2021 proxy season. However, the adopting release for the rules states that the SEC welcomes early compliance, and in April 2020, in response to the SEC's proposed rule amendments, Glass Lewis announced that unedited company feedback on its research will be included with its proxy research papers and delivered to all of its investor clients.[21]

Notable proposed rulemakings include the following:

Compensation to "Platform Workers." Proposed amendments to Securities Act Rule 701, which provide an exemption from registration for the issuance of compensatory securities by nonreporting issuers, and Form S-8, the Securities Act registration statement for compensatory offerings by reporting issuers.[22] The proposed amendments to Rule 701 and Form S-8 are designed to modernize the framework for compensatory securities offerings in light of the significant evolution in compensatory offerings and composition of the workforce, allowing employees and other workers to receive equity compensation from their company while maintaining important investor protections. Additionally, in a companion release, the SEC also proposed rules to conditionally permit, on a temporary five-year trial basis, an issuer to provide equity compensation to certain "platform workers" who provide services available through the issuer's technology-based marketplace platform. Both rule proposals are subject to a 60-day public comment period after publication in the *Federal Register*.

Resource Extraction Payments Disclosure. Proposed new Exchange Act Rule 13q-1 and related amendments to Form SD.[23] The proposed rules that would require resource extraction issuers to disclose (in an annual report on Form SD) certain payments made to foreign governments or to the U.S. federal government for the commercial development of oil, natural gas or minerals. The proposed rules represent the SEC's third attempt at implementing this Dodd-Frank Act mandate. The proposed rules aim to address many of the concerns raised on the previous attempts, and would result in regulation that is overall less burdensome for issuers. Currently, the SEC is scheduled to adopt final rules on December 16, 2020.

[20] In October 2019, ISS filed suit against the SEC and Chairman Jay Clayton in connection with the SEC's September 2019 guidance, which stated that proxy voting advice is a solicitation under the proxy rules, claiming the guidance was arbitrary and capricious and improperly implemented. *Institutional S'holder Services Inc. v. SEC*, Civil Action No. 1:19-cv-03275 (D.C. Oct. 31, 2019). 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 Advice Rules" (August 26, 2019). While the litigation was stayed pending adoption of the final rules, ISS reactivated the lawsuit in August 2020. The outcome and impact, if any, of the litigation remains to be seen.

[21] See Glass Lewis' press release "Glass Lewis Announces That Company Opinions Are Now Included With Research and Voting Recommendations" (April 2, 2020).

[22] See the SEC's proposing releases "Temporary Rules To Include Certain 'Platform Workers' in Compensatory Offerings Under Rule 701 and Form S-8" (November 24, 2020) and "Modernization of Rules and Forms for Compensatory Securities Offerings and Sales" (November 24, 2020).

[23] See our client alert "SEC Re-Proposes Rules To Implement Resource Extraction Payment Disclosure Requirements" (December 24, 2019).

Revisit COVID-19-Related Disclosures in Light of SEC Staff Guidance

In response to the unprecedented disruption caused by the COVID-19 pandemic in 2020, the SEC and staff provided both formal and informal guidance to help frame some of the questions companies should consider in their public reporting obligations. Given that challenging disclosure questions related to COVID-19 will remain, companies should continue to keep this guidance in mind. A brief overview of the guidance is provided below.

SEC Staff Disclosure Guidance

To date, the SEC staff has issued the following disclosure guidance related to COVID-19:

- On March 25, 2020, the SEC's Division of Corporation Finance issued CF Disclosure Guidance: Topic No. 9, "Coronavirus (COVID-19)" expressing its views on disclosure and other securities law obligations regarding COVID-19 and other related business and market disruptions and provided an illustrative (but non-exhaustive) list of considerations companies should take into account when making disclosure decisions.[24]
- On April 8, 2020, SEC Chairman Jay Clayton and Division of Corporation Finance Director William Hinman issued a joint statement encouraging companies to provide information about not only their historical results but also their current financial and operating status, as well as how their operations and financial conditions may change due to COVID-19.[25]
- On June 23, 2020, the SEC's Division of Corporation Finance issued CF Disclosure Guidance: Topic No. 9A, "Coronavirus (COVID-19) — Disclosure Considerations Regarding Operations, Liquidity, and Capital Resources" addressing, among other things, disclosures focusing on the impact of COVID-19 on operations, liquidity and capital resources.[26]
- On June 23, 2020, SEC Chief Accountant Sagar Teotia also issued a statement regarding significant accounting, auditing and financial reporting issues recently addressed by the Office of the Chief Accountant in connection with the COVID-19 pandemic.[27]

Such disclosure guidance advised companies to consider, among other things, the following:

MD&A. How COVID-19 has impacted the company's financial condition and results of operations and whether management expects COVID-19 to impact future operating results and near-and-long-term financial condition. To the extent COVID-19 has adversely impacted revenues, management should consider whether such impact is material to their sources and use of funds, as well as the materiality of any assumptions about the magnitude and duration of COVID-19's impact on revenues. MD&A analysis should also take into account how COVID-19 has impacted capital and financial resources, including overall liquidity position and outlook, and impacts on a company's access to capital and funding sources, such as revolving credit facilities.

Business. Any material business developments related to COVID-19 should be adequately described. For example, if a company has relied on or is relying on supply chain financing, structured trade payables, reverse factoring or vendor financing to manage its cash flow, it

[24] See our client alert "SEC Extends Relief, Staff Offers Further Guidance and Flexibility to Companies Affected by COVID-19" (March 27, 2020).

[25] See our client alert "SEC Chairman and Division of Corporation Finance Director Urge Robust Disclosure Amid COVID-19 Uncertainty" (April 10, 2020).

[26] See our client alert "SEC Staff, Chief Accountant Provide Additional Guidance Related to COVID-19" (June 29, 2020).

[27] See *id.*

should consider disclosing these arrangements. Disruptions related to COVID-19 might also require disclosure. For example, in some instances, COVID-19 has affected the demand for a company's products or services, or resulted in a material adverse impact on supply chains or the methods used to distribute products or services. In other instances, COVID-19 might materially impact human capital resources and productivity.

Non-GAAP Disclosures. A company should not present non-GAAP financial measures or metrics for the sole purpose of presenting a more favorable view of the company. If a company presents metrics related to COVID-19, or changes the method by which it calculates a metric as a result of COVID-19, it should refer to general non-GAAP presentation principles. In addition, in some instances, a GAAP financial measure may not be available at the time of an earnings release because the measure may be impacted by COVID-19-related adjustments that may require additional information and analysis to complete. In these situations, the SEC staff confirmed it will not object to companies reconciling a non-GAAP financial measure to preliminary GAAP results that either include provisional amounts based on a reasonable estimate, or a range of reasonably estimable GAAP results. The provisional amount or range should reflect a reasonable estimate of COVID-19-related charges not yet finalized. In addition, if a company presents non-GAAP financial measures that are reconciled to the provisional amounts or an estimated range of GAAP financial measures, it should limit the measures in its presentation to those non-GAAP financial measures it is using to report financial results to the board of directors and the company should explain, to the extent practicable, why the line items or accounting is incomplete, and what additional information or analysis may be needed to complete the accounting.

Internal Control Over Financial Reporting. COVID-19-related circumstances, such as remote work arrangements, may adversely affect a company's ability to maintain operations, including financial reporting systems, internal control over financial reporting, and disclosure controls and procedures. As financial reporting processes are adapted to the changing environment presented by COVID-19, a company should consider whether it needs to implement new or enhanced internal controls to mitigate the risks of operating in a telework environment or the additional risks of material misstatements resulting from changes to the business and other uncertainties. Any changes that materially affect, or are reasonably likely to materially affect, a company's internal control over financial reporting should be disclosed in the periodic report for the fiscal period in which the change occurred.

Going Concern Issues. If there is substantial doubt about a company's ability to continue as a going concern, management should disclose the conditions giving rise to substantial doubt as well as management's evaluation of those conditions and plans to alleviate substantial doubt.

Government Financial Assistance and the CARES Act. Companies receiving government assistance, such as loans or tax relief under the Coronavirus Aid, Relief and Economic Security Act (CARES Act), should consider the short- and long-term impact of such assistance on their financial condition, results of operations, liquidity and capital resources, in addition to critical accounting estimates and assumptions.

Disclose Accurately or Face Consequences

In December 2020, the SEC announced charges against a company for making misleading disclosures about the impact of the COVID-19 pandemic on its business operations and financial condition. According to the SEC's order, the company's filings were materially false and misleading because the company projected an image of business as usual to public investors, but revealed a large cash burn rate to lenders and private equity investors while seeking additional liquidity. SEC Enforcement Director Stephanie Avakian said, "When public companies describe for investors the impact of COVID-19 on their business, they must speak accurately," and "[t]he Enforcement Division, including the Coronavirus Steering Committee, will continue to scrutinize COVID-related disclosures to ensure that investors receive accurate, timely information, while also giving appropriate credit for prompt and substantial cooperation in investigations."[28]

Looking ahead, companies should continue to consider these types of questions along with general disclosure principles when assessing and disclosing the impact of COVID-19.

[28] See the SEC's press release "SEC Charges the Cheesecake Factory for Misleading COVID-19 Disclosures" (December 4, 2020).

Assess Impact of SEC Staff Comments

A recent study by Ernst & Young (EY)[29] observed that the SEC Division of Corporation Finance staff issued approximately 15% fewer comment letters on company filings during the 12-month period ended June 30, 2020, compared to the prior-year period, continuing the downward trend of recent years.

Of the comments issued, the EY survey reveals that the use of non-GAAP financial measures surpassed revenue recognition as the most frequent area of comment. MD&A and revenue recognition ranked second and third, respectively, once again rounding out the top three most frequent comment areas. The declining scrutiny of revenue recognition is not surprising given the SEC staff's focus last year on company disclosures relating to the adoption of the new revenue standard, Accounting Standard Codification Topic 606, "Revenue From Contracts With Customers."

Although the last few months of the EY survey capture the beginning months of the unprecedented COVID-19 pandemic, EY's study reveals the SEC staff did not issue a significant number of comments on disclosure relating to the pandemic in periodic reports. Of those comments issued, focus generally was on pandemic-related risk factors and known trends and uncertainties in MD&A, including expectations of the impact caused by the pandemic on a company's operating results and near- and long-term financial condition.

Below is a summary of the SEC staff's most noteworthy areas of focus.

Non-GAAP Financial Measures. The SEC staff continues to focus on non-GAAP financial measures and compliance with the SEC staff's related interpretive guidance.[30] In particular, the SEC staff comments continue to probe whether certain performance indicators should be identified as non-GAAP measures and to request that the most directly comparable GAAP financial measure be presented with equal or greater prominence relative to the non-GAAP measure. Although most of these comments target the use of non-GAAP measures in earnings releases and SEC filings, the SEC staff also reviews materials outside of SEC filings, including on company websites and in investor presentations. Therefore, companies should ensure that any public disclosures of non-GAAP financial measures comply with applicable SEC rules and staff guidance.

It also is worth noting that the SEC staff issued some comments of non-GAAP adjustments related to the effects of the COVID-19 pandemic. Those comments generally sought information about the nature of the adjustments and method and approach in quantifying the adjustments. As the EY survey notes, companies should carefully consider how their adjustments relate to the COVID-19 pandemic and why the adjustments are incremental to, and separable from, normal operations. For example, temporary "hazard pay" for employees at risk for infection is more likely to be considered incremental and separate from normal operations than employees' wages for increased hours required to perform regular duties. For information on related SEC staff disclosure guidance, see the section titled "Revisit COVID-19-Related Guidance Disclosure in Light of SEC Staff Guidance."

MD&A. The SEC staff comments continue to focus on key performance indicators and operating metrics, including period-over-period comparisons and whether companies have disclosed key performance indicators used by management that would be material to investors. Key

[29] See EY's SEC Reporting Update "Highlights of Trends in 2020 SEC Comment Letters" (September 17, 2020).

[30] See the section titled "Reassess Disclosure Controls and Procedures."

performance indicators can be financial or nonfinancial and vary based on a company's industry and business. For example, an online service provider may focus on the number of active users, clicks or new accounts.

The SEC issued interpretive guidance in January 2020, advising companies to provide additional disclosures about key performance indicators and other metrics in their MD&A.[31] While the guidance generally is consistent with prior statements from the SEC staff, the issuance of commission-level guidance is noteworthy in that it may result in greater SEC staff scrutiny regarding the use and disclosure of key performance indicators. For example, although recent SEC staff comments have typically acknowledged the potential value of using key performance indicators and operating metrics in MD&A, they often request companies to revise disclosures to make clear how management uses such metric(s) in managing or monitoring the performance of their business, including whether a correlation may be drawn between the metric(s) and operating results.

[31] See our client alert "SEC Proposes Amendments To Enhance MD&A Disclosures and Issues New MD&A Interpretative Guidance" (January 31, 2020).

In addition to performance metric disclosures, and as evidenced by SEC staff comments, the SEC staff is closely monitoring discussions of known trends or uncertainties, particularly related to COVID-19, that are reasonably expected to impact future results both in the near- and long-term. Importantly, the SEC staff, beginning in March 2020, has been publicly encouraging companies to think creatively about the kinds of forward-looking information they can provide to investors, as historical information may be relatively less significant given the economic and operational uncertainties resulting from the COVID-19 pandemic. For example, the SEC staff considers particularly helpful disclosure concerning current liquidity positions, access to sources of financing, potential violations of debt covenants, and the use of governmental financial assistance that has materially affected, or is reasonably likely to materially affect, a company's financial condition or operating results. Accordingly, in addition to discussing the effects, if any, that COVID-19 has had on business operations, companies should, where appropriate, describe what management expects the future impact of the COVID-19 pandemic will be, how management is responding to evolving events and how it is planning for related uncertainties going forward.

Reassess Disclosure Controls and Procedures

It has been over 15 years since the SEC adopted the requirements for public companies to establish disclosure controls and procedures and for chief executive officers (CEOs) and chief financial officers (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 the SEC recently issued guidance for companies to consider when they disclose key performance indicators and metrics and the SEC's enforcement division remains very focused on company disclosure and accounting issues. We believe companies should consider this new guidance and reassess their disclosures controls and procedures to determine whether any potential changes are advisable.

Disclosure Guidance

In January 2020, the SEC issued guidance on disclosure of key performance indicators and metrics (KPIs) in the MD&A section of company periodic reports.[32] The interpretive guidance reminds companies of their obligation to disclose in the MD&A all key variables and other factors, if material to investors, that management use to manage their business, and to include a narrative regarding such measures that enables investors to see the company "through the eyes of management." The guidance also notes that KPIs included in the MD&A should not deviate materially from metrics companies use to manage operations or make strategic decisions.

Specifically, the guidance describes how companies should disclose changes to the methods by which they calculate KPIs and states that the SEC expects companies to include with KPIs:

- a clear definition of the metric and how it is calculated;
- a statement indicating the reasons why the metric provides useful information to investors; and
- a statement indicating how management uses the metric in managing or monitoring the performance of the business.

In addition, the guidance notes that when KPIs are material, companies should consider whether they have effective disclosure controls and procedures in place to consistently and accurately process information related to the disclosure of such metrics. Companies should also keep in mind that their MD&A must include disclosure of trends and uncertainties "unless a company is able to conclude either that it is not reasonably likely that the trend, uncertainty or other event will occur or come to fruition, or that a material effect on the company's liquidity, capital resources or results of operations is not reasonably likely to occur."[33] This disclosure threshold is lower than the general materiality standard of probability and magnitude.

Recent Enforcement Matters

In its most recent fiscal annual year, the SEC reported that approximately 46% of all enforcement actions were based on issuer reporting and disclosure allegations. A number of those actions provide helpful reminders of areas to focus on as companies reassess their disclosure controls and procedures.

[32] See the SEC's interpretive release "Commission Guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations" (January 30, 2020).

[33] See the SEC's interpretive release "Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations" (December 29, 2003).

In December 2020, the SEC settled charges against a national restaurant company related to misleading disclosures about the impact of the COVID-19 pandemic on its business operations and financial condition. In its SEC filings, that company stated that its restaurants were "operating sustainably" during the COVID-19 pandemic.[34] According to the order, the filings were materially false and misleading because the company's internal documents at the time showed that the company was losing a significant cash amount each week and that it projected that it had only 16 weeks of cash remaining. The SEC statement that was issued when the matter was settled highlighted the importance of companies having a "proactive, principles-based approach to disclosure" and tailoring their disclosures to their business and operations.

In three other matters settled in late 2020, the SEC charged two large automobile manufacturers and two senior executives of a large financial institution with disclosure violations related to nonfinancial disclosures, including key performance metrics.[35] One of the automobile manufacturers was charged with misleading disclosures regarding the results of an internal audit because the disclosures did not identify the limited scope of the audit. The other manufacturer was charged for disclosing inaccurate and misleading information about its practices in compiling retail sales volume. Both of these settlement orders were premised on the requirement for companies to include such additional information in their public disclosures in order to make the other disclosures, in light of the circumstances under which they are made, not misleading.

Finally, the actions against the two financial company executives, including the CEO, highlight the important role the SEC believes individuals play in ensuring accurate public disclosures. These individuals were found to have certified the accuracy of the company's disclosures in annual and quarterly reports, which contained misleading statements regarding a KPI related to the company's cross-selling strategy. In a statement issued announcing these settlements, the director of the SEC's enforcement division noted that the SEC "will continue to hold responsible not only the senior executives who make false and misleading statements but also those who certify to the accuracy of misleading statements despite warnings to the contrary." For additional detail, see the section titled "Revisit Internal Procedures Relating to Company Share Repurchases."

The events of 2020 created a dynamic and challenging environment for issuer share repurchases. From a legal perspective, many issuers faced unusual and extreme facts that merited careful attention, albeit within a relatively well-understood framework.[36] However, an SEC enforcement proceeding announced in October 2020 serves as a warning to examine the *process* in which such considerations take place.[37]

[34] See the SEC's press release "SEC Charges the Cheesecake Factory for Misleading COVID-19 Disclosures" (December 4, 2020).

[35] See the SEC's press releases "SEC Charges BMW for Disclosing Inaccurate and Misleading Retail Sales Information to Bond Investors" (September 24, 2020); "Fiat Chrysler Agrees To Pay $9.5 Million Penalty for Disclosure Violations" (September 28, 2020); and "SEC Charges Former Wells Fargo Executives for Misleading Investors About Key Performance Metric" (November 13, 2020).

[36] See our client alert "Repurchase and Trading Issues Arising Out of COVID-19 Market Disruptions" (March 26, 2020).

[37] See the SEC's press release "SEC Charges Andeavor for Inadequate Controls Around Authorization of Stock Buyback Plan" (October 15, 2020).

Revisit Internal Procedures Relating to Company Share Repurchases

The events of 2020 created a dynamic and challenging environment for issuer share repurchases. From a legal perspective, many issuers faced unusual and extreme facts that merited careful attention, albeit within a relatively well-understood framework.[38] However, an SEC enforcement proceeding announced in October 2020 serves as a warning to examine the *process* in which such considerations take place.[39]

Recent SEC Enforcement Matter

In August 2017, an oil refinery company (the target) commenced steps that ultimately led to it being acquired by another company (the acquirer). As is often the case, the discussions advanced in fits and starts. During one pause in discussions, but just two days before a meeting scheduled to "'refresh' the prior work," the target's CEO directed its CFO to repurchase $250 million in target company shares. Both officers were aware of, and were actively engaged in, the target's preparations for the upcoming resumption of discussions with the acquirer.

While one may expect that brief sketch to foreshadow allegations under Exchange Act Section 10(b) and Rule 10b-5, a dissent published by two commissioners suggests that the SEC could not demonstrate the element of scienter required for success on those grounds. In this respect, the target's legal department had specifically considered whether the discussions between the two parties constituted material nonpublic information, concluding that they did not. On the back of that conclusion, the target adopted a purchase plan under Exchange Act Rule 10b5-1.

Without scienter, everything may have seemed fine; however, under that Rule 10b5-1 plan, the target made approximately $2.5 billion in repurchases at an average price of $97 per share in the months before both parties announced an acquisition valuing the target at more than $150 per share. Without turning to Rule 10b-5, the SEC nonetheless imposed a $20 million fine on the grounds that the target's "abbreviated and informal process to evaluate the materiality of the acquisition discussions [at the time it adopted the Rule 10b5-1 plan] … did not allow for a proper analysis of the probability that the target would be acquired[,]" and thus allowed the repurchase to occur in violation of the "internal accounting controls" standard of Exchange Act Section 13(b)(2)(B).[40]

As one would expect, the target's board of directors had previously authorized the company to repurchase its shares, directing that such repurchases be made pursuant to company policy prohibiting purchases (or the adoption of a Rule 10b5-1 plan) while the company was in possession of material nonpublic information. The SEC noted, though, that the target's "informal process did not require conferring with persons reasonably likely to have potentially material information regarding significant corporate developments," and thus was not sufficient to provide "reasonable assurance that its buyback would be executed in accordance with" the board approval. In short, without the SEC having to reach the conclusion that the merger talks were material nonpublic information, it nonetheless held the company liable for an accounting controls violation on the grounds that the company had not done enough to conclude that the merger talks were not material.

[38] See our client alert "Repurchase and Trading Issues Arising Out of COVID-19 Market Disruptions" (March 26, 2020).

[39] See the SEC's press release "SEC Charges Andeavor for Inadequate Controls Around Authorization of Stock Buyback Plan" (October 15, 2020).

[40] See Exchange Act Section 13(b)(2)(B) (requiring issuers to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are executed in accordance with management's general or specific authorization).

Recommended Actions

In light of the SEC's charges in this case, what lessons can companies learn and what actions should they take? This case serves as an illustration of one specific facet of "corporate hygiene" that SEC leadership has emphasized in other contexts since the onset of the COVID-19 pandemic, *i.e.*, that corporate policies and related controls should not only prevent insider trading, but also prevent the appearance of impropriety or misalignment of interests.[41] More specifically, in addition to trading decisions by insiders — the traditional subjects of insider-trading policies — companies should consider the role of formal and consistently applied policies to govern the company's own repurchase practices. Those policies should establish the practices by which a company will make an assessment of whether particular facts and circumstances constitute material nonpublic information. While those practices will inevitably vary from company to company, an effective internal control in this context should not only identify and gather the pertinent facts and circumstances, but should also subject them to consideration under relevant legal standards. Although the target's CEO initiated the repurchase while aware of the relevant information, the weakness in the process was that it did not bring together that information and the specific framework applicable to an assessment of the materiality of a potential transaction, including the probability that such transaction would occur.[42]

Finally, companies need to remember that it is not good enough to merely have a policy in place, the company needs to actually follow the policy. In practice, that may mean forcing senior management to revisit preliminary decisions once others (likely to be the legal department) have determined the appropriate framework for assessing the materiality of the applicable facts. The need to go through what may be a time-consuming clearance process may argue for the greater use of longer-term Rule 10b5-1 plans for repurchases (to decrease the frequency of the process), an outcome that appears to fit nicely with senior SEC staff's recent comments about the importance of well-designed Rule 10b5-1 plans.[43]

[41] See, *e.g.*, Jay Clayton's letter to Brad Sherman, Chair of the House Financial Services Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets (September 14, 2020).

[42] Indeed, the SEC's order specifically invokes authority regarding the role of probability of success of a proposed transaction in determining whether the current possibility of such transaction is material.

[43] See William Hinman's speech "The Regulation of Corporation Finance — A Principles-Based Approach" (November 18, 2020).

Review Executive Compensation in Light of COVID-19 and Related Guidance From ISS and Glass Lewis

As discussed in our March 23, 2020, client alert "Recommendations for Compensation Committees During the COVID-19 Crisis," compensation committees were charged earlier this year with implementing executive compensation programs intended to incentivize and retain employees in the context of the COVID-19 pandemic. Compensation committees had to consider the timing of compensation decisions, bonus and equity award performance targets and metrics, discretion and adjustment of performance targets, burn rates and grant pricing, option repricing and compensation reductions, and waivers during a period of extreme market volatility and business uncertainty.

Nine months later, many companies that were hit hardest by the global market downturn in 2020 due to the ongoing pandemic have responded or will respond to these challenges with changes to their executive compensation programs. For those companies taking the wait-and-see approach and opting not to immediately implement executive pay adjustments, now may be the time to consider whether adjustments to their executive compensation programs are warranted based on current circumstances and company performance. The most prevalent actions among those who made changes to their executive compensation programs are summarized below.

Changes to Executive Compensation Programs

According to Equilar's COVID-19 Executive Pay Adjustment Survey,[44] nearly half (49.6%) of 115 survey participants from a variety of industries have made or plan to make changes to their executive compensation plans as of October 2020. The most prevalent action among those making changes to compensation is the reduction or elimination of executive salaries. The second-most prevalent action is to forgo raising salaries, followed by the reduction or modification of executive annual bonus payouts.

According to the same Equilar survey, slightly less than half (44.6%) of survey participants have made changes or intend to make changes to their executive incentive plans. The most prevalent action among those making changes to their incentive plans is to adjust goals to reflect the current environment. The second-most prevalent action is to change one or more performance metrics, followed by changes to discretionary plans. Fewer than 3% of survey participants elected to eliminate awards altogether.

Semler Brossy reported similar findings for incentive design changes in response to COVID-19 for Russell 3000 companies. From March 1, 2020, through October 24, 2020, 195 Russell 3000 companies announced structural changes to their inflight and/or go-forward incentive plans, and nearly half (46%) of those companies previously announced temporary reductions to executive base salaries as an immediate response to COVID-19.[45] Semler Brossy defines "in-flight" changes as changes that cover any structural changes to an ongoing plan and "go-forward" changes as changes that cover any forward-looking structural changes to a recently started or upcoming plan.

According to the Semler Brossy report, 148 Russell 3000 companies disclosed annual incentive plan changes. The most common structural annual incentive plan change has been to reduce the target and/or max payout opportunity. The second-most common change has been

[44] See Equilar's "COVID-19 Executive Pay Adjustments Survey Results" (October 2020).

[45] See Semler Brossy's "Incentive Design Changes in Response to Covid-19" (October 24, 2020).

to add new metrics, commonly focused on liquidity or strategic measures in the context of the pandemic. Of the 148 Russell 3000 companies in this sample, 20 canceled or suspended the annual incentive plan entirely, and another 13 switched to paying the annual incentive plan in equity instead of cash.

As a proxy disclosure point, companies that make changes to their annual incentive plans should consider whether such changes could impact how the annual bonuses are presented in the summary compensation table. For example, companies typically disclose annual bonus awards in the non-equity incentive plan column of the summary compensation table; however, if annual bonus awards are converted into discretionary bonuses, then such awards will be required to be disclosed in the bonus column of the summary compensation table. In addition, Institutional Shareholder Services (ISS) and shareholders may be more forgiving of changes to short-term incentive plans, while adjustments to long-term incentive plans will continue to be highly scrutinized, as described in more detail below.

According to the Semler Brossy report, 100 Russell 3000 companies disclosed long-term incentive plan changes, of which 22 companies switched performance-based restricted stock unit (PSU) metrics, 21 companies granted special awards to one or more named executive officers, and 21 companies elected to cancel outstanding long-term incentive grants and/or suspend granting new awards. Further, the companies in this sample of 100 Russell 3000 companies made the following changes:

- 20 companies adjusted the long-term incentive vehicle mix to a higher weighting of time-based vehicles (*i.e.*, time-based restricted stock units or stock options);
- 19 companies reduced the PSU target and/or max payout opportunity;
- 17 companies modified the PSU performance period;
- 14 companies delayed goal-setting for PSUs;
- 12 companies disclosed modifications to in-flight PSU awards' performance goals; and
- seven companies applied discretion to adjust the PSU/cash long-term incentive plan payouts at the end of their performance periods.

In addition to making discretionary changes to prior executive compensation programs, companies may also need to implement new executive compensation programs going forward to operate effectively during the ongoing pandemic. If the economic climate is still too uncertain to set credible goals for 2021, some alternatives to consider in order to continue to motivate and retain key talent while furthering investors' interests include the following, as proposed by Mercer's Executive Compensation and Regulatory Group:[46]

- using relative metrics;
- using strategic/qualitative metrics (*e.g.*, sustainability metrics);
- establishing shorter performance periods (*i.e.*, quarterly or biannual for short-term incentives and annual for long-term incentives) with additional service-based vesting requirements;
- providing less stringent plan leverage, such as by setting wider ranges for performance around threshold and target performance;
- lowering or eliminating thresholds to help achieve a minimum payout; and/or
- building in discretion to make adjustments to performance targets or award payouts (up or down).

Compensation committees will need to continue to remain nimble and creative when faced with the ongoing impacts of the COVID-19 pandemic. The common theme underlying executive compensation and incentive plan design during this turbulent time is the ability of the compensation committee to use its discretion to address novel issues that generally arise only during periods of extreme market volatility. Compensation committees and companies should consult with their legal, tax and accounting advisers and compensation consultants as they address these challenges. Companies should also carefully consider the ISS and Glass Lewis guidance discussed below as they assess 2020 performance and any related proxy disclosure for the 2021 proxy season. One of the key takeaways from such guidance is that it is important as ever for companies to disclose the rationale and explain with specificity the circumstances of their compensation decisions.

Proxy Advisory Firm Guidance Regarding the Impacts of the COVID-19 Pandemic

ISS and Glass Lewis have issued guidance regarding the impacts of the COVID-19 pandemic. The notable compensation-related points are summarized below.

[46] See Mercer's "Addressing In-Flight Incentive Awards" (October 2020).

ISS COVID-19 Guidance

On April 8, 2020, ISS provided policy guidance regarding compensation issues in light of the COVID-19 pandemic.[47] ISS acknowledged that many companies will materially change performance metrics, goals or targets used in short-term compensation plans. ISS also encouraged boards to provide contemporaneous disclosure to shareholders of these changes and the reasons for making these changes. Although such disclosure is often not required by securities law, the guidance suggested it may result in a more favorable reception by ISS.

For long-term compensation plans, ISS reiterated that its benchmark voting policies generally are not supportive of changes to outstanding awards, but stated it will assess any changes on a case-by-case basis to determine if "appropriate" discretion was exercised by directors and if the company provided an adequate explanation of any changes to shareholders. ISS will continue to assess any structural changes to long-term compensation plans under its existing benchmark policy framework.

ISS also reaffirmed that it will assess any shareholder proposals to reprice stock options on a case-by-case basis and will generally recommend against any repricing that occurs within one year of a precipitous drop in the company's stock price. Additionally, ISS will consider whether (i) the repricing is value-neutral to shareholders (a value-for-value exchange); (ii) shares in respect of surrendered options are added back to the plan reserve; (iii) the vesting schedule of replacement awards is unchanged; and (iv) executive officers and directors are excluded from the repricing.

ISS confirmed that this guidance will generally continue to apply for the 2021 proxy season, with updates and modifications as needed.[48]

ISS Frequently Asked Questions (FAQs)

On October 15, 2020, ISS released FAQs regarding U.S. Compensation Policies and the COVID-19 Pandemic[49] ahead of its regularly scheduled annual compensation FAQs, which are anticipated to be published in December 2020. The FAQ document is intended to provide general guidance as to how ISS may approach COVID-19 pandemic-related pay decisions in the context of pay-for-performance qualitative evaluations and determine vote recommendations for the upcoming proxy season.

The FAQs regarding executive compensation programs cover the topics summarized below:

Temporary Salary Reductions. Salary reductions alone will be given limited weight because salaries tend to make up such a small portion of executive compensation. ISS would consider more meaningful incentive compensation reductions that are commensurate with salary reductions. In other words, temporary salary reductions will be given mitigating weight to the extent they decrease total pay.

Bonus/Annual Incentive Programs. ISS expects many companies to make adjustments to their annual incentive plans, which may include changes to metrics, performance targets and measurement periods. Some companies may even suspend their annual incentive plans entirely and instead make one-time discretionary payments. ISS would normally consider such actions problematic; however, in the context of the 2020 economic downturn, ISS may view such actions to be reasonable so long as the business justifications and rationale are clearly disclosed and the resulting pay outcomes appear reasonable.

ISS' qualitative review will continue to evaluate incentive programs on a case-by-case basis. However, ISS notes that investors will require additional disclosure to evaluate annual incentive plan changes or discretionary awards. ISS provided the following examples of key disclosure items that would help investors evaluate COVID-19 pandemic-related changes to an annual incentive program:

- the disclosure should articulate specific challenges that were incurred as a result of the pandemic and how those challenges rendered the original program design obsolete or the original performance targets impossible to achieve, as well as address how any required changes are not reflective of poor management performance;
- for companies making mid-year changes versus one-time discretionary awards, the company should explain why that approach was taken (as opposed to the alternative approach) and how such actions further investors' interests;
- one-time discretionary awards should still carry performance-based considerations, and companies should disclose the underlying criteria, even if not based on the original metrics or targets (wherein investors are likely to find generic descriptions, such as "strong leadership during challenging times," to be insufficient);

[47] See ISS' "Impacts of the COVID-19 Pandemic: ISS Policy Guidance" (April 8, 2020).

[48] See the section "COVID-19 Guidance" in ISS' "2021 Global Proxy Voting Guidelines Updates and Process for ISS Benchmark Policy Development" (November 12, 2020).

[49] See ISS' FAQs "U.S. Compensation Policies and the COVID-19 Pandemic" (October 15, 2020).

- the company should discuss how the resulting payouts appropriately reflect both executive and company annual performance, and the disclosure should clarify (or estimate) how the resulting payouts compare with what would have been paid under the original program design (noting that above-target payouts under changed programs will be closely scrutinized); and
- companies that have designed the following year's annual incentive program (for 2021) are encouraged to disclose information about positive changes, which ISS may consider as a mitigating factor in its qualitative evaluation.

Long-Term Incentive Programs. ISS generally will not support changes to long-term incentive programs, on the theory that long-term incentives should be designed to smooth performance over a long-term period and not be altered after the beginning of the cycle based on a short-term market shock. Accordingly, changes to in-progress cycles will generally be viewed negatively, particularly for companies that exhibit a quantitative pay-for-performance misalignment. However, more "modest" alterations to a long-term incentive program could be viewed as reasonable. For example, movement to relative or qualitative metrics may be viewed as reasonable. More drastic changes, on the other hand, such as shifts to predominantly time-vesting equity or short-term measurement periods, will continue to be viewed negatively. Lastly, companies should clearly explain any changes to long-term incentive programs to allow investors to evaluate the compensation committee's actions and rationale.

COVID-19-Related Retention and One-Time Awards. Some companies may grant one-time awards to address concerns resulting from the COVID-19 pandemic, which may include executive retention. As with one-time awards granted in prior years, companies that grant one-time awards should clearly disclose their rationale (including magnitude and structure), as well as describe how such awards further investors' interests. Awards should be reasonable in magnitude and isolated in practice, and vesting conditions should be long-term, strongly performance-based and clearly linked to the underlying concerns the award aims to address. Boilerplate language regarding "retention concerns" will not be viewed as sufficient rationale. Awards should also contain shareholder-friendly guardrails to avoid windfall scenarios, including limitations on termination-related vesting.

Retention or Other One-Time Awards Granted in the Context of Forfeited Incentives. One-time awards granted as a replacement for forfeited performance-based awards will be scrutinized by ISS. Companies are expected to explain the specific issues driving the decision to grant the awards in the context of forfeited incentives and describe how such awards further investors' interests. Moreover, companies will also need to explain how such awards do not merely insulate executives from lower pay.

Changes to ISS' Responsiveness Policy. Companies receiving less than 70% support on their advisory say-on-pay proposals will continue to be subject to ISS' responsiveness policy, which examines the following three factors: (i) the disclosure of the board's shareholder engagement efforts; (ii) the disclosure of the specific feedback received from dissenting shareholders; and (iii) any actions or changes made to pay programs and practices to address shareholders' concerns. However, while the first two factors remain the same, if a company is unable to implement changes due to the COVID-19 pandemic under the third factor, then the proxy statement should disclose specifically how the pandemic has impeded the company's ability to address shareholders' concerns, as well as the company's longer-term plan for addressing those concerns.

Option Repricing Policies. ISS will continue to oppose option repricings, which occur within one year following a drop in a company's stock price. Furthermore, if an option repricing is undertaken without prior shareholder approval, ISS may recommend votes against directors who approved the repricing.

The FAQs discussed above demonstrate that ISS still intends to scrutinize COVID-related changes to executive compensation programs, while also acknowledging that companies are facing extraordinary circumstances in the midst of the COVID-19 pandemic and 2020 economic downturn. In particular, ISS concedes that compensation changes that are normally problematic under its guidance may be reasonable under pandemic conditions but stresses the need to provide clear disclosures and specific justifications for the changes that result from any COVID-19 pandemic-related problems faced by the company.

Glass Lewis COVID-19 Guidance

In March 2020, Glass Lewis outlined its approach to governance issues in the context of the COVID-19 pandemic.[50] Glass Lewis provides that it generally determines the reasonableness of any proposed changes to compensation programs and outcomes by considering whether they are consistent and proportional to the impact on shareholder interests and employees. Specifically, Glass Lewis warns that "trying to make executives whole at even further expense to shareholders and other employees is a certainty for proposals to be rejected and boards to get thrown out."

[50] See Glass Lewis' blog post by Aaron Bertinetti "Everything in Governance Is Affected by the Coronavirus Pandemic. This Is Glass Lewis' Approach" (March 26, 2020).

Further, Glass Lewis expects compensation committees to proactively make changes to executive compensation that align with the experiences of shareholders and employees, noting that there is a heavy burden of proof for directors and executives to justify their compensation levels in a drastically different market for talent, and that executives might need to take a pay cut. In fact, it expects that companies hit hard by the crisis will have taken early and decisive action to roll back planned salary increases or above-target bonus outcomes, sharing the pain felt by employees and shareholders.

Finally, Glass Lewis confirms that it will afford more discretion in its analysis for those companies that Glass Lewis believes have shown a "good" and established history on governance, performance and the use of board discretion prior to the COVID-19 pandemic.

Glass Lewis generally intends to rely on its contextual approach to governance issues in light of the COVID-19 pandemic and other existing guidelines as opposed to continuously updating them for new issues or novel approaches throughout the upcoming proxy season.

Confirm Approach to Perquisites and Note Recent SEC Enforcement Actions

In recent years, the SEC has indicated renewed interest in enforcing the Regulation S-K Item 402 compensation disclosure requirements, particularly involving the disclosure of perquisites. Perquisites and other personal benefits must be reported in the "All Other Compensation" column of the summary compensation table if the aggregate value of the perquisites and personal benefits received by a named executive officer is equal to or greater than $10,000.[51]

Identifying Perquisites

In order to attract and retain executives, many companies provide perquisites and other personal benefits, sometimes referred to together as "perks," that are made available only to certain executives as part of their overall compensation package. Common perks include company-provided vehicles, tax and financial planning, executive health programs, country or eating club memberships, use of a company aircraft, home security, relocation programs, spouse travel and charitable gift matching. These examples are not exhaustive, and the SEC staff expects companies to apply its two-step analysis to any appropriate item or arrangement to determine whether it requires disclosure.

Under the two-step analysis: (i) an item is not a perquisite or personal benefit if it is integrally and directly related to the performance of the executive's duties; and (ii) otherwise, an item is a perquisite or personal benefit if it confers a direct or indirect benefit that has a personal aspect, without regard to whether it may be provided for some business reason or for the convenience of the company, unless it is generally available on a nondiscriminatory basis to all employees.[52]

In practice, it can be difficult to determine whether a benefit is a perquisite. Companies must analyze the applicable facts and circumstances in order to determine whether each particular benefit is a perquisite, as well as implement a system for identifying, tracking and calculating perquisites that correctly applies the SEC's standards. Accordingly, recent SEC staff guidance and enforcement actions may be instructive when it comes to identifying, valuing and disclosing perks.

COVID-19 Compliance and Disclosure Interpretation

In reporting compensation for periods affected by the COVID-19 pandemic, questions arise as to whether benefits provided to executive officers that are specific to working from home constitute perks for purposes of the SEC's disclosure rules. In response to these questions, the SEC staff released Compliance and Disclosure Interpretation (C&DI) 219.05, which confirms that companies should continue to use the traditional two-step analysis set forth above and further provides that what is "integrally and directly related" to an executive officer's duties may be different, or broader, than what was previously considered to be integrally and directly related prior to the COVID-19 pandemic.

For example, the C&DI states that enhanced technology needed to make a named executive officer's home his or her primary workplace upon imposition of local stay-at-home orders as a result of COVID-19 would generally not be a perquisite or personal benefit because of the integral and direct relationship to the performance of the executive's duties. On the other hand, if items such as new health-related or personal transportation benefits that are provided to address new risks arising because of COVID-19 are not integrally and directly related

[51] See Regulation S-K, Instructions to Item 402(c)(2)(ix).

[52] See the SEC's adopting release "Executive Compensation and Related Person Disclosure" (August 29, 2006).

to the performance of the executive's duties, those items may be perquisites or personal benefits even if the company would not have provided the benefit but for the COVID-19 pandemic, unless they are generally available to all employees.[53]

Recent SEC Enforcement Actions

Companies continue to receive heightened scrutiny from the SEC, proxy advisory firms and activist shareholders regarding the provision and disclosure of executive perks. In particular, the SEC is focused on ensuring that companies' internal controls and procedures properly disclose how, and how much, they pay their top executives.

In June 2020, the SEC settled charges against a Bermuda-based insurance company for failing to disclose in its proxy statements over $5.3 million paid to its then-CEO in the form of perquisites and personal benefits.[54] The SEC's order finds that the insurance company's proxy statements for 2014 through 2018 disclosed that it had provided a total of approximately $1.2 million in perks, chiefly retirement and financial planning benefits, to its then-CEO, and failed to disclose over $5.3 million that it had paid on the CEO's behalf for personal use of the insurance company's corporate aircraft, helicopter trips and other personal travel, housing costs, transportation for family members, personal services, club memberships, and tickets and transportation to entertainment events. Prior to this enforcement action, an activist shareholder also accused the insurance company of misusing corporate assets, including undisclosed use of the insurance company's corporate aircraft, resulting in a widely publicized proxy contest.

The SEC's order charges the insurance company with violating federal securities law provisions concerning proxy solicitation, reporting, books and records and internal controls. The order recognizes that the insurance company undertook significant remedial efforts prior to settling the SEC's enforcement action, including launching an internal investigation, revising its executive compensation policies and implementing enhanced internal controls. The order also notes that the company replaced the CEO, entered into an agreement to obtain reimbursement from him, changed the composition of its board (in cooperation with the activist shareholder) and shared the results of its internal investigation with the SEC staff. The insurance company consented to the SEC's cease-and-desist order and paid a $900,000 civil penalty. The CEO resigned from his position in November 2019 and agreed to reimburse the insurance company for certain perks and other personal expenses.

In September 2020, the SEC issued an order instituting cease-and-desist proceedings against a Texas-based company in the business of providing live-adult entertainment for its failure to disclose a total of $615,000 in perks paid over a five-year period to its CEO, CFO and executive vice president.[55] These undisclosed perks included the cost of the personal use of the company's aircraft and company-provided vehicles, reimbursement for personal commercial airline flights, the company's charitable contributions to a school that two of the CEO's children attended and the cost of providing housing and a meals allowance to the CFO. During the relevant period, the entertainment company told investors it did not provide its named executive officers with significant perquisites.

The entertainment company undertook a number of remedial efforts, including (i) engagement of outside counsel to conduct an independent investigation; (ii) engagement of a third-party consultant to assist in reviewing and revising its executive compensation process, policies and controls; and (iii) implementing new internal controls and compliance policies and procedures concerning perquisites, aircraft usage, expense reimbursement, travel, charitable contributions, related party transactions and family employment. In addition, the entertainment company shared the results of its outside counsel's independent investigation with the SEC staff.

The SEC settled charges against the entertainment company, the CEO and the CFO, in which they agreed to the cease-and-desist order and to pay civil penalties in the amounts of $400,000, $200,000 and $35,000, respectively. The SEC enforcement action in this case was generated by the SEC staff's use of risk-based data analytics to identify statistical outliers, which allows it to generate investigative leads that are stronger than the standard mix of referrals and complaints that it receives. The SEC staff has indicated that it will continue to use these data analytics to uncover potential violations relating to the disclosure rules.

The following week of September 2020, the SEC issued another order instituting cease-and-desist proceedings against a multinational hotel hospitality company for its failure to disclose in its proxy statements approximately $1.7 million worth of certain travel-related perks it paid to, or on behalf of, its CEO and certain other executives, referred to collectively as "named executive officers," from 2015 through 2018.[56] The board-authorized perks included, among other things, expenses associated with the CEO's personal use of the hospitality company's corporate aircraft and the named executive officers' hotel stays.

[53] See the SEC staff's C&DIs "Regulation S-K" (September 21, 2020).

[54] See the SEC's Exchange Act Rel. No. 89009 "In the Matter of Argo Group International Holdings, Ltd." (June 4, 2020).

[55] See the SEC's Exchange Act Rel. No. 89935 "In the Matter of RCI Hospitality Holdings, Inc., Eric S. Langan, and Phillip K. Marshall, CPA" (September 21, 2020).

[56] See the SEC's Exchange Act Rel. No. 90052 "In the Matter of Hilton Worldwide Holdings Inc." (September 30, 2020).

After receipt of a written document and information request from the SEC staff, the hospitality company conducted an internal review of its perquisite disclosures and its system for identifying, tracking and calculating perks. In its 2020 proxy statement, the hospitality company provided revised disclosures regarding perks provided to its CEO in 2017 and 2018 and to other named executive officers for the same time period. The hospitality company consented to the SEC's cease-and-desist order, which requires the hospitality company to pay a $600,000 civil penalty.

The hospitality company's system for identifying, tracking and calculating perks incorrectly applied a standard whereby a business purpose would be sufficient to determine that certain items were not perquisites or personal benefits that required disclosure. This failure to correctly identify perks illustrates that even where the company has determined that an expense is an ordinary or necessary business expense for tax or other purposes, that determination is not responsive to the inquiry as to whether the expense provides a perquisite or other personal benefit for disclosure purposes. In other words, an item that would legitimately be a tax-deductible business expense may nonetheless require disclosure as a perk if it is not "integrally and directly related" to the performance of the executive's duties.

Recommendations for Approach to Perquisites

Although the SEC has provided general principles and interpretive guidance, gray areas remain in the area of perquisites disclosures, and companies should take a broad view of what constitutes a perquisite or personal benefit to ensure that they have internal controls and procedures in place for compliance with the executive compensation disclosure rules.

In particular, companies may consider adopting a perquisites policy that broadly defines what the company considers a perquisite or personal benefit, specifies which perks are authorized to be provided, and addresses the relevant disclosure and other considerations arising from such perks. The policy should be reviewed periodically by the company's compensation committee to ensure it is accurate and up-to-date. Compensation committees should also review the company's perk-related disclosures themselves to help ensure accuracy and compliance with the disclosure rules.

The disclosure rules are complicated, and care must be taken to ensure compliance. For example, when an executive receives perks with an aggregate value of $10,000 or more in a fiscal year, each perk, regardless of its amount, must be specifically identified by type, and any perk that has a value exceeding the greater of $25,000 or 10% of the aggregate value of all perks received by the named executive officer must be quantified and disclosed in a footnote to the summary compensation table. Certain of these amounts, and in particular the value of company aircraft usage, are subject to complex calculation rules (and typically are reported at values that differ from their imputed value for taxation purposes).

Each perk that a company provides to its executive officers and directors has an SEC disclosure, tax and corporate governance element that requires close attention. Companies should keep records of their internal processes and procedures regarding perquisite disclosures and carefully document their analysis and conclusions. Taking these steps can help reduce the risk of a potential SEC investigation or action based on the company's internal controls and procedures.

Incorporate Lessons Learned From the 2020 Say-on-Pay Votes and Compensation Disclosures and Prepare for 2021 Pay Ratio Disclosures

In addition to considering how to disclose compensation decisions in light of the COVID-19 pandemic as discussed above, companies should also consider their recent annual say-on-pay votes and general 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 2020 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 ISS and Glass Lewis.

Overall Results of 2020 Say-on-Pay Votes

Below is a summary of the results of the 2020 say-on-pay votes from Semler Brossy's annual survey[57] and trends over the last nine years since the SEC adopted its say-on-pay rules. Overall, say-on-pay results at Russell 3000 companies surveyed in 2020 were generally the same or slightly better than those in 2019, despite the impact of the COVID-19 pandemic on compensation.

- Approximately 97.7% of Russell 3000 companies received at least majority support on their say-on-pay vote, with approximately 93% receiving above 70% support. This demonstrates slightly stronger say-on-pay support in 2020 compared with 2019, when approximately 97.3% of Russell 3000 companies received at least majority support, with approximately 91% receiving above 70% support.
- ISS' support for say-on-pay proposals in 2020 through September 2020 has been the highest observed over the last 10 years, with 89% of companies surveyed receiving an ISS "For" recommendation, compared with the historical average through 2019 of approximately 87.2%.[58]
- Russell 3000 companies received an average vote result of 90.5% approval in 2020, which is the same as the average vote result in 2019.
  - The average vote result exceeded 95% approval in 2020 across multiple industries, including automotive retail, paper packaging, electronic components, human resource and employment services, commodity chemicals, electronic manufacturing services and electronic equipment and instruments.[59]
  - The oil and gas drilling industry had the lowest level of average support of 79.3% compared with other industries, while the following industries received an average vote result of less than 83.1%: internet services and infrastructure, air freight and logistics, movies and entertainment, and steel.[60]
- Approximately 2.3% of say-on-pay votes for Russell 3000 companies failed in 2020 as of September 2020, which was slightly lower than the 2.7% failure rate for 2019 measured in October 2019.
- 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 since 2011.

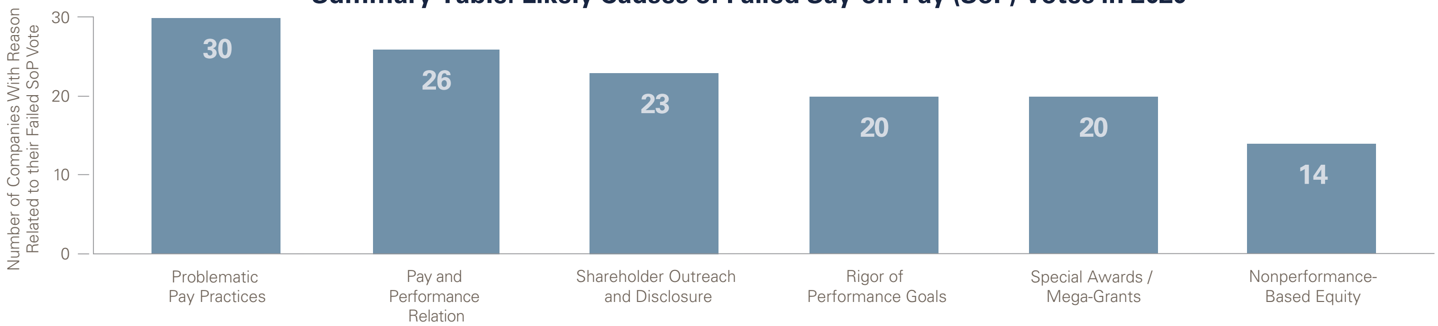
[57] See Semler Brossy's report "2020 Say on Pay & Proxy Results" (September 24, 2020). Unless otherwise noted, Semler Brossy's report is the source of pay ratio, say-on-pay and equity plan proposal statistics in this annual client alert.

[58] See Semler Brossy's report "2019 Say on Pay & Proxy Results Year-End Report" (January 23, 2020).

[59] See Willis Towers Watson's report "U.S. Executive Pay Votes — 2020 Proxy Season Review" (September 2020).

[60] See *id.*

Summary Table: Likely Causes of Failed Say-on-Pay (SoP) Votes in 2020*



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

- One-third of S&P 500 companies and 28% of Russell 3000 companies surveyed have received less than 70% support at least once since 2011.

Factors Driving Say-on-Pay Failure

Overall, the most common causes of say-on-pay vote failure were problematic pay practices, pay and performance relation, shareholder outreach and disclosure, rigor of performance goals, special awards/mega-grants and nonperformance-based equity awards, as summarized in the chart above.

Notably, shareholder outreach and disclosure efforts have increased from the sixth most frequently cited likely cause of say-on-pay vote failure in 2019 to the third in 2020, highlighting the importance of robust shareholder engagement efforts during this time, especially if a company's compensation has changed in connection with the COVID-19 pandemic. Otherwise, the likely causes of say-on-pay failure remained largely consistent between 2019 and 2020, with problematic pay practices and pay and performance relation (*i.e.*, a disconnect between pay and performance) as the continuing frontrunners.

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 FAQs to help shareholders and companies understand changes to ISS compensation-related methodologies. In December 2019, ISS published its most recent general United States Compensation Policies FAQ[61] summarizing which problematic practices are most likely to result in an adverse ISS vote recommendation. The problematic practices include the following and are expected to remain problematic in 2021:

- repricing or replacing of underwater stock options or stock appreciation rights 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 personal use of corporate aircraft, executive life insurance, secular trusts, restricted stock vesting, home-loss buyouts or any lifetime perquisites;
- new or extended executive agreements that provide for (i) termination or change in control severance 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; (iv) multiyear guaranteed awards that are not at-risk due to rigorous performance conditions; (v) a "good reason" termination definition that presents windfall risks, such as definitions triggered by potential performance failures (*e.g.*, company bankruptcy or delisting); or (vi) 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.

Other issues contributing to low say-on-pay support include:[62]

- inadequate disclosure around changes to performance metrics, such as disclosures that fail to explain changes and how they relate to performance;
- high-target incentives for companies that are underperforming relative to their peers;
- special bonuses and mega equity grants without sufficient rationale or risk-mitigating design features; and

[61] See ISS' FAQs "United States Compensation Policies" (December 6, 2019).

[62] See *id.* FAQ No. 43 and FAQ No. 44.

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

ISS is expected to release a full set of updated compensation FAQ in December 2020, which will provide robust guidance for 2021.

Glass Lewis Guidance

Glass Lewis published its 2021 Proxy Paper Guidelines[63] for the United States, which include several compensation updates for 2021. Generally, Glass Lewis' 2021 Proxy Paper Guidelines encourage robust disclosure of equity-granting practices and changes to compensation programs, emphasize Glass Lewis' continued preference for performance-based awards and disapproval of excise tax gross-ups, and shed light on Glass Lewis' process for evaluating option exchange and repricing proposals and selecting peer groups for its pay-for-performance analysis. For additional information, see our December 7, 2020, client alert "ISS and Glass Lewis Release Updated Proxy Voting Guidelines."

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, especially in light of the disproportionate impact of COVID-19 on low income workers. This year's proxy season provides 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.

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' FAQs 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 to address the low level of support, other recent compensation actions, whether the issues raised were recurring, the company's ownership structure and whether the proposal's support level was less than 50%, which should elicit the most robust stakeholder engagement efforts and disclosures.

Looking ahead to 2021, companies that received say-on-pay results below the ISS and Glass Lewis thresholds should consider enhancing disclosures of their shareholder engagement efforts in 2021 and the specific actions they took to address potential shareholder 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 proposals 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 company-specific reports and guidance to determine the reason for their vote recommendations in 2020. 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 2021 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.

[63] See Glass Lewis' "2021 Proxy Paper Guidelines: An Overview of the Glass Lewis Approach to Proxy Advice — United States" (November 24, 2020).

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 of 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, and this trend was even stronger in 2020. Average support for golden parachute proposals dropped from 79% in 2019 to 74% from January 1, 2020, through July 17, 2020.[64] 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 and excessive cash payouts as significant secondary concerns. Companies historically have also cited performance awards vesting at maximum as a significant secondary concern.

Equity Plan Proposal Results

Equity plans continue to be widely approved, with less than 1% of equity plan proposals at Russell 3000 companies receiving less than a majority vote in 2020 through September 2020.[65] Average support for 2020 equity plan proposals as of September 2020 was 89.5%, which was higher than the 88.5% average support observed in October 2019.

Most companies garner strong equity plan proposal support from shareholders, regardless of the say-on-pay results. As of September 2020, Russell 3000 companies with less than 70% say-on-pay approval that presented an equity plan proposal still received 82% support for the equity plan proposal.

Equity plan proposals are expected to become more common in 2021, because companies are expected to request shares to mitigate the dilution of equity compensation that corresponds with the macroeconomic impacts of COVID-19. Prior to the COVID-19 pandemic, equity plan proposals were becoming increasingly rare, and such decrease may have been 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.

[64] See Willis Towers Watson's report "U.S. Executive Pay Votes — 2020 Proxy Season Review" (September 2020).

[65] See Semler Brossy's report "2020 Say on Pay & Proxy Results" (September 24, 2020).

Effective in 2021, the threshold number of points to receive a favorable equity plan proposal recommendation from ISS is expected to increase from 55 points to 57 points for the S&P 500 model and from 53 points to 55 points for the Russell 3000 model, while remaining at 53 points for all other Equity Plan Scorecard models.[66] This will raise the bar for many companies seeking large share increases in response to the pandemic's impact on their compensation programs, leading some companies to require subsequent equity plan proposals over the coming years.

Other Proxy Advisory Firm Takeaways

ISS' updated methodology for evaluating whether nonemployee director (NED) pay is excessive has taken effect and is expected to continue to apply in 2021. Under such policy, ISS may issue adverse vote recommendations for board members responsible for approving/setting NED pay beginning with meetings occurring on or after February 1, 2020. Such recommendations could occur where ISS determines there is a recurring pattern (two or more consecutive years) of excessive director pay without disclosure of a compelling rationale for those prior years or other mitigating factors.

Each year, 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. This year, ISS accepted these updates through December 4, 2020.[67]

Prepare for 2021 Pay Ratio Disclosures

The year 2021 marks the fourth 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.[68] This section helps companies prepare for the fourth year of mandatory pay ratio disclosures by considering the following:

- Can the same median employee be used this year, and if not, what new considerations should be taken into account when identifying the median employee?
- What else do companies need to know for 2021?

[66] See ISS' FAQs "U.S. Compensation Policies and the COVID-19 Pandemic" (October 15, 2020).

[67] See ISS' article "Company Peer Group Feedback" (2020).

[68] 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.

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.

Companies may encounter important challenges when selecting a median employee for pay ratio disclosures about compensation in fiscal 2020:

- Companies that have been using the same median employee since pay ratio disclosures were first required will need to perform calculations to identify the median employee for fiscal 2020, because they have used the same median employee for the three-year maximum.
- Other companies that were originally planning to feature the same median employee as last year should not do so if their employee populations or employee compensation arrangements significantly changed in the past year, including, without limitation, in response to the COVID-19 pandemic, such as widespread layoffs, furloughs and compensation adjustments.
- Companies may again be required to perform calculations to identify a median employee for pay ratio disclosures regarding fiscal 2021, given continued evolution in workforce composition and compensation arrangements.

When selecting a median employee for pay ratio disclosures regarding fiscal 2020, companies should carefully consider how to incorporate furloughed employees:

- First, determine whether such furloughed individuals should still be considered "employees" as of the date the employee population is determined for the pay ratio calculation (the "determination date"), based on the facts and circumstances about the furlough.[69]
  - SEC staff guidance does not elaborate on how companies should take facts and circumstances into account when determining whether to include furloughed employees in the pay ratio calculation; *provided* that it does direct companies to categorize furloughed individuals who are ultimately identified by the company as employees as full-time, part-time, temporary or seasonal employees for determining whether to annualize their compensation.[70]
  - Instruction 5 to Item 402(u) considers permanent employees on an unpaid leave of absence to be employees, which may help companies reason by analogy when determining whether furloughed individuals should be considered employees for the pay ratio calculation. For example, individuals on an unpaid furlough with a defined end date could be considered analogous to employees on an unpaid leave of absence and therefore included in the calculation. Moreover, if individuals on furlough receive pay or continued health benefits, such furlough may be analogous to a paid leave of absence, tipping the balance toward inclusion of such furloughed individuals in the pay ratio calculation.
- Next, if the company determines that furloughed individuals are employees as of the determination date, it should then evaluate whether to annualize their pay for the pay ratio calculation. In general, such furloughed employees' compensation should be determined under the same method that applies to analogous non-furloughed employees.
  - Instruction 5 to Item 402(u) permits annualizing compensation for full-time or part-time employees that were employed by the company for less than the full fiscal year, such as newly hired employees or permanent employees on an unpaid leave of absence. However, pursuant to such instruction, companies may not annualize total compensation for temporary or seasonal employees.
  - Companies should determine based on the facts and circumstances of the furlough whether such furloughed employees should be classified as full-time, part-time, temporary or seasonal, and determine whether to annualize their compensation accordingly.

Additionally, companies should consider how headcount changes may impact their ability to exclude certain non-U.S. employees from their pay ratio calculation under the commonly relied upon *de minimis* exception in Item 402(u)(4)(ii). Therefore, companies should evaluate whether non-U.S. employees in the aggregate and by jurisdiction newly constitute or no longer constitute more than 5% of the company's total employees.

- The *de minimis* exception generally 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.
  - If a company's non-U.S. employees account for 5% or less of their total employees, the company may either exclude all non-U.S. employees or include all non-U.S. employees.
  - Alternatively, if over 5% of a company's total employees are non-U.S. employees, the company may exclude up to 5% of its total employees who are non-U.S. employees;

[69] See SEC staff's Question 128C.04 at "Compliance & Disclosure Interpretations ("CD&Is") Questions and Answers of General Applicability" (Last Update: September 21, 2020).

[70] See *id*.

provided that the company exclude all non-U.S. employees in a particular jurisdiction if it excludes any employees in that jurisdiction, and employees excluded under Item 402(u)'s data privacy exception count toward this limit.

- Non-U.S. jurisdictions with employees that exceed 5% of a company's total employees may not be excluded from the pay ratio calculation under the *de minimis* exception, although they may be permitted to be excluded under the data privacy exception.

Even if a company uses the same median employee in its proxy statement filed in 2021 as in 2020, 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 generally 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 consistently applied compensation measure (CACM). For example, a company may exclude employees from a 2019 business combination from its 2020 pay ratio calculations, but those excluded employees should probably factor into the company's 2021 median employee calculations.
    - Determine whether the *de minimis* exception applies within the context of the company's 2020 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.

Other Points To Keep in Mind

Although the SEC provides companies with 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. In addition, companies may elect to make supplemental disclosures regarding the pay ratio in the context of the COVID-19 pandemic, to the extent applicable.

Companies also should recognize that state and local governments are increasingly viewing pay ratios as a tax revenue generating opportunity. For example, on November 3, 2020, San Francisco voters approved a proposition to impose an additional gross receipts tax or an administrative office tax on some businesses engaging in business in San Francisco when their highest-paid managerial employee earns more than 100 times the median compensation paid to their employees based in San Francisco.[71] Such tax will range from 0.1%-0.6% of the business's taxable gross receipts or between 0.4%–2.4% of payroll expense for those businesses in San Francisco, with the tax rate depending on the degree to which such ratio exceeds 100:1 and whether the business is an administrative or a non-administrative business. It will take effect commencing in tax years beginning on or after January 1, 2022, and will generally apply to both public and private companies.[72]

Lawmakers in at least eight U.S. states — including California, Connecticut, Illinois, Massachusetts, Minnesota, New York, Rhode Island and Washington — and federal representatives have launched proposals relating to taxation based on CEO-worker pay ratios.[73]

[71] See City and County of San Francisco, Department of Elections "November 3, 2020 Election Results — Summary" (November 2020). See also "Initiative Ordinance — Business and Tax Regulations Code — Tax on Businesses With Disproportionate Executive Pay" (July 31, 2020).

[72] See *id.*

[73] See Institute for Policy Studies, Inequality.org "CEO-Worker Pay Resource Guide" (November 2020).

Consider Trends and Developments on Employee, Environmental, Social and Governance Metrics in Executive Compensation

As the COVID-19 pandemic, racial justice movement and political discourse in 2020 heightened awareness of employee, environmental, social and governance (EESG) issues,[74] shareholders, customers and employees increasingly recognize EESG issues can materially impact company value. From an executive compensation perspective, EESG goals are most frequently reinforced through incentive compensation programs and clawback policies.

EESG Metrics and Incentive Compensation Programs

In recognition of growing expectations that companies confront EESG issues, a small but increasing number of companies are tying executive incentive compensation performance metrics to EESG factors.

Quantitative research suggests that large public companies are spearheading implementation of EESG metrics in incentive plans and that their emphasis is on employee, social and environmental metrics:

- One study found that 62% of *Fortune* 200 companies incorporate EESG measures in their executive compensation programs.[75] The most common metrics related to customer satisfaction, talent development, and diversity and inclusion, with 48%, 41% and 38% of such companies that use EESG metrics featuring the measure in their incentive plans, respectively. Notably, well over the majority of *Fortune* 200 companies with a diversity and inclusion metric measure it on a discretionary basis, rather than assigning it a formal weighting. Metrics that are relatively easy to quantify, such as customer satisfaction, product quality and safety, were more likely to be featured in explicit metrics, while talent development, turnover/retention and culture were more likely to be measured based on a discretionary, individual assessment.
- Another study found that approximately 39% of S&P 500 companies, approximately 30% of Russell 1000 companies and approximately 21% of Russell 3000 companies include at least one environmental or social metric in their incentive plans.[76] Such study also found that use of environmental and social metrics in incentive plans were up 4.3% in 2020, compared with 2019.
- Based on a 2020 study that included publicly traded, private for-profit and nonprofit organizations, 6% of companies surveyed currently include formal EESG metrics in their executive incentive plans and an additional 9% reported that they intend to add one or more formal EESG metrics in 2021, with social goals most commonly featured or intended to be featured.[77]

The practice of linking executive compensation to achievement of workforce diversity goals has recently been in the spotlight. Data supporting the business case for diversity and inclusion at work has been growing even stronger with time, with one global study of over 1,000 companies finding that the most diverse companies are now more likely than ever to outperform nondiverse companies on profitability.[78] Certain companies are already linking a

[74] These topics are often referred to as ESG issues, but in recognition of the importance of employee-specific concerns regarding worker health and safety, pay equity and diversity in the workplace, this annual client alert adds an "E" for employee to such term. Otherwise, employee issues typically are grouped together with social issues, under the "S" in "ESG."

[75] See Harvard Law School Forum on Corporate Governance article posted by John Borneman, Tatyana Day and Olivia Voorhis of Semler Brossy "ESG + Incentives 2020 Report" (August 29, 2020).

[76] See Glass Lewis' report "2020 Proxy Season Review — United States" (September 2020).

[77] See Pearl Meyer's "Looking Ahead to Executive Pay Practices in 2021 — Executive Summary" (October 2020).

[78] See McKinsey & Company's report by Vivian Hunt DBE, Sara Prince, Sundiatu Dixon-Fyle and Kevin Dolan "Diversity Wins: How Inclusion Matters" (May 2020).

defined portion of executive compensation to achievement of specific diversity and inclusion metrics. For example, certain of a prominent ride-sharing company's PSUs for certain of its named executive officers, including its CEO, are 25% contingent on achievement of diversity targets aimed at growing the global percentage of women and U.S. underrepresented minorities above certain levels of seniority, measured over a three-year period.[79] However, one study found that less than 3% of approximately 3,000 companies disclosed in public pay disclosures that fulfilling diversity goals was linked to a portion of their chief executives' pay and few companies provided details on their diversity goals or the share of compensation that is contingent on them.[80] While some companies currently have formal diversity and inclusion goals with specific weightings, many companies are featuring diversity and inclusion metrics that are measured on a discretionary, qualitative basis, likely due to sensitivity around setting and reporting adherence to quotas and the difficulty of measuring inclusion with quantitative metrics.[81] The world's largest coffeehouse chain, for example, recently committed to adding metrics related to inclusion and increasing minority representation in the workforce to their executive compensation programs beginning in fiscal 2021 for employees at the senior vice president level and above, although specific details about the amount of compensation that will be contingent on such metrics and exactly how they will be measured has not yet been released.[82]

Overall, companies should actively and carefully consider whether EESG-related metrics are appropriate for their incentive programs and how to best implement and disclose them.

[79] See Uber Technologies, Inc.'s "Definitive Proxy Statement on Schedule 14A" (March 30, 2020).

[80] See *The New York Times*' article by Peter Eavis "Want More Diversity? Some Experts Say Reward C.E.O.s for It" (July 14, 2020).

[81] See Harvard Law School Forum on Corporate Governance article posted by John Borneman, Tatyana Day and Olivia Voorhis of Semler Brossy "ESG + Incentives 2020 Report" (August 29, 2020).

[82] See Starbucks Stories and News "Our Commitment to Inclusion, Diversity, and Equity at Starbucks" (October 14, 2020). See also *The Wall Street Journal*'s article by Heather Haddon "Starbucks Ties Executive Pay to 2025 Diversity Targets" (October 14, 2020).

EESG and Clawback Policies

Clawback policies are another aspect of executive compensation that may be used to reinforce EESG objectives, such as to deter and penalize sexual misconduct and discrimination in the workplace. Approximately 18.3% of companies with annual meetings between January 1, 2020, and June 30, 2020, had clawback policies that could be triggered without a financial restatement and covered situations such as broader misconduct and reputational harm.[83] However, many companies may be waiting to amend their clawback policies until the clawback rules proposed under the Dodd-Frank Act are finalized, which is an initiative that has stalled and may gain momentum under the new Biden administration.

As discussed in the section titled "Consider Shareholder Proposal Trends and Developments," the only compensation-related shareholder proposal that received majority support in 2020 concerned expanding a clawback policy. The company had a clawback policy that permitted recoupment if a corporate officer had been determined to have "engaged in fraud or intentional misconduct that materially contributed to the need for the restatement or if otherwise required by applicable SEC or Nasdaq rules."[84] The proposal requested that the clawback be expanded to cover a broader range of situations where senior executives contributed to financial or reputational harm to the company, regardless of whether such harm necessitated a financial restatement, and also proposed that the company disclose decisions concerning recoupments under the clawback policy to shareholders on a go-forward basis.[85] Although the support for the proposal may have been linked to company-specific circumstances, it demonstrates that shareholders are taking note of clawback policies and can bring successful proposals to expand them.

[83] See Glass Lewis' report "2020 Proxy Season Review — United States" (September 2020).

[84] See Stericycle, Inc.'s Definitive Proxy Statement on Schedule 14A (April 9, 2020).

[85] See *id*.

Consider Recommendations To Increase Board Diversity and Enhance Related Disclosures

Board diversity has moved to the forefront of the minds of investors over the past several years. In 2020, numerous institutional investors vocalized their demands for greater board diversity, lawmakers and securities exchanges put forth new board diversity rules, and shareholders sought to hold companies accountable for allegedly failing to follow through with their previously disclosed board diversity commitments.

Board diversity is expected to continue to be a preeminent focus for the upcoming 2021 proxy season, so companies should consider proactively taking steps to begin complying with proposed board diversity disclosure rules that may soon be adopted and shareholder requests to increase diversity in the boardroom. In addition, to the extent additional information about board diversity will be considered and/or disclosed, appropriate questions can be added to the annual director and officer questionnaires used to elicit and confirm information in connection with annual reporting and compliance matters.

Nasdaq Proposes New Board Diversity Rules

As discussed in our December 4, 2020, client alert "Nasdaq Proposes New Board Diversity Requirements," Nasdaq has submitted a rules proposal with the SEC that would impose a mandatory "board diversity matrix" disclosure framework and require Nasdaq-listed companies to either meet certain board composition diversity thresholds or explain why they fall short.

Board Diversity Matrix. The proposed rules would require companies to disclose, in a standard form board diversity matrix provided by Nasdaq, data concerning the total number of board members and how each board member self-identifies with regard to gender, race, ethnicity and LGBTQ+ status. Notably, directors would not be identified by name nor would they be compelled to identify as a member of any groups. Directors who choose not to identify would have their responses recorded as "undisclosed."

Board Diversity Threshold. The proposal would require companies to appoint at least two diverse board members or explain why they have not done so. In particular, under the proposal, boards of domestic companies would need at least one director who self-identifies as female and at least one director who self-identifies as a minority with regard to race, ethnicity or sexual orientation. Foreign private issuers would also be required to have at least two diverse board members, although they may satisfy this requirement by appointing two females.

Should the proposal be approved, the timeframe for phasing in the board diversity threshold rules is as follows: All Nasdaq-listed companies would be required to have at least one diverse director within two years; companies listed on the Nasdaq Global Select or Nasdaq Global Markets would be required to have at least two diverse directors within four years; and companies listed on the Nasdaq Capital Market would be required to have at least two diverse directors within five years.

Growing Focus on Board Racial and Ethnic Diversity

Given the racial equality movement currently sweeping across the globe, it should come as no surprise that there is growing institutional investor focus on promoting racial and ethnic diversity in the boardroom. For example, BlackRock expects companies to provide board diversity disclosures (including race and ethnicity data) to enable investors to make informed diversity assessments, "with an eye toward more voting action against boards not exhibiting diversity in 2022."[86] In addition, BlackRock will focus more on average director tenure, in seeking "a balance between the knowledge and experience of seasoned directors and the fresh perspective of newer directors."

State Street's letter to board chairs recognizes a positive correlation between boards with racial and ethnic diversity and, among other things, long-term financial performance. To this end, the letter provides that, starting in 2021, State Street will expect companies in its investment portfolio to disclose:

- *Strategy*: the role diversity plays in the company's broader human capital management practices and long-term strategy;
- *Goals*: a description of the company's diversity goals, how these goals contribute to the company's overall strategy, and how these goals are managed and progressing;
- *Metrics*: measures of diversity among the company's global employee base and board, including the racial and ethnic makeup of the board of directors;
- *Board diversity*: its goals and strategy related to racial and ethnic representation at the board level, including how the board reflects the diversity of the company's workforce, community, customers and other key stakeholders; and
- *Board oversight*: a description of how the board executes its diversity and inclusion oversight role.

Across the pond, the United Kingdom's largest asset manager, Legal & General Investment Management (LGIM), published a whitepaper announcing that, starting in 2022, LGIM will vote against nominating committee chairs of S&P 500 companies that do not have ethnically diverse directors. Similar to State Street, the whitepaper also asks companies to provide board composition diversity disclosure with regard to ethnicity.

In addition, in October 2020, a 22-member investor coalition — including the Illinois, Connecticut and Pennsylvania state treasurers — representing over $3 trillion in assets under management launched the Russell 3000 Board Diversity Disclosure Initiative, urging companies to disclose in their 2021 annual proxy statements data on the racial and ethnic composition of their boards. Each of the 22 members behind the initiative either has or is examining policies to vote against nominating committees who fail to disclose such data in their proxy statements.

[86] BlackRock's "2021 Stewardship Expectations" (December 2020).

As discussed in the section titled "Assess Impact of Proxy Advisory Voting Guidelines by ISS and Glass Lewis," for annual meetings on or after February 1, 2022, ISS will recommend voting against the nominating committee chair of any Russell 3000 or S&P 1500 company that has no racial or ethnically diverse board members. Similarly, both ISS and Glass Lewis will assess board diversity disclosures provided by S&P 500 companies in their 2021 proxy statements, highlighting companies whose boards lack racial and ethnic diversity or fail to provide adequate diversity disclosures.[87]

Board Accountability Project 3.0 Update

2020 Proxy Season. In October 2019, New York City Comptroller Scott M. Stringer (NYC Comptroller) and the New York City Retirement System (NYCRS) launched the "Boardroom Accountability Project 3.0" initiative by sending letters to 56 S&P 500 companies requesting that they adopt a "Rooney Rule" policy. The NYCRS' Rooney Rule policy requires companies to consider both women and people of color for every open board seat and CEO appointment. That same month, the NYC Comptroller also announced his intention to file shareholder proposals "at companies with lack of apparent racial diversity at the highest levels."

The NYC Comptroller stood true to his word. During the spring 2020 proxy season, he submitted Rooney Rule policy shareholder proposals to 17 of the 56 companies mentioned above. Pursuant to negotiations with the NYC Comptroller's office, 13 of those 17 companies approved and publicly disclosed policies requiring the initial list from which any new independent director nominee or external CEO is chosen to include female and racially diverse candidates. Of the remaining four companies, two adopted modified Rooney Rule policies that apply to directors but not CEOs. In addition, one of the companies that adopted a modified Rooney Rule policy was able to omit the NYC Comptroller's shareholder proposal from its proxy statement on the basis of substantial implementation under Exchange Act Rule 14a-8(i)(10).

2021 Proxy Season. Each year, companies file respective EEO-1 reports with the Equal Employment Opportunity Commission (EEOC), providing certain workforce diversity statistics. However, the EEOC is prohibited by law from publicly disclosing

[87] In addition, for the 2021 proxy season, both ISS and Glass Lewis will recommend voting against nominating committee chairs of all-male boards, and in 2022, Glass Lewis intends to recommend voting against nominating committee chairs where boards have only one female.

corresponding EEO-1 data. On July 1, 2020, the NYC Comptroller sent letters to 67 S&P 100 companies requesting that they provide a written commitment to publicly disclose their annual EEO-1 reports. The letters argue that EEO-1 reports are the "gold standard" for diversity disclosure, and indicate that, if a company is unresponsive, the NYC Comptroller may submit shareholder proposals or oppose the election of director nominees standing for reelection at the 2021 annual shareholder meeting. Of the 67 companies, 34 have since committed to publicly disclosing their EEO-1 data.

State Diversity Laws

In September 2020, California amended a statute to require any public company whose Form 10-K identifies its principal executive office as being located in California to have a certain number of directors from an underrepresented community (*i.e.*, directors who self-identify as a person of color or as LGBTQ+). More specifically, by the end of 2021, such companies must have at least one director from an underrepresented community. By the end of 2022, companies that have nine or more directors must have a minimum of three directors from underrepresented communities (two directors from underrepresented communities for companies with five to eight directors). In addition, the statute authorizes the California secretary of state to impose fines of $100,000 for a first-time violation and $300,000 for each subsequent violation.

Other states have passed similar laws. For example, New York law requires companies that are "authorized to do business in [the] state" to disclose the number of women on their boards, and Illinois law requires any public company whose principal executive office is located in Illinois to disclose the number of board members who identify as women or racial or ethnically diverse.

Shareholder Lawsuits

Throughout 2019, many companies represented to the public, either in their annual proxy statements or through other means, that they were committed to actively seeking women and minority candidates for management and/or board positions. As discussed in our September 30, 2020, client alert "Shareholder Derivative Suits Likely To Extend to COVID-19, Racial Equality," in 2020, at least six shareholder derivative lawsuits were filed against directors of companies that allegedly failed to live up to these commitments.

The crux of the allegations presented in these lawsuits is that, despite company statements indicating commitments to diversity, the board is not diverse and has taken no real steps toward increasing diversity. As a result, the lawsuits assert that directors deceived shareholders by making false assertions about the company's diversity commitments, in breach of their fiduciary duties and in violation of federal proxy laws. It is yet to be seen whether these shareholder plaintiffs will prevail on such claims.

Notably, all of the lawsuits were filed against companies that allegedly did not have any people of color serving on their boards. Accordingly, companies — especially those without boardroom diversity — should consider revisiting their policies, practices and disclosures concerning diversity.

Note Calls for Action and Disclosure Related to Environmental and Sustainability Concerns

In 2020, some of the largest institutional investors, including BlackRock and Vanguard, published their views concerning climate change and other environmental and sustainability issues they believe their portfolio companies should actively address in their business models and/or disclosures. Among other things, these investors have made clear their expectations that companies should provide robust, standardized disclosures regarding related issues. There also has been an increasing level of activity and related engagement efforts by a broader group of stakeholders on these matters.

Given that these calls for action and disclosures are not expected to abate, boards of directors and management should consider, among other things, the viewpoints and topics outlined below.

Commentary From Investors and Proxy Advisory Firms

An increasing number of institutional investors have proclaimed that sustainability issues, including with respect to climate change, are financially material and thus have integrated consideration of those issues into their investment decisions.

For example, in January 2020, in his annual letter to chief executive officers, BlackRock CEO Larry Fink stated that sustainability is at the center of BlackRock's investment approach and specifically urged companies to (i) publish disclosure in line with industry-specific SASB guidelines by year-end or disclose a similar set of data in a way that is relevant to the company's particular business; and (ii) disclose climate-related risks in line with the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD).[88] Mr. Fink also shared his views that climate change has become a "defining factor" in companies' long-term value and that "climate risk is investment risk."

BlackRock subsequently reported in July 2020 that, over the prior 12 months, it had voted against one or more management recommendations at 53 companies it identified as making insufficient progress on integrating climate risk into their business models or disclosures, and that it had identified another 191 companies as being "on watch" for potential negative votes in 2021.[89] In addition, BlackRock has indicated that, beginning in 2021, it would expand its focus to a broader universe of companies[90] and would request that those companies disclose a business plan aligned with the goal of limiting global warming to well below 2 degrees Celsius, consistent with achieving net zero global greenhouse gas emissions by 2050.[91] BlackRock also indicated that it would be more inclined to vote in favor of sustainability-focused shareholder proposals where material business risks could be better managed and disclosed.

Similarly, in his January 2020 letter to directors of public companies, State Street President and CEO Cyrus Taraporevala emphasized that addressing material sustainability issues is "essential to a company's long-term financial performance."[92] Mr. Taraporevala noted that, in addition to continuing to actively engage with boards, State Street will use its proxy vote to "press companies that are falling behind and failing to engage" on sustainability.

[88] See BlackRock, Larry Fink's letter to CEOs titled "A Fundamental Reshaping of Finance" (January 2020).

[89] See BlackRock's "Investment Stewardship Annual Report" (September 2020).

[90] The broader universe covers a wide-ranging list of industry sectors: communication services, consumer discretionary, consumer staples, energy, financials, health care, industrials, information technology, materials, real estate and utilities.

[91] See BlackRock's "Our 2021 Stewardship Expectations" (December 2020).

[92] State Street's "CEO's Letter on Our 2020 Proxy Voting Agenda" (January 28, 2020).

Vanguard likewise noted in June 2020 that it considers climate risk to be a board-level risk and urged companies to "be aware of their role in the climate crisis and act as appropriate to protect their shareholders and stakeholders."[93] Vanguard also noted that it expects "effective disclosure of climate risks using investor-oriented frameworks such as those promoted by the [TCFD]." Specifically on climate-related risks, Vanguard stressed that the boards should purposefully include directors competent on climate matters, stay vigilant in their oversight and mitigation of climate risk, and be clear and effective in disclosing climate-related risks.[94]

In September 2020, the Council of Institutional Investors (CII), a nonprofit association representing U.S. pension and employee benefit funds, adopted a statement encouraging companies to "disclose standardized metrics established by independent, private sector standard setters along with reporting mandated by applicable securities regulations to better ensure investors have the information they need to make informed investment and proxy voting decisions."[95] The statement also noted that, over time, CII expects companies to obtain external assurance of the sustainability performance information they provide.

In addition to institutional investors, ISS and Glass Lewis have indicated that, when formulating voting recommendations, they consider how companies ensure appropriate oversight of material risks to their operations, including risks related to sustainability, such as environmental and social issues. ISS' proxy voting guidelines state that ISS may recommend a vote against board members based on (i) material governance failures or risk oversight, including failure to adequately guard against or manage ESG risks; or (ii) a lack of public disclosures on sustainability in conjunction with a failure to adequately manage or mitigate such risks.[96] ISS also has stated that it "seeks to promote support for recognized global governing bodies promoting sustainable business practices advocating for stewardship of environment, fair labor practices, non-discrimination, and the protection of human rights"[97] and that it will recommend a vote for proposals asking companies to report in accordance with the standards developed by such global bodies.

For their part, Glass Lewis' proxy voting guidelines provide that if a company does not properly manage or mitigate its environmental or social risks, Glass Lewis may consider recommending a vote against the responsible board members or, in the absence of explicit board oversight of such risks, recommending a vote against the audit committee members.[98]

The increasing focus on environmental and sustainability issues was also apparent during the 2020 proxy season by the types and number of shareholder proposals that called for related actions and disclosures. For instance, in 2020, environmental and social shareholder proposals represented 55% of all shareholder proposals submitted to companies and a record 21 such proposals gained majority support.[99] For additional information on shareholder proposals, see the section titled "Consider Shareholder Proposal Trends and Developments."

Disclosure Considerations

Beyond the existing disclosure requirements for involvement in certain material environmental legal proceedings and potential material effects from compliance with environmental laws, SEC rules generally do not mandate disclosure on sustainability issues.

There has been some pressure, however, including from SEC Commissioners Allison Herren Lee and Caroline A. Crenshaw, for the SEC to require disclosure on certain sustainability topics. Although the SEC has declined to mandate such disclosure thus far, the change in administration could push the SEC to more seriously consider additional disclosure requirements. Similar pressure has been seen outside of the U.S., such as in the U.K., where in November 2020 the joint Government-Regulator TCFD Taskforce issued its interim report and roadmap toward mandating climate-related TCFD-aligned disclosures by 2025, with a significant portion of the requirements to be implemented by 2023. To date, no such rule or legislation on sustainability disclosure has been proposed in the U.S. Nevertheless, in light of the increasing investor calls for action and disclosure related to environmental and sustainability issues, many companies will revisit disclosures and policies concerning related topics.

[93] Vanguard's "How Vanguard Addresses Climate Risk" (June 2020).

[94] See Vanguard's "Climate Risk Governance: What Vanguard Expects of Companies and Their Boards" (June 2020).

[95] CII's "Statement on Corporate Disclosure of Sustainability Performance" (September 22, 2020).

[96] See ISS' "United States Sustainability Proxy Voting Guidelines: 2020 Policy Recommendations" (December 31, 2019).

[97] *Id.* Such global bodies include the United Nations Environment Programme Finance Initiative (UNEP FI), United Nations Principles for Responsible Investment (UNPRI), United Nations Global Compact, Global Reporting Initiative (GRI), Carbon Principles, International Labor Organization Conventions (ILO), CERES Roadmap for Sustainability, Global Sullivan Principles, MacBride Principles, and environmental and social European Union Directives. See *id.*

[98] See Glass Lewis' "2020 Proxy Paper Guidelines: An Overview of the Glass Lewis Approach to Proxy Advice — United States" (2020).

[99] See ISS' "2020 Proxy Season Preview — Environmental & Social Issues" (May 8, 2020).

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

Proxy advisory firms ISS[100] and Glass Lewis[101] have updated their voting guidelines for the 2021 annual meeting season. Companies should assess the potential impact of these updates when considering changes to their corporate governance practices, shareholder engagement and proxy statement disclosures.[102] Companies should also note that, for annual meetings held after January 1, 2021, ISS will no longer provide draft research reports to U.S. S&P 500 companies before sending the reports to ISS' institutional investor clients.[103]

Board Diversity.[104] ISS' 2021 research reports for companies in the Russell 3000 or S&P 1500 will highlight company boards that lack racial and ethnic diversity or lack disclosure of racial and ethnic diversity. Further, starting in 2022, ISS will recommend voting against or withhold from the chairs of company nominating committees, or other directors on a case-by-case basis, of companies in the Russell 3000 or S&P 1500 with boards that have no apparent racial or ethnically diverse members, and for which no mitigating factors are identified. ISS provides an exception to this voting policy if a board included a racial and/or ethnic minority member at the preceding annual meeting, and if the company makes a firm commitment to appoint at least one racially and/or ethnically diverse director within one year. In determining its specific recommendation, ISS will consider aggregate diversity statistics provided by company boards if the statistics are specific to racial and/or ethnic diversity.

Glass Lewis' reports for companies in the S&P 500 will include an assessment of company disclosure in the proxy relating to board diversity, skills and the director nomination process, including the board's current percentage of racial/ethnic diversity.

Gender Diversity. In ISS' prior-year annual meeting proxy guidelines, ISS reported that it would recommend voting against the chair of the nominating committee (or other directors as appropriate) of an all-male board of directors, unless the company included proxy statement disclosure of a "firm commitment" to appoint at least one woman to the company's board within a year, in certain circumstances. Effective February 2021, ISS will no longer consider such mitigating factors. Instead, ISS will make an exception to its gender diversity policy only if a company had a woman on its board at its preceding annual meeting and the board commits to appointing a female director at its next annual meeting.[105]

Glass Lewis will continue to recommend against the nominating committee chair of a board that has no female members and will now note as a concern boards including fewer than two female directors. For meetings held after January 1, 2022, Glass Lewis generally will recom-

[100] See ISS' "United States Proxy Voting Guidelines — Benchmark Policy Recommendations" (November 19, 2020). For a summary of ISS' 2020 updates for the U.S., Canada and Latin America, see ISS' "Americas Proxy Voting Guidelines Updates for 2021" (November 12, 2020). For an executive summary of all policy updates to ISS' global proxy voting guidelines, see ISS' "2021 Global Proxy Voting Guidelines Updates and Process for ISS Benchmark Policy Development" (November 12, 2020).

[101] See Glass Lewis' "2021 Proxy Paper Guidelines: An Overview of the Glass Lewis Approach to Proxy Advice — United States" (November 17, 2020) and Glass Lewis' "2021 Proxy Paper Guidelines: Environmental, Social & Governance ("ESG") Initiatives" (November 24, 2020).

[102] For related executive compensation updates, see the section titled "Review Executive Compensation in Light of COVID-19 and Related Guidance From ISS and Glass Lewis."

[103] The SEC's new proxy advisory firm rules, discussed in the section titled "Note Status of Recent and Pending SEC Rulemaking Matters," eventually will require ISS and other firms to provide a free copy of their research reports to companies at or before the reports are provided to the firm's clients, assuming certain conditions are met, which will often be the case.

[104] For additional information regarding board diversity disclosure, see the section titled "Consider Recommendations To Increase Board Diversity and Enhance Related Disclosures."

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

mend voting against the nominating committee chair of a board with fewer than two female directors.[106] Depending on the circumstances, Glass Lewis may extend this recommendation to additional members of the nominating committee. In determining its recommendation, Glass Lewis will consider company disclosure of its diversity considerations, and may refrain from recommending that shareholders vote against directors of companies outside the Russell 3000 index, or when boards have provided a sufficient rationale or plan to address the lack of diversity on the board. In addition, Glass Lewis will make voting recommendations in accordance with board composition requirements in applicable state laws, such as California, when they come into effect.

ESG Oversight.[107] Following a 2020 roundtable discussion that ISS held with market constituents on environmental and social shareholder proposals, climate change risk, human capital management and proposals related to companies' support for the Business Roundtable's statement on the purpose of a corporation, ISS updated its proxy voting guidelines to include an additional example of when ISS will, under extraordinary circumstances, issue negative voting recommendations for material failures of risk oversight. For 2021, ISS will include "demonstrably poor risk oversight of environmental and social issues, including climate change" as an example of a failure of risk oversight that may merit such a recommendation.

Glass Lewis' updated policy states that it will note as a concern when boards of companies in the S&P 500 do not provide clear disclosure concerning board-level oversight of environmental and/or social issues. Beginning with shareholder meetings held after January 1, 2022, Glass Lewis generally will recommend voting against the governance chair of a company in the S&P 500 that fails to provide explicit disclosure concerning the board's role in overseeing these issues. In addition, Glass Lewis will consider the following factors when determining its recommendations on management-sponsored environmental and social proposals:

- the request of the resolution and whether it would materially impact shareholders;
- whether there is a competing or corresponding shareholder proposal on the topic;
- the company's general responsiveness to shareholders and to emerging environmental and social issues;
- whether the proposal is binding or advisory; and
- management's recommendation on how shareholders should vote on the proposal.

Board Refreshment. Under ISS' revised board refreshment policy, ISS will consider management proposals regarding director term limits on a case-by-case basis, taking into account, for example, the rationale management provided for adopting a term limit. ISS also will determine recommendations regarding shareholder proposals to adopt director term limits on a case-by-case basis, considering the scope of the shareholder proposal and the evidence of problems at the company combined with, or exacerbated by, a lack of board refreshment. In addition, ISS will recommend voting for proposals to remove mandatory age limits.

Glass Lewis will note as a potential concern instances where the average tenure of nonexecutive directors is 10 years or more and no new independent directors have joined the board in the past five years. Glass Lewis will not make voting recommendations solely on this basis in 2021; however, insufficient board refreshment may be a contributing factor in Glass Lewis' recommendations if it coincides with additional board-related concerns.

Virtual Shareholder Meetings. ISS adopted a new policy of generally recommending voting in favor of management proposals to allow virtual shareholder meetings, as long as the proposal does not preclude in-person meetings. The new policy encourages companies to disclose the circumstances under which virtual-only meetings would be held and to allow for comparable rights and opportunities for shareholders to participate in such meetings as they would during in-person meetings.[108]

Glass Lewis removed its temporary exception regarding holding virtual annual meetings due to the COVID-19 pandemic, which had applied to meetings from March 1 to June 30, 2020. Therefore, Glass Lewis' standard policy will remain in effect for 2021. For companies holding virtual annual meetings, Glass Lewis expects "robust" disclosure in the company's proxy statement addressing the ability of shareholders to participate in the meetings.

Gender, Race and Ethnicity Pay Gaps. ISS updated its policy regarding vote recommendations on a case-by-case basis concerning proposals that request a report on a company's pay data by gender, race or ethnicity, or a report on a company's policies and goals to reduce any gender, race or ethnicity pay gaps.

[106] For boards with six or fewer members, Glass Lewis' existing voting policy requiring a minimum of one female director will remain in place.

[107] For a discussion on recent developments regarding sustainability disclosure, see the section titled "Note Calls for Action and Disclosure Related to Environmental and Sustainability Concerns."

[108] See the section titled "Plan for Another Year of Virtual Shareholder Meetings."

ISS will now take into account a company's disclosure regarding gender, race or ethnicity pay gap policies or initiatives compared to the company's industry peers, as well as local laws regarding categorization of race and ethnicity and definitions of ethnic and racial minorities.

Glass Lewis' current policy of reviewing, on a case-by-case basis, proposals requesting a report on company efforts to ensure pay parity or requesting that companies disclose their median gender pay ratios, remains unchanged.

Shareholder Litigation Rights. ISS revised its exclusive forum policies, which now differentiate between federal and state forum selection provisions. Under the revised policies, adoption of federal or state forum selection provisions without a shareholder vote generally will be considered a one-time violation of ISS' policy against unilateral bylaw or charter amendments, which could result in a recommendation to vote against company directors.

ISS generally will recommend voting for federal forum selection provisions that specify the district courts of the United States as the exclusive forum for federal securities law matters, but ISS will recommend voting against provisions that restrict the forum to a particular federal district court.

Regarding state forum selection provisions, ISS generally will recommend a vote for charter or bylaw provisions that specify courts located within Delaware as the exclusive forum for corporate law matters for Delaware corporations. ISS will make voting recommendations on a case-by-case basis on such provisions that specify states other than Delaware and generally will recommend voting against forum selection provisions that specify a state other than the company's state of incorporation as the exclusive forum for corporate law matters or that specify a particular local court within the state.

Glass Lewis has not updated its policy on forum selection provisions, under which it will recommend voting against bylaw or charter amendments seeking to adopt an exclusive forum provision, absent certain evidence provided by the company.

Advance Notice Requirements. ISS modified its policy on advance notice proposals, for which, under both the current and modified guidelines, ISS will make voting recommendations on a case-by-case basis, supporting proposals that allow shareholders to submit proposals and nominations as close to the meeting date as reasonably possible and within the broadest window possible. The previous deadline ISS considered reasonable was the provision of shareholder notice of a proposal/nomination not more than 60 days prior to the meeting, with a submittal window of at least 30 days prior to the deadline. The updated policy provides that, to be reasonable, a company's deadline must be no earlier than 120 days prior to the anniversary of the previous year's meeting, with a submittal window of no shorter than 30 days from the beginning of the notice period.

Glass Lewis will continue to recommend that shareholders vote against proposals that would require advance notice of shareholder proposals or of director nominees.

Reports Regarding Certain Employee Matters. ISS adopted a new policy of making voting recommendations on a case-by-case basis regarding proposals requesting a report on (i) a company's use of mandatory arbitration in employment-related claims; or (ii) company actions taken to strengthen policies and oversight to prevent workplace sexual harassment or risks posed by a company's failure to prevent workplace sexual harassment. ISS will take into account, as applicable:

- the company's current policies, practices and oversight mechanisms related to the use of mandatory arbitration agreements on workplace claims or on preventing workplace sexual harassment;
- whether the company has been the subject of recent controversy, litigation or regulatory actions related to the use of mandatory arbitration agreements on workplace claims or workplace sexual harassment issues; and
- the company's disclosure of its policies and practices related to the use of mandatory arbitration agreements compared to its peers or regarding workplace sexual harassment policies or initiatives compared to its industry peers.

Glass Lewis has not added a similar policy to its guidelines.

Climate Change. Glass Lewis updated its policy regarding climate change to remove its consideration of a company's industry when reviewing climate reporting resolutions and generally will recommend in favor of shareholder resolutions requesting that companies provide enhanced disclosure on climate-related issues, taking into consideration a number of factors. In evaluating proposals seeking disclosure on climate-related lobbying, which Glass Lewis generally will support, Glass Lewis will take into account:

- whether the requested disclosure would meaningfully benefit shareholders' understanding of the company's policies and positions on this issue;

- the industry in which the company operates;
- the company's current level of disclosure regarding its direct and indirect lobbying on climate change-related issues; and
- any significant controversies related to the company's management of climate change or its trade association memberships.

ISS has not updated its voting recommendation policies on proposals relating to climate change risks, greenhouse gas emissions, energy efficiency or renewable energy.

Other Matters. Additional updates to ISS' and Glass Lewis' voting guidelines are summarized below:

- ISS' updated guidelines provide that, in considering whether to recommend a vote against or a withhold vote from all nominees — except for new nominees, who will continue to be considered on a case-by-case basis — for a company with a poison pill, ISS will recommend such a vote if the pill, short-term or long-term, has a deadhand or slowhand feature;
- ISS updated its fee shifting policy to provide that it generally will recommend a vote against charter or bylaw provisions that mandate fee-shifting whenever plaintiffs are not completely successful on the merits;
- Glass Lewis adopted a new policy regarding its approach to special purpose acquisition companies (SPACs), which includes its generally favorable view of proposals seeking to extend business combination deadlines and describes its approach to determining the independence of board members at a post-combination entity who previously served as executives of the SPAC;
- Glass Lewis generally will support shareholder proposals requesting that companies provide EEO-1 reporting and will no longer consider a company's industry or the nature of its operations when evaluating diversity reporting proposals; and
- Glass Lewis will recommend voting against a company's governance committee chair when the company has not disclosed a detailed record of proxy voting results from the last annual meeting.

Consider Shareholder Proposal Trends and Developments

The 2020 proxy season saw the continuation of certain trends from previous seasons and featured some new developments. Below is a brief summary of observations from the last proxy season that may shed light on what to expect this upcoming season, along with an overview of recent amendments to Exchange Act Rule 14a-8.

2020 Proxy Season Summary

The number of shareholder proposals submitted to companies last year dipped slightly from the prior year — 829 in 2020, down from 862 in 2019 — continuing a general downward trend in proposal submission rates over the past few years. Despite the decline, the overall number of proposals that went to a vote was flat — 468 in 2020, versus 469 in 2019 — resulting in a slightly higher proportion of proposals ending up on companies' ballots. In addition, as has been the case in recent years, large-cap companies were the primary focus of shareholder proposals, with companies in the S&P 500 accounting for roughly three out of every four proposals that went to a vote in 2020.

Environmental and Social Proposals. For the fourth year in a row, environmental and social-oriented proposals outpaced the total number of governance proposals submitted to companies, with 408 environmental and social proposals submitted compared to 374 governance-focused proposals. Despite the high number of submissions of environmental and social proposals, more governance proposals (269) ultimately made it onto companies' ballots than environmental and social proposals (181). A record number (22) of environmental and social proposals also received majority support in 2020, nearly doubling the amount that received majority support in 2019 (12).

Environmental Proposals. There were a large number of environmental proposals (100) submitted to companies in 2020, addressing a broad range of topics, including, among others, climate change risks and reporting, greenhouse gas emissions, environmental impact reporting and sustainability reporting. Consistent with a trend from 2019, only a small number (30) went to a vote. The environmental proposals that were voted on in 2020 garnered average support of approximately 32%, an increase from average support of approximately 25% in 2019. In a notable change from the 2019 proxy season, where no environmental proposals received majority support, seven received majority support in 2020.

As has been the case in previous proxy seasons, a substantial subset of the environmental proposals submitted to companies in 2020 related to the specific topic of climate change — about 60. These proposals generally focused on the steps the companies were taking to address climate change risks and align their operations or disclosures consistent with the goals of a specific international environmental framework. The number of climate change proposals that went to a vote increased slightly to 13 in 2020 from 11 in 2019, and the average support for these proposals increased to approximately 41% in 2020 from approximately 32% in 2019, with four climate change proposals receiving majority support in 2020. The increase in average support most likely reflects the views recently articulated by large institutional investors. For a discussion of these views and other environmental and related issues, see the section titled "Note Calls for Action and Disclosure Related to Environmental and Sustainability Concerns."

Social Proposals. Consistent with the 2019 proxy season, the largest subset of nonenvironmental-focused social proposals were those relating to corporate political contributions and/or lobbying activities. In the context of political contributions proposals, proponents generally sought increased disclosure from companies of their policies and procedures for making contributions and expenditures relating to political campaigns. In the context of lobbying proposals, proponents generally sought reports on companies' policies and procedures governing lobbying, payments made relating to lobbying and descriptions of oversight of corporate lobbying. While the number of these two groups of proposals declined to 95 from 102 submitted in the 2019 proxy season, average support for the proposals that went to a vote (63) increased from approximately 34% during 2019 to a record average support of approximately 36% in 2020, and a record seven of these proposals received majority support in 2020, up from four in 2019.

A significant portion of social-oriented proposals in 2020 concerned a mix of human rights and diversity topics. Of these, about 45 proposals related to human rights (down from about 54 in 2019), averaging approximately 28% support, relatively consistent with 2019. These proposals covered a wide range of topics, including, among others, risks related to human trafficking in companies' supply chains, immigrant detention in for-profit private prisons and gun violence. None of these proposals received majority support, compared with two human rights proposals receiving majority support in 2019.

Against the backdrop of protests calling for racial equity in 2020, the number of proposals focused on diversity increased, with 32 proposals relating to workforce diversity submitted in 2020 (nearly doubling the amount (17) submitted in 2019). Perhaps due to the increased success of negotiations between companies and proponents, only 25% of these proposals went to a vote in 2020. In addition, four workplace diversity proposals received majority support in 2020, an increase from two in 2019.

Board diversity proposals remained prevalent, although there were fewer in 2020 (30) than in 2019 (50). The board diversity proposals that went to a vote in 2020 received average support of 30%, with two proposals receiving majority support, consistent with the number of proposals receiving majority support in 2019. One notable variety of board diversity proposal submitted in 2020 sought to adopt a version of the NFL's "Rooney Rule" in searches for new board members and CEOs. These proposals requested that companies adopt a policy mandating that the initial list of candidates considered to fill board seats or to identify a new CEO includes qualified female and racially or ethnically diverse candidates.

The number of gender pay gap proposals submitted to companies declined significantly in 2020, with 14 proposals submitted compared to 29 submitted in 2019. Proposals focusing on sexual harassment also declined in 2020, with only five proposals submitted compared to 10 in 2019.

Governance Proposals. Continuing a trend from the 2019 proxy season, a significant percentage of the proposals that went to a vote in 2020 concerned governance-related topics, with 269 out of 468 proposals, compared with 259 out of 469 in 2019. These proposals covered a wide-range of topics, including, among others, the ability of shareholders to act by written consent, calls for an independent chair, requests related to shareholders' ability to call special meetings and requests for a proxy access right. Forty-three governance proposals received majority support in 2020, down from 63 proposals receiving majority support in 2019.

The most common governance topic in 2020 was written consent, with 70 proposals submitted, 63 voted on and five receiving majority support. Proposals calling for an independent chair, the most common governance topic in 2019, were the second-most common governance topic in 2020, with 46 proposals voted on (compared to 60 in 2019). Average support for independent chair proposals increased slightly to approximately 35% in 2020 from approximately 30% in 2019, with two of these proposals receiving majority support in 2020 compared to none in 2019.

Another common governance topic in 2020 related to requests to provide for, or make easier, the ability of shareholders to call a special meeting. The number of special meeting proposals voted on in 2020 increased to 43 from 27 in 2019, although average support declined slightly to approximately 42% from 45% in 2019. Proposals focused on proxy access declined significantly in 2020, with 21 proposals submitted in 2020 (of which 14 went to a vote) compared to 38 proposals submitted in 2019 (of which 30 went to a vote). Average support for these proposals in 2020 was 33%, with one proposal passing.

Executive Compensation Proposals. The number of executive compensation-related proposals submitted in 2020 declined to 28 from 61 in the 2019 proxy season. The number of executive compensation-related proposals that went to a vote also declined — to 29 in 2020 from 37 in 2019 — although these proposals received in 2020 had slightly higher average support of approximately 22% (compared with approximately 20% in 2019). These proposals covered a wide range of topics, such as requests related to CEO pay ratio, incentive compensation and clawback policies. Only one executive compensation proposal received majority support in 2020, relating to a clawback policy, consistent with 2019, when clawback proposals were the only two executive compensation-related proposals receiving majority support. Although compensation-related shareholder proposals spanned a variety of topics, the two most common proposal types in 2020 involved requests to assess the feasibility of including an environmental or social metric in the executive compensation program and requests to adopt a share retention policy for executives, reflecting the more general increase in environmental and social proposals in 2020.

SEC Amendments to Rule 14a-8

On September 23, 2020, the SEC adopted amendments to the procedural requirements and resubmission thresholds relating to shareholder proposals submitted for inclusion in company proxy statements pursuant to Exchange Act Rule 14a-8. The amendments, which are summarized below, (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) end the ability of representatives to submit multiple proposals on behalf of other shareholders for the same meeting; and (v) raise the levels of support that a proposal must receive to be resubmitted at future shareholder meetings. Notably, the rules begin to apply to proposals submitted for annual or special meetings to be held on or after January 1, 2022; therefore, these rules will not apply until after this upcoming 2021 proxy season.

Tiered Ownership Requirements. Currently, in order to be eligible to have a proposal included in a company's proxy materials pursuant to Rule 14a-8, a proponent must have owned at least $2,000 of company stock continuously for at least one year. Under the new rules, a proponent will be required to satisfy one of three alternative tests that will require a shareholder to have continuously held at least:

- $2,000 of the company's securities entitled to vote on the proposal for at least three years;
- $15,000 of the company's securities entitled to vote on the proposal for at least two years; or
- $25,000 of the company's securities entitled to vote on the proposal for at least one year.

In addition, shareholders will no longer be permitted to aggregate their shares in order to meet the minimum ownership requirements.

The rules provide for an additional transition period so that shareholders currently eligible to submit shareholder proposals will not lose that eligibility if they continue to hold the shares. Specifically, shareholders who satisfy the $2,000/one-year ownership test as of the effective date of the new rules will continue to be eligible to submit proposals for annual or special meetings held prior to January 1, 2023, provided they continuously hold at least $2,000 of a company's securities from that effective date through the date of submission.

Documentation When a Proposal Is Submitted by a Representative. In Staff Legal Bulletin No. 14I, the SEC staff stated that it would look to certain documentation describing a shareholder's delegation of authority to a representative to submit a shareholder proposal. The amended rules largely codify this requirement. Specifically, if a shareholder uses a representative to submit a shareholder proposal or otherwise act on the proponent's behalf with respect to the proposal, the shareholder will be required to provide the company with documentation signed and dated by the shareholder:

- identifying the company to which the proposal is directed;
- identifying the annual or special meeting for which the proposal is submitted;
- identifying the shareholder submitting the proposal and the shareholder's representative;
- including a statement authorizing the representative to submit the proposal and otherwise act on the shareholder's behalf;
- identifying the specific topic of the proposal to be submitted; and
- including the shareholder's statement supporting the proposal.

Information Regarding the Proponent's Availability for Engagement With the Company. As part of the new Rule 14a-8 procedural requirements, the amendments will require a proponent to provide the company with a written statement that the proponent is able to meet with the company in person or by teleconference no less than 10 days nor more than 30 days after submission of the shareholder proposal. The proponent will be required to provide the company with contact information as well as specific times during the regular business hours of the company's principal executive offices that the proponent is available to discuss the proposal with the company.

One Proposal Limit. Currently, under Exchange Act Rule 14a-8(c), a shareholder may submit no more than one proposal to a company for a particular meeting. However, under the current rule a single representative could submit multiple proposals for the same meeting on behalf of different shareholders. The amendments will apply the one-proposal limit to each "person" rather than each shareholder, so that a person is not able to submit one proposal as a shareholder and a different proposal for the same meeting as a representative of another shareholder or to submit different proposals for the same meeting as a representative for multiple shareholders.

Resubmission Thresholds. Rule 14a-8 currently provides a basis for exclusion of a proposal if the proposal addresses substantially the same subject matter as a proposal or proposals included in the company's proxy materials within the preceding five years. In order for the exclusion to apply, the most recent vote must have occurred within the preceding three years and the proposal must have received less than 3%, 6% or 10% of votes cast if voted on once, twice, or three or more times, respectively. The amendments will increase the level of shareholder support that a proposal must receive to be eligible for resubmission. A proposal dealing with substantially the same subject matter as a previous proposal or proposals included in the company's proxy materials within the preceding five years may be excluded under the amended rules if the most recent vote was within the preceding three years and was:

- less than 5% of the votes cast if previously voted on once;
- less than 15% of the votes cast if voted on twice; and
- less than 25% of the votes cast if voted on three or more times.

In a notable change from the proposed rules, the final amendments do not include a "momentum" provision, which would have permitted exclusion of certain resubmitted proposals that experienced declining shareholder support.

Plan for Another Year of Virtual Shareholder Meetings

During the first half of 2020, the number of public companies holding virtual annual meetings sky rocketed due to the COVID-19 pandemic, increasing almost fivefold compared to the 2019 calendar year, with Broadridge Financial Solutions, a public corporate services company (Broadridge), alone hosting nearly 1,500 virtual shareholder meetings.[109] Looking ahead, due to the uncertainty relating to the COVID-19 pandemic, companies should prepare for the possibility of needing to hold virtual annual meetings during the 2021 proxy season.[110]

Lessons From 2020 Virtual Meetings

Despite how quickly many companies had to shift their annual meetings from an in-person to a virtual format during the 2020 proxy season, companies were generally able to successfully hold virtual annual meetings and allow investors to participate. Some companies experienced technical issues or had difficulty scheduling their virtual meetings, however, due to the influx of companies relying on the same technology to hold such meetings. To prevent these issues from occurring this upcoming season, companies should engage early with virtual meeting service providers to schedule their meetings, discuss how best to handle technical difficulties, and learn how virtual meeting platforms have evolved in response to company and investor feedback during the 2020 proxy season. In addition, companies should consider investor feedback regarding their 2020 shareholder meetings when drafting related proxy statement disclosure and planning for their next meeting.

Proxy Advisory Firm and Investor Group Perspectives

During the 2020 proxy season, both ISS[111] and Glass Lewis[112] issued guidance supportive of virtual meetings during the COVID-19 pandemic. Glass Lewis, however, stated that for virtual meetings in future years, it expects companies to provide "robust" proxy disclosures regarding shareholders' ability to participate in the meetings.[113] In addition, in its 2021 proxy voting guidelines, ISS adopted a new policy of generally recommending voting in favor of management proposals to allow virtual shareholder meetings, as long as the proposal does not preclude in-person meetings.[114]

Despite proxy advisory firm support for virtual shareholder meetings, some investors remain concerned about a lack of transparency surrounding those meetings, particularly because during the 2020 proxy season, typically only companies were able to see the questions shareholders asked during question and answer sessions. As a result, in a July 2020 letter to the SEC, the CII, the Interfaith Center on Corporate Responsibility and others called the virtual meetings held in 2020 a "poor substitute" for in-person meetings and stated that companies should provide shareholders a more straightforward means of accessing, participating in and voting at the meetings.[115] More recently, a multi-stakeholder working group, led by the Rutgers Center for Corporate Law and Governance, the CII and the Society for Corporate Governance, published

[109] See Broadridge's "Virtual Shareholder Meetings — 2020 Mid-Year Facts and Figures" (2020).

[110] See our client alert "Planning Ahead: Virtual Shareholder Meetings in the 2021 Proxy Season" (September 30, 2020).

[111] See ISS' "Impacts of the COVID-19 Pandemic — ISS Policy Guidance" (April 8, 2020).

[112] See Glass Lewis' "Immediate Glass Lewis Guidelines Update on Virtual-Only Meetings Due to COVID-19 (Coronavirus)" (March 19, 2020).

[113] In its 2021 guidelines, Glass Lewis removed its temporary exception regarding holding virtual annual meetings due to the COVID-19 pandemic, which had applied to meetings from March 1, 2020, to June 30, 2020. For more information, see the section titled "Assess Impact of Proxy Advisory Voting Guidelines by ISS and Glass Lewis."

[114] See ISS' "United States Proxy Voting Guidelines" (November 19, 2020).

[115] See the CII, *et al.*'s "Virtual and Hybrid Meetings: Concerns From 2020 Proxy Season" (July 6, 2020).

a report on recommended practices in conducting virtual shareholder meetings and providing related disclosures.[116] This report is intended to assist companies in conducting their virtual meetings so that the shareholder meeting experience is as close as possible to the in-person meeting experience.

SEC Staff Guidance

The SEC's Division of Corporation Finance issued guidance in April 2020 concerning virtual meetings, in light of COVID-19.[117] The guidance noted that companies should clearly disclose logistical details, such as how shareholders can remotely access, participate in and vote at the meeting, and how companies should disclose changes to an annual meeting, such as switching from an in-person to a virtual meeting.

Shareholder Participation

According to Broadridge, during the 2020 proxy season, 97% of companies hosting a virtual annual meeting on Broadridge's platform allowed live questions from shareholders, and 11% of companies allowed shareholders to submit questions before the meeting. In addition, of companies with shareholder proposals, 25% of companies allowed shareholders to submit questions before the virtual meeting.[118] Companies should consider the manner in which they will provide for shareholder participation in the event of a virtual annual meeting and include related disclosure in their proxy statements.

State Law Requirements

Companies considering holding a virtual annual meeting in 2021 should review their state corporate laws covering the ability to, and permissible methods of, holding virtual annual meetings or switching from an in-person to a virtual annual meeting. The majority of states, including Delaware, permit companies to hold virtual-only shareholder meetings. However, for the states that do not permit such meetings, such as New York (which provided emergency relief due to the COVID-19 pandemic), the availability of any relief is uncertain for 2021 annual meetings. Companies should therefore monitor developments in their state of incorporation concerning relevant statutory changes or new executive orders and should review their governing documents to ensure they allow for virtual meetings.

[116] See the Rutgers Center for Corporate Law and Governance, *et al.*'s "Report of the 2020 Multi-Stakeholder Working Group on Practices for Virtual Shareholder Meetings" (December 10, 2020).

[117] See the SEC's "Staff Guidance for Conducting Shareholder Meetings in Light of COVID-19 Concerns" (April 7, 2020).

[118] See Broadridge's "Virtual Shareholder Meetings: 2020 Mid-Year Facts and Figures" (2020).

SEC Reporting and Compliance and Corporate Governance Contacts

Brian V. Breheny
Washington, D.C.
202.371.7180
brian.breheny@skadden.com

Marc S. Gerber
Washington, D.C.
202.371.7233
marc.gerber@skadden.com

Andrew J. Brady
Washington, D.C.
202.371.7513
andrew.brady@skadden.com

Hagen J. Ganem
Washington, D.C.
202.371.7503
hagen.ganem@skadden.com

Josh La Grange
Palo Alto
650.470.4575
josh.lagrange@skadden.com

Ryan J. Adams
Washington, D.C.
202.371.7526
ryan.adams@skadden.com

Blake M. Grady
Washington, D.C.
202.371.7591
blake.grady@skadden.com

Jeongu Gim
Washington, D.C.
202.371.7223
jeongu.gim@skadden.com

Caroline S. Kim
Washington, D.C.
202.371.7555
caroline.kim@skadden.com

Justin A. Kisner
Washington, D.C.
202.371.7367
justin.kisner@skadden.com

Executive Compensation and Benefits Contacts

Regina Olshan
New York
212.735.3963
regina.olshan@skadden.com

Joseph M. Penko
New York
212.735.2618
joseph.penko@skadden.com

Erica Schohn
New York
212.735.2823
erica.schohn@skadden.com

Joseph M. Yaffe
Palo Alto
650.470.4650
joseph.yaffe@skadden.com

Stephanie Birndorf
Palo Alto
650.470.3117
stephanie.birndorf@skadden.com

Allison M. Kroeker
Palo Alto
650.470.3148
allison.kroeker@skadden.com

Leon Chomiak contributed to this client alert.

One Manhattan West / New York, NY 10001 / 212.735.3000