Considerations For The 2018 Proxy Season: Part 3

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Each company faces important decisions in preparing for its 2018 annual meeting and reporting season. This **three-part series** covers essential areas that companies should focus on as they plan for 2018, including corporate governance, executive compensation and disclosure matters. Part 3 of this article focuses on various disclosure and other considerations, including the impact of U.S. Securities and Exchange Commission staff comments and enforcement trends, efforts to increase environmental, social and governance reporting, SEC guidance and trends in cybersecurity-related matters, finalizing adoption of new revenue recognition standards, potential changes in pay practices due to the Tax Cuts and Jobs Act, compliance with new IFRS XBRL tagging requirements and Section 162(m), and recent developments in insider trading laws and policies.

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Assess Impact of SEC Staff Comments and Enforcement Trends

Although a recent study by EY (formerly Ernst & Young) indicates that the annual number of comment letters issued by the SEC Division of Corporation Finance staff on company filings has decreased approximately 40 percent since 2014,[1] more than 50 percent of SEC registrants received comments from the staff on their filings in the last year. Those comment letters continue to focus on certain key topics in their filing reviews. The most common of those topics are non-GAAP (generally accepted accounting principles) financial measures and management discussion and analysis, or MD&A, disclosures.

Non-GAAP Financial Measures

As is commonly known, the SEC staff provided updated guidance in May 2016 concerning the disclosure of non-GAAP financial measures that resulted in a significant impact on company disclosures. The issuance of that guidance was followed by greater scrutiny of the use of non-GAAP financial measures by the SEC staff. The staff has recently announced that it believes that its guidance had the impact the staff intended and, as a result, it does not believe that the topic will continue as a focus of filing reviews. Nevertheless, companies should continue to ensure that disclosures of non-GAAP measures comply with the applicable SEC rules and staff guidance.

MD&A Disclosures

In addition to Division of Corporation Finance staff comments on filing reviews, the SEC Division of Enforcement staff has continued to focus on disclosure-related matters. Those matters have included actions based on the alleged failure to comply with the SEC requirements for disclosures related to loss contingencies, MD&A and non-GAAP financial measures. In one recently settled matter involving the alleged failure of the CEO and chief financial officer to adequately address the company's liquidity and capital resources in the MD&A,[2] the SEC relied on its 2003 interpretative guidance that requires the MD&A to 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."[3] This disclosure threshold is different from the general materiality standard of probability and magnitude.

Companies should continue to revisit their MD&A disclosures to ensure that they appropriately emphasize material information and describe all known trends and uncertainties reasonably likely to have a material effect on the company's financial condition or results of operations. As the SEC highlighted in the settled matter described above, known trends and uncertainties should be disclosed when it is reasonably likely they will occur. Companies also should review other areas of their disclosures, such as their risk factors, to determine whether these other disclosures suggest the existence of known trends and uncertainties not discussed in MD&A and revise their disclosures accordingly.

Assess Recent Requests for Increased Environmental, Social and Governance Reporting

Requests for companies to focus on environmental, social and governance (ESG) reporting processes, oversight and disclosure have grown recently as certain investors have increasingly argued that ESG factors have become integrated into financial analysis as a means to evaluate risks and opportunities.[4] For purposes of these matters, "ESG" generally refers to a wide range of issues, including climate change and measures of a company's carbon emissions, labor and human rights policies, and board diversity and shareholder engagement initiatives under the corporate governance component. Large institutional investors, including BlackRock, Vanguard and State Street Global Advisors, have encouraged companies to adopt specific ESG strategies, report on climate change issues, and enhance climate competency at the management and board levels.[5]

SEC Request for Feedback

The SEC also has requested feedback as to whether it should adopt specific rules related to ESG reporting. In April 2016, the SEC issued a concept release titled "Business and Financial Disclosure Required by Regulation S-K" seeking public input on modernizing the disclosure requirements in Regulation S-K.[6] In that release, the SEC requested "feedback on which, if any, sustainability and public policy disclosures are important to an understanding of a registrant's business and financial condition and whether there are other considerations that make these disclosures important to investment and voting decisions." The SEC has not announced any plans to propose new rules based on the feedback it has received in response to this request. And, under the current SEC leadership, we do not expect any such new rules to be proposed.

Matters to Consider

We believe companies should assess these requests for additional ESG reporting and changes to company processes and determine if any actions should be taken in response. As part of those considerations, companies should identify whether any of their

shareholders have called for additional reporting or changes and, if so, engage with those shareholders to better understand what specific steps those investors think the company should take. For instance, there are a number of ESG reporting standards that a company could choose to adopt. The Sustainability Standards Board is one of the organizations that has established sustainability accounting standards relating to the public disclosure of material sustainability information. The Global Reporting Initiative has published another set of sustainability reporting standards. Moreover, the Financial Stability Board's Task Force on Climate-related Financial Disclosures published an international framework with recommendations for voluntary climate-related financial disclosures in June 2017, which resulted from the TCFD's study of stakeholder engagement on ESG issues and existing climate-related disclosure regimes.[7] Companies that decide to provide additional ESG reporting will need to assess the potential materiality of any ESG-related disclosures and determine whether they should adopt established standards and industry recommendations.

Reconsider SEC Guidance and Recent Trends in Cybersecurity-Related Matters

There have been a number of companies recently impacted by high-profile cybersecurity matters. Those matters have raised questions about whether additional and earlier public disclosures should have been made, company policies and procedures should be revised, and the SEC should amend its rules in response to these continued threats. Indeed, in connection with an announcement of a cybersecurity incident involving the SEC's EDGAR (Electronic Data Gathering, Analysis and Retrieval) filing system, SEC Chairman Jay Clayton reminded companies that they "should consider whether their publicly filed reports adequately disclose information about their risk management governance and cybersecurity risks, in light of developments in their operations and the nature of current and evolving cyber threats" and "must take their periodic and current disclosure obligations regarding cybersecurity risks seriously."[8]

It is unclear whether the SEC will take further steps to address the increased cybersecurity risks. Certain senior SEC staff members have recently stated that consideration is being given to this issue. Meanwhile, we recommend that companies reconsider prior SEC staff guidance related to cybersecurity matters and whether any of the company's disclosure, communication, insider trading or other policies should be revised to address cybersecurity risks.

In October 2011, the staff of the SEC's Division of Corporation Finance issued guidance to assist companies in assessing what disclosures should be provided with respect to cybersecurity risks and cyberincidents and how cybersecurity risks and their impact should be described in SEC filings.[9] Although there is no SEC disclosure requirement explicitly referring to cybersecurity risks and cyberincidents, the staff guidance noted that a number of existing disclosure requirements may impose an obligation to disclose such matters. Those requirements could include the disclosures related to risk factors, MD&A, the business and legal proceedings descriptions, and the notes to the financial statements.

Companies also should re-evaluate disclosure policies and internal communication protocols to ensure that cybersecurity incidents are considered in a timely manner by company personnel with the required expertise to advise on these matters and that information regarding these incidents is shared internally with those individuals at the company responsible for disclosure decisions, trading restrictions and other related matters. Decisions as to whether or when to publicly disclose information regarding a cybersecurity incident or to restrict trading in company securities should be carefully evaluated by senior management.

Finalize Adoption of New Revenue Recognition Standards

The much-discussed new revenue standards jointly issued by the Financial Accounting Standards Board and the International Accounting Standards Board to harmonize revenue recognition standards between U.S. GAAP and International Financial Reporting Standards will become effective for annual reporting periods beginning after Dec. 15, 2017. As a result, calendar year companies will need to commence reporting under the new standard beginning with their Forms 10-Q for the quarterly period ending March 31, 2018. The new common revenue recognition standard is set forth in Accounting Standards Update No. 2014-09, "Revenue From Contracts With Customers (Topic 606)" and IFRS 15, "Revenue From Contracts With Customers."

Adoption Methods

Companies may choose between two adoption methods. Under the modified retrospective method, a company is required to reflect the cumulative effects of the new standard on its financial statements in its first-quarter 2018 Form 10-Q, but does not need to revise historical periods that predate adoption. Accordingly, the company's 2017 and 2016 financial statements will not need to be revised at the time it files its 2018 Form 10-K. Under the full retrospective method, a company is required to revise all historical periods included in the reported financial statements to reflect the new standard. For example, a company that uses the full retrospective method will be required to apply the new standard to its first-quarter 2018 financial statements in its Form 10-Q and retrospectively revise the comparable first-quarter 2017 financial statements therein. Similarly, in its 2018 Form 10-K, the company will be required to apply the new standard to its 2018 financial statements and retrospectively revise its 2017 and 2016 financial statements therein.

Transition Disclosure

It appears that many calendar-year companies have heeded the various public admonitions from the SEC staff and used the third-quarter Form 10-Q to provide expanded disclosure of their progress on implementation of the new standard, as well as the quantitative (to the extent reasonably estimable) and qualitative impacts of the new standard. The 2017 Form 10-K will represent the last chance for these companies to revisit and enhance, as needed, their transition disclosures. As part of these efforts, companies are reminded that the audit committee should be involved to ensure that the proper internal controls over financial reporting and disclosure controls and procedures are in place to monitor the application of the new standard.

Impact on Form S-3

Companies that opt to use the full retrospective method need to consider the impact, if any, of the adoption of the new accounting standard on their access to the capital markets. As a general matter, companies are required to update previously issued historical financial statements incorporated by reference into a new Form S-3 to reflect a subsequent change in accounting principle. As such, companies that use the full retrospective method to adopt the new standard will be required to provide retrospectively revised historical financial statements in any new Form S-3 (or post-effective amendment thereto) that includes financial statements covering a period reflecting adoption of the new standard (i.e., first quarter 2018 or later). To illustrate, a company that adopts the new standard as of Jan. 1, 2018, will be required to retrospectively revise its 2017, 2016 and 2015 financial statements to reflect the new standard in a Form S-3 filed after its first-quarter 2018 Form 10-Q is filed with the SEC. Typically, this would be accomplished by filing a Form 8-K under Item 9.01 to include the revised financial statements as an exhibit. The Form 8-K automatically would be incorporated by reference into the Form S-3. It should be noted that the company in this example will be required to retrospectively revise its 2015 financial statements even though it would not otherwise be required to retrospectively revise this "fourth year" of financial statements at the time of filing its 2018 Form 10-K.

A company may conduct a shelf takedown of an effective Form S-3 filed prior to the full retrospective adoption of the new standard without revising its historical financial statements unless the company concludes that the adoption of the new standard represents a "fundamental change" under Item 512(a) of Regulation S-K (which traditionally is viewed as a very high bar). Companies, however, should confirm that their independent auditors will agree to provide comfort on the historical financial statements that have not been recast.

Note Status of Dodd-Frank Act and Other SEC Rulemaking Matters

The SEC's work on the remaining Dodd-Frank Act corporate governance and disclosure rulemaking mandates continues to be mired in delay. It is increasingly unclear when or whether these remaining mandates — hedging disclosures, pay-versus-performance and clawback provisions — will be finalized. In fact, perhaps because of the change in leadership at the SEC and the vote by the House of Representatives to approve the Financial Choice Act of 2016 to repeal provisions of the Dodd-Frank Act, the SEC downgraded the status of these rule proposals to "long-term actions" from "proposed rule stage," informally indicating that the SEC does not intend to take action on the proposals in the next 12 months.

Although the SEC is not expected to advance the expected Dodd-Frank Act required rulemaking provisions, in October 2017, the SEC proposed changes that would modernize and simplify the disclosure items in Regulation S-K and related rules and forms. The proposed amendments included changes to Regulation S-K Item 102 to provide that a description of a company's physical properties only will be required if the properties are material to the company and to Regulation S-K Item 303(a) to reduce the period-to-period comparison required in MD&A from three to the two most recent fiscal years. In addition, the proposed amendments would fundamentally change the existing, burdensome process companies are required to follow to redact and request confidential treatment for certain information included in SEC filings. The proposed changes reflect a push by the SEC to reduce costs and burdens on public companies while continuing to ensure all material information is provided to investors. It is unclear whether these changes will be adopted, but changes are not expected until any earlier than late 2018.

Monitor Potential Changes in Pay Practices Due to the Tax Cuts and Jobs Act

Prior drafts of the House and Senate versions of the Tax Cuts and Jobs Act included proposals that would have dramatically affected compensation practices and disclosures in upcoming years. Proposed changes included eliminating deferred compensation and the essential tax rules governing most stock options. However, these proposed changes were not included in the final law signed by President Donald Trump on Dec. 22, 2017.

Comply With New IFRS XBRL Tagging Requirement

In March 2017, the SEC published the long-delayed IFRS Taxonomy.[10] As a result of the availability of the taxonomy, foreign private issuers that prepare their financial statements under IFRS as issued by the International Accounting Standards Board must file their financial statements in eXtensible Business Reporting Language (XBRL) for fiscal years ending on or after Dec. 15, 2017.

XBRL is a technology for tagging data to identify and describe information in a company's financial statements. The interactive data format makes a company's financial statements machine-readable so they can be downloaded, analyzed and compared using certain software applications. The SEC had long been delayed in its efforts to develop a standard list of data tags — the "taxonomy" — for IFRS as issued by IASB.

Under the SEC rules, issuers must prepare an XBRL exhibit that contains tagged data for the face of the financial statements, the footnotes to the financial statements and the related financial statement schedules. The XBRL exhibit must be submitted with the following filings:

- Annual reports and transition reports on Form 20-F or Form 40-F.
- Reports on Form 6-K, but only to the extent the Form 6-K contains interim financial statements included pursuant to the nine-month updating requirement of Item 8.A.5 of Form 20-F or a revised version of financial statements that were previously filed with the SEC.

A company conducting an initial public offering is not required to include XBRL data in its IPO registration statement. For subsequent registered offerings, XBRL data is only required in the registration statement if it includes (rather than incorporates by reference) financial statements and contains a price or a price range, and at any later time when the financial statements are changed (rather than in each filing or amendment). In the context of a business combination, XBRL financial information will be required for the registrant (the acquiring company) but not for the target company being acquired.

A company that maintains a public website also is required to post the XBRL data to its public website by the end of the day on which the registration statement or periodic report was filed with the SEC or was required to be filed (whichever is earlier). The XBRL data must remain on the company's website for 12 months. Companies should accomplish this by posting the relevant SEC filing to their website — merely providing a hyperlink to the SEC's website will not be sufficient for this purpose.

Comply with IRC Section 162(m)

The Section 162(m) regulations under the Internal Revenue Code generally require that issuers seek shareholder approval every five years of the performance goals with respect to which performance-based compensation is to be paid. If the business criteria for performance goals under a plan were last approved in 2013, such criteria will require shareholder approval in 2018. Companies should also be mindful of lawsuits based on failures to meet the requirements of Section 162(m).

We strongly encourage companies to monitor their equity-award-granting processes carefully and ensure that in-house and outside counsel are afforded an opportunity to review proposed executive compensation actions, particularly with respect to significant grants to executives and new hires. Companies also should review the status of the members of the compensation committee to ensure they are independent and qualify under Section 162(m). Moreover, any proxy disclosures relating to Section 162(m) should be carefully reviewed to implement executive compensation programs, including the ability to award nondeductible compensation.

The Tax Cuts and Jobs Act contains significant changes to the executive compensation deduction rules in Section 162(m) of the Internal Revenue Code that could dramatically impact the way many companies design and administer executive compensation programs. Effective for tax years beginning on or after Jan. 1, 2018, the exception under Section 162 (m) for qualified performance-based compensation and commissions will be eliminated, so that all compensation paid to a covered employee in excess of $1 million would be nondeductible, including post-termination and post-death payments, severance, deferred compensation and payments from nonqualified plans. In addition, the covered employees subject to 162(m) will be expanded to include the CFO, the three other most highly compensated officers who are named executive officers for the taxable year, and each individual who was a covered employee for any taxable year beginning after Dec. 31,

2016.[11]

Note Recent Developments in Insider Trading Laws and Policies

There have been a number of interesting developments recently in federal insider trading laws. These developments were accompanied by a continued media interest in insider trading claims and allegations — from the Second Circuit upholding the conviction of a high-profile hedge fund portfolio manager, to the demand for an investigation into the possible sale of company securities by certain executives following the disclosure of a material cyber data breach. Although these developments do not generally require specific changes to company insider trading policies and practices, we recommend that companies evaluate their policies and practices to reduce potential risks from insider trading matters.

Recent Court and Regulatory Actions

In December 2016, the U.S. Supreme Court held[12] that a gift of confidential information to a "trading relative or friend" is sufficient to establish a personal benefit required to hold the recipient of the tip liable under Exchange Act Section 10(b), siding with the Ninth Circuit Court of Appeals' ruling on appeal to resolve a split with the Second Circuit concerning that issue.[13] The Supreme Court ruling did not address another element of the Second Circuit ruling, though, which presumably still controls — namely that the government must prove that the trading defendant knew that the information came from an insider or that the insider received a personal benefit in exchange for the tip.

A related development on that point that arose earlier in 2016 was the successful prosecution of insider trading claims based in part on the view that an insider's failure to disclose his relationship with a trader included on a routine post-deal announcement trading investigation by the Financial Industry Regulatory Authority demonstrated the insider's benefit in tipping the trader.[14] Such post-announcement investigations by FINRA have become routine, and law enforcement authorities seem to have also increased the aggressiveness of their own enforcement methods. These methods have included making use of search warrants rather than subpoenas, using technological aids both new and old, such as wire-tapping and data analytics, and applying prosecutorial pressure to owners of accounts used in connection with insider trading even when the accounts owners themselves were not necessarily culpable.

While most companies' confidential information policies already will prohibit such tipping, SEC and FINRA proceedings remind employers that merely having such policies isn't enough, and that they must be observed and enforced, as well. Both the SEC and FINRA have conducted recent enforcement procedures concerning financial institutions' failures to enforce policies and procedures intended to prevent disclosure of material nonpublic information. One lesson to draw from all of these developments is that companies should be explicit with their insiders in acknowledging that any misuse of confidential company information can potentially give rise to insider trading violations (alongside other damaging effects), such that management must be devoted to enforcing the related policies; that substantial resources are devoted to detecting and prosecuting insider trading violations; and that the potential consequences (to both the company and the individuals involved in any scheme to violate the law) can be enormous.

Suggested Matters to Consider

Following on that high-level reminder, companies also should periodically review the details of insider trading policies to consider whether they continue to serve the company's needs and give due consideration to the evolution of applicable "best practices," the company's past experience with the existing policy, and other relevant considerations, such as public stances by members of the company's peer group.

Although the appropriate scope and form of any such review will be dictated by the company's particular circumstances, many companies should consider:

- whether changes in the geographic scope of the company's business or the exchanges on which its securities are traded merit reference to any specific legal framework;
- if the company's categorization of employees and other persons into groups remains appropriate (e.g., whether heightened restrictions, such as compliance with a preclearance policy, are targeted at the right people);
- if the company's policy is sufficiently clear in addressing gifts and estate planning transactions in contexts where they may raise concern;
- the continuing appropriateness of the timing of recurring closed- or open-trading windows;
- whether the policy establishes when news may be considered to have become public;
- if the company should mandate trading only through Exchange Act Rule 10b5-1 trading plans for any subset of persons subject to the policy;
- whether the company should permit trading plans to be adopted (or terminated or modified) only with the advance approval of the company, or permit the use of only a company-approved form of trading plan;
- if the company should announce the adoption (or termination or modification) of trading plans by certain persons (a practice that while not widespread may nonetheless be relatively common among certain peer groups);
- whether the company should reserve the right to restrict transactions that may otherwise be permitted under the policy, such as suspending the customary exception permitting insiders to engage in transactions directly with the company during periods in which they are not otherwise allowed to trade;
- how the policy addresses pledging, hedging and derivatives securities transactions, in light of governance advocates' interest in both disclosure of such policies and their willingness to consider significant hedging and pledging to be a board oversight failure; and
- whether the company has adequate training in place to best insure compliance with the policy.

Regarding the penultimate bullet, note that Institutional Shareholder Services recently codified its position with respect to whether companies allow securities to be pledged, which is evaluated on a case-by-case basis with consideration of the magnitude and rationale, as well as efforts to wind down pledging. Since 2013, ISS has recommended votes against committee members with oversight over instances where executives or directors have raised concerns by pledging significant amounts of company stock. The new update formalizes this policy for 2018.

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[1] EY's SEC Reporting Update — 2017 Trends in SEC Comment Letters (Sept. 25, 2017).

[2] https://www.sec.gov/litigation/admin/2017/34-80947.pdf.

[3] SEC Release No. 33-8350 (Dec. 19, 2003).

[4] See SEC's Concept Release titled "Business and Financial Disclosure Required by Regulation S-K" (April 13, 2016) available at https://www.sec.gov/rules/concept/2016/33-10064.pdf. For additional guidance, refer to BlackRock Inc.'s article titled "Exploring ESG: A Practitioner's Perspective" (June 2016) available at https://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-exploring-esg-a-practitioners-perspective-june-2 016.pdf.

[5] For additional information, refer to https://www.blackrock.com/corporate/en-gb/about-us/investment-stewardship and https://www.blackrock.com/corporate/en-us/investor-relations/larry-fink-ceo-letter; https://about.vanguard. com/investment-stewardship/governance-letter-to-companies.pdf; https://www.ssga.com/investment-topics/ environmental-social-governance/2017/2016-Annual-Stewardship-Report-Year-End.pdf.

[6] https://www.sec.gov/rules/concept/2016/33-10064.pdf.

[7] https://www.fsb-tcfd.org/publications/final-recommendations-report.

[8] Statement on Cybersecurity, issued by Chairman Jay Clayton (Sept. 20, 2017).

[9] CF Disclosure Guidance: Topic 2 (Cybersecurity), Oct. 13, 2011.

[10] https://www.sec.gov/rules/other/2017/33-10320.pdf.

[11] For more information about the impact of the Tax Cuts and Jobs Act on Section 162 (m), please see our Jan. 4, 2018, memorandum titled "Section 162(m) After the Tax Cuts and Jobs Act: What to Do Now."

[12] Salman v. United States, 137 S. Ct. 420 (2016). See Skadden's related Dec. 7, 2016, memorandum titled "Salman Rejects Heightened Personal-Benefit Requirement in Insider Trading Prosecutions."

[13] See United States v. Newman, 773 F. 3d 438, 452 (2d Cir. 2014), cert. denied, 136 S. Ct. 242 (2015).

[14] See How FINRA's Surveillance Helped Score a Hole in One in "Golf Lingo" Insider Trading Case at https://www. finra.org/investors/how-finras-surveillance-helped-score-hole-one-golf-lingo-insider-trading-case.

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