# Matters to Consider for the 2019 Annual Meeting and Reporting Season

11 / 30 / 18


**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 2019 annual meeting and reporting season.

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

# Checklist of Matters to Consider for the 2019 Annual Meeting and Reporting Season

# Comply With Updated SEC Filing Requirements

The U.S. Securities and Exchange Commission (SEC) has adopted new rules that companies should consider as they prepare year-end reports and other filings.

## Disclosure Simplification

On August 17, 2018, the SEC adopted amendments to streamline disclosure requirements as part of an ongoing disclosure effectiveness review.[1] These rule changes went into effect on November 5, 2018, and target disclosure requirements that were outdated, superseded or already covered by disclosures under U.S. Generally Accepted Accounting Principles (GAAP), International Financial Reporting Standards (IFRS) or other SEC rules. While the amendments generally are technical in nature, the following changes should be considered when preparing annual reports on Form 10-K:

- **Ratio of Earnings to Fixed Charges.** Companies are no longer required to disclose the historical and pro forma ratios of earnings to fixed charges and/or historical and pro forma ratios of combined fixed charges and preference dividends to earnings.
- **Historical Stock Price Disclosure.** Companies are no longer required to disclose the high and low prices of common equity traded on an established public trading market, although companies must disclose their trading symbols.
- **Historical Dividend Disclosure.** Companies are no longer required to disclose the frequency and amount of cash dividends in the body of the Form 10-K, as such information already should be included in the financial statements. Disclosure of the restrictions that currently, or are likely to, materially limit a company's ability to pay dividends on its common equity also should be found in its financial statements.
- **Segment Financial Information.** Companies are no longer required to disclose segment financial information and financial information by geographic area in the body of the Form 10-K, as such information already should be included in the financial statements.
- **Research and Development Disclosure.** Companies are no longer required to disclose the amount spent on research and development activities for all years presented.

## Form Cover Pages

For yet another year, rules recently adopted by the SEC have resulted in changes to the cover pages of many SEC forms. As noted in our September 21, 2018, client alert "Reminders of Recent Updates for Upcoming SEC Filings," companies should revise their Form 10-K cover pages as reflected in the following mark-up:

> Indicate by check mark whether the registrant has submitted electronically ~~and posted on its corporate Web site, if any,~~ every Interactive Data File required to be submitted ~~and posted~~ pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit ~~and post~~ such files).
>
> ☐ Yes ☐ No

[1] The SEC's press release "SEC Adopts Amendments to Simplify and Update Disclosure Requirements" (Aug. 17, 2018) and adopting release are available here.

> Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.
>
> ☐ Large accelerated filer ☐ Accelerated filer
>
> ☐ Non-accelerated filer ~~(Do not check if a smaller reporting company)~~ ☐ Smaller reporting company
>
> ☐ Emerging growth company

These revisions address the following two technical changes:

- In connection with the new Inline XBRL rules adopted in June 2018,[2] the SEC eliminated the website-posting requirement, which is no longer referenced on the cover page of Forms 10-Q and 10-K. Previously, issuers were required to submit their XBRL data as exhibits and were also required to post XBRL data files on their websites. While the new Inline XBRL requirement does not apply to upcoming annual reports on Form 10-K for calendar year 2018, the SEC nonetheless has implemented changes to the Form 10-K cover page.
- As discussed below, the SEC approved amendments to the definition of a "smaller reporting company" (SRC), expanding the number of registrants that qualify as SRCs. In connection with this, the SEC revised Form 10-K and other Exchange Act and Securities Act form cover pages to remove the instruction informing filers to not check the "non-accelerated filer" box if the issuer is an SRC. After these amendments, issuers will now be able to check multiple boxes on the cover page related to their filer status (*e.g.*, both the accelerated filer and SRC boxes).

[2] The SEC's press release "SEC Adopts Inline XBRL for Tagged Data" (June 28, 2018) and adopting release are available here.

## SRC Amendments

As noted above and discussed in our July 9, 2018, client alert "SEC Expands 'Smaller Reporting Company' Definition," the SEC approved amendments to the definition of SRC under the rules and regulations of the Securities Act and the Exchange Act on June 28, 2018.[3] These amendments went into effect on September 10, 2018. Under the new definition, a company will qualify as an SRC if it has either (i) a public float of less than $250 million as of the last business day of its most recently completed second fiscal quarter, or (ii) annual revenues of less than $100 million during the most recently completed fiscal year with less than $700 million public float (or no public float).

A company that newly qualifies as an SRC has the option to take advantage of the scaled disclosure accommodations beginning with its next periodic or current report due on or after, or in any registration or proxy filing or amended filing made on or after, September 10, 2018. For example, a calendar year-end company that became an SRC in 2018 could use scaled disclosures in its upcoming Form 10-K. Under the SEC's rules and regulations, issuers *must* reflect SRC status starting with the first Form 10-Q for the year after it becomes an SRC but *may* begin taking advantage of the scaled disclosure accommodations beginning in the third quarter of the year it enters SRC status.[4] As a reminder, SRC status is determined separately from accelerated filer status, which occurs at fiscal year-end.

Changes to a company's filer status also may affect proxy statements. The information required in a proxy statement generally is tied to the company's filer status at the time of its Form 10-K filing. As a result, a company reporting as an SRC in its 2018 Form 10-K may provide SRC-level disclosures in its annual proxy statement. The timing of the annual meeting does not affect the analysis.[5]

[3] The SEC's press release "SEC Expands the Scope of Smaller Public Companies That Qualify for Scaled Disclosures" (June 28, 2018) and adopting release are available here.

[4] *See* 17 C.F.R. § 229.10(f)(2)(i)(C) (Item 10 of Regulation S-K); 17 C.F.R. § 230.405 (Securities Act Rule 405 definition of "smaller reporting company" paragraph (3)(i)(C)); 17 C.F.R. § 240.12b-2 (Exchange Act Rule 12b-2 definition of "smaller reporting company" paragraph (3)(i)(C)).

[5] *See* Question 104.13, the SEC's Compliance and Disclosure Interpretations "Questions and Answers of General Applicability" (Nov. 7, 2018), available here.

# Consider SEC Cybersecurity Guidance and Enforcement Actions

During 2018, there have been a number of actions by the SEC related to cybersecurity matters impacting public companies. These actions, which we summarize below, have included two pieces of helpful guidance and a few key enforcement matters. We recommend that companies consider these actions in connection with year-end reporting and as part of any periodic review of company policies and procedures.

## SEC Guidance

As discussed in our February 23, 2018, client alert "SEC Issues Interpretive Guidance on Cybersecurity Disclosures," the SEC issued an interpretive release[6] providing guidance for public companies relating to disclosures of cybersecurity risks and incidents, disclosure controls and procedures, and insider trading policies. The key takeaways from this guidance are summarized below.

**Material Risks and Incidents.** Companies should consider whether there are material cybersecurity risks and incidents that should be disclosed in registration statements, periodic reports and other filings with the SEC as part of the disclosure of risk factors, management's discussion and analysis of financial condition and results of operations, descriptions of the company's business and legal proceedings, and financial statements and accompanying notes. The guidance confirmed that the materiality of cybersecurity risks and incidents will depend on their nature, extent, potential magnitude and range of harm that an incident could cause.

**Board Risk Oversight.** Companies should consider the requirement to disclose in proxy statements the board's role in risk oversight. In light of the guidance, as well as investor calls for such information, companies may wish to take a fresh look at their proxy statement disclosure regarding board oversight of risk and consider addressing or enhancing disclosures regarding board oversight of cybersecurity risks.

**Disclosure Controls and Procedures.** Companies should evaluate whether their disclosure controls and procedures are sufficient to ensure that relevant information pertaining to cybersecurity risks and incidents is collected, processed and reported up the chain on a timely basis to allow for management to assess and analyze whether cybersecurity risks and incidents should be disclosed. Companies should also review protocols for reporting cybersecurity incidents to ensure that persons having familiarity with, and responsibility for, a company's SEC disclosure decisions are included in the information flow regarding cybersecurity matters that have the potential to be material to investors.

**Insider Trading Policies.** Companies should evaluate whether their insider trading policies are designed to prevent insider trading on the basis of material nonpublic information relating to cybersecurity incidents and risks. Companies also should consider whether restrictions on trading need to be imposed during periods when they are investigating and assessing the significance of a cybersecurity incident.

**Regulation FD Policies.** Companies should review any Regulation FD policies to ensure it is made clear that material nonpublic information could involve cybersecurity risks and incidents.

[6] The SEC's press release "SEC Adopts Statement and Interpretive Guidance on Public Company Cybersecurity Disclosures" (Feb. 21, 2018) and related guidance are available here.

## SEC Report of Investigation

On October 16, 2018, the SEC issued a Report of Investigation detailing the SEC Enforcement Division's consideration of the internal accounting controls of nine companies that were victims of "business email compromises," a form of cyberfraud.[7] The companies described in the report lost a combined $100 million after their internal accounting controls failed to protect against two types of fraudulent email schemes. The SEC issued the report, forgoing a traditional enforcement action, to communicate the SEC's view that this issue is problematic and to put companies and individuals on notice that the SEC intends to pursue enforcement actions concerning similar conduct in the future.

The report highlighted the need for companies to design and maintain internal accounting control systems that adequately address the cybersecurity risks they face. The persons undertaking the alleged cyber-related frauds covered in the report were able to identify vulnerabilities in the issuers' controls over, for instance, payment authorization and verification procedures. The report also noted that the alleged perpetrators succeeded in the frauds in large part because employees were unaware of, or did not understand, the internal controls of their employers and failed to recognize multiple red flags indicating that a fraudulent scheme was underway.

We recommend that companies consider the findings in this report and confirm that internal accounting controls properly address the risks of cyber-related threats and safeguard company assets from those risks. In particular, companies should ensure that their internal accounting controls are tailored to address, among other things, human vulnerabilities with respect to cyber-related risks.

[7] The SEC's press release "SEC Investigative Report: Public Companies Should Consider Cyber Threats When Implementing Internal Accounting Controls" (Oct. 16, 2018) and the Section 21(a) Report of Investigation are available here. Our October 19, 2018, summary of the report, "SEC Investigative Report on Cybersecurity Emphasizes Internal Controls," is available here.

## SEC Enforcement Focus

Cybersecurity incidents have also led to a number of noteworthy recent SEC enforcement actions. In March 2018, the SEC initiated an action against a former chief information officer, alleging that he avoided significant losses by trading on material nonpublic information regarding a massive data breach at his company.[8] In April 2018, the SEC settled charges with a technology company based on the SEC's view that the company misled investors by failing to properly disclose information regarding a significant data breach.[9] And in September 2018, the SEC settled charges against a financial advisory firm related to a cyber intrusion that compromised the personal information of thousands of customers.[10]

In the matter involving the technology company, the SEC's order stated that it believed that the company's disclosures in its public filings were misleading because they omitted known trends or uncertainties presented by the data breach, the company failed to establish or implement internal controls around the evaluation and disclosure of cyber incidents, and the company's risk factor disclosures in its public filings were misleading because they claimed the company only faced the risk of potential future data breaches without disclosing that a data breach had in fact already occurred.

The SEC's enforcement actions involving cybersecurity matters follow the announcement in September 2017 that the SEC had established a Cyber Unit to consolidate the expertise of the SEC's Division of Enforcement and enhance its ability to identify and investigate cyber-related threats. At the time the Cyber Unit was launched, Stephanie Avakian, co-director of the SEC's Enforcement Division, identified cyber-related threats as "among the greatest risks facing investors and the securities industry."

We believe that the SEC's growing emphasis on cyber issues provides further support for the need for companies to remain focused on cybersecurity disclosures and policies.

[8] The SEC's press release "Former Equifax Executive Charged With Insider Trading" (Mar. 14, 2018) and related SEC complaint are available here.

[9] The SEC's press release "Altaba, Formerly Known as Yahoo!, Charged With Failing to Disclose Massive Cybersecurity Breach; Agrees to Pay $35 Million" (Apr. 24, 2018) and related SEC order are available here.

[10] The SEC's press release "SEC Charges Firm With Deficient Cybersecurity Procedures" (Sept. 26, 2018) and related SEC order are available here.

# Assess Impact of SEC Staff Comments and Statements

Although the staff of the SEC's Division of Corporation Finance reviews a large number of Form 10-K filings and other disclosures made by companies each year, the majority of these reviews do not result in a comment letter being issued to the company. A recent study by Ernst & Young (EY) indicates the annual number of comment letters issued by the SEC staff has decreased by approximately 25 percent compared to last year, or over 40 percent since 2014.[11] This continuing downward trend is consistent with recent remarks from senior members of the SEC staff reiterating their focus on disclosures that would be material to investors.

Below is a summary of the key focus areas in recent SEC staff comment letters, as well as SEC staff remarks, that companies should consider in preparing their upcoming annual reports and other SEC filings.

## Non-GAAP Financial Measures

According to the EY report, about half of the decrease in comments since last year is attributed to a drop in the number of comments relating to non-GAAP financial measures that previously had seen an uptick following the release of updated SEC staff guidance in May 2016. Nevertheless, non-GAAP financial measures still remained one of the top areas of SEC staff focus during the 12-month period ended June 30, 2018.

The SEC staff recently also expressed a continuing focus on individually tailored performance measures, especially those that are unusual and complex, such as "adjusted revenues," which companies should ensure comply with the applicable requirements under Item 10(e) of Regulation S-K and Regulation G. Companies should continue to revisit their non-GAAP disclosures in SEC filings, including earnings releases, as well as other public disclosures, such as investor presentations and information posted on company websites.

## Revenue Recognition

Companies should consider the impact on their disclosures of the new revenue recognition accounting standard, ASC 606, which went into effect in December 2017. ASC 606 replaced prescriptive industry-specific rules with a principles-based model to standardize revenue booking for comparable transactions across industries. The new standard may require management to make significant judgments on how to classify transactions and when revenues should be booked.

According to a recent report by Intelligize Inc., only 32 of the roughly 4,000 U.S. publicly listed companies chose to apply the new rules early, and nearly one-third of those early adopters received SEC staff comments on their compliance with the revenue recognition standard. Three-quarters of the comment letters included questions about how companies arrived at their decisions for performance obligations measurements.[12]

[11] EY's SEC Reporting Update "2018 Trends in SEC Comment Letters" (Sept. 24, 2018) is available here.

[12] Intelligize's report "Impact of New Revenue Recognition Standards on Public Companies" (Nov. 5, 2018) is available here.

## Other Recent Developments

Senior members of the SEC staff have emphasized that companies should also consider the following disclosure topics:

- **Cybersecurity.** Companies should align their disclosure practices with the SEC's February 2018 interpretive guidance, as discussed above in the section titled "Consider SEC Cybersecurity Guidance and Enforcement Actions." In particular, companies should consider cybersecurity in their board risk oversight disclosures in their annual proxy statements and assess their disclosure controls and procedures, as well as insider trading policies.
- **Brexit.** Companies should assess the associated risks of the ongoing uncertainty and potential impact of the U.K.'s pending exit (Brexit) from the European Union. In recent statements, the SEC staff has advised that it will continue to monitor company disclosures related to Brexit leading up to the March 2019 deadline to reach an agreement.
- **LIBOR Phase-Out.** Companies with financial instruments that rely on the benchmark interest rate LIBOR (the London Interbank Offered Rate), which British financial regulators are phasing out, should consider the implications of transitioning to another benchmark. The SEC staff has noted that there are significant uncertainties surrounding legacy financial instruments that rely on LIBOR and how replacing it with another benchmark would impact a company's hedge accounting. To the extent the LIBOR phase-out is material, companies should disclose that fact and the implications of the phase-out, including any associated risks and uncertainties.

# Prepare for Additional Changes to Auditor Reports

The Public Company Accounting Oversight Board's (PCAOB) new model for auditor reports is being implemented in two phases.[13] The first phase, which already is effective, requires auditor reports to include, among other things, disclosure of the auditor's tenure of service to the company and a statement that the auditor is required to be independent from the company under applicable U.S. federal securities laws and PCAOB standards. The second, more burdensome, phase, which requires the communication of critical audit matters (CAMs) from the current period audit, will go into effect for audits of large accelerated filers for fiscal years ending on or after June 30, 2019.[14] While still many months away, companies already should be preparing for this significant change.

## Background

As we explained in our June 7, 2017, client alert "Accounting Oversight Board Adopts New Model for Auditor Reports," a CAM is a matter communicated or required to be communicated to the audit committee that:

- relates to accounts or disclosures that are material to the financial statements; and
- involves especially challenging, subjective or complex auditor judgment.

If an auditor determines that a CAM from the current period audit exists,[15] the auditor will be required to communicate certain information in its report accompanying the audited financial statements. Such information includes:

- an identification of the CAM;
- a description of the principal considerations that led the auditor to determine that the matter constituted a CAM;
- a description of how the CAM was addressed in the audit; and
- a reference to the relevant financial statement accounts or disclosures.

## CAMs as an Original Source of Company Information

Many commentators have expressed concern that inclusion of CAMs in auditor reports could result in those reports becoming the original source of information about a company. To address these concerns, the new PCAOB standard includes a note explaining that auditors are not expected to provide information about a company that has not been made publicly available by the company unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a CAM or how the matter was addressed in the audit. The SEC also expressed its belief that instances in which auditors would be required to provide information about the company that its management has not already made public would be the exception rather than a pervasive occurrence.

[13] See our December 11, 2017, client alert "Filing a New Form S-3? What You Need to Know About the New Revenue Recognition Standards," available here.

[14] Communication of CAMs will be required for all other nonexempt filers for audits of fiscal years ending on or after December 15, 2020. Exempt filers include emerging growth companies; brokers and dealers; investment companies other than business development companies; and employee stock purchase, savings and similar plans.

[15] CAMs that arose from a prior period audit (*e.g.*, during an earlier period presented in the financial statements) may be covered but are not required in an auditor's report.

## Next Steps

In preparation for CAMs disclosures in auditor reports, companies should be working closely with their auditors now to determine the methodology the auditor plans to use to identify potential CAMs and to identify as early as possible which matters may be considered CAMs. Doing so will help companies and audit committees determine what, if any, additional disclosure should be included in SEC filings, such as in the management's discussion and analysis and risk factors sections, to address any issues related to CAMs. Many audit firms already are performing dry runs with their audit clients. Participating in these dry runs may help to reduce the likelihood of newly identified CAMs or other unwelcome surprises shortly before a Form 10-K filing when financial reporting teams already may be pressed for time.

# Confirm Implementation of New GAAP Leases Standards

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are in the midst of a three-year effort to enhance the accounting and reporting of revenue for customer contracts, leases and financial instrument credit losses. The adoption of responsive new accounting standards, commonly referred to by the SEC staff as "New GAAP Standards," kicked off in 2018 when most public companies adopted new revenue recognition standards. With required effective dates beginning in January 2019, the new leases standards are an immediate challenge facing companies that have significant operating lease obligations. The new financial instrument credit losses standards will culminate the efforts to implement the New GAAP Standards when they become effective beginning in January 2020.

## New Leases Standards Overview

Under current accounting standards, lessees are not required to include operating leases (as compared to capital leases) on the balance sheet. That approach will change under the new leases standards. The new FASB and IASB standards aim to increase transparency and comparability by requiring companies to recognize lease assets and lease liabilities on the balance sheet and disclose key information about leasing arrangements for all leases except for certain exempt short-term leases.[16]

## Effective Date

The new leases standards will take effect for most public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. As a result, most 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, 2019. Emerging growth companies that have elected to defer compliance with new or revised financial standards as permitted by the JOBS Act will need to apply the new leases standards to fiscal years beginning after December 15, 2019, and interim reporting periods beginning the following year.

## Adoption Methods

The new leases standards provide for a modified retrospective approach, which requires companies to recognize and measure all leases within the scope of the standard that exist as of the beginning of the earliest comparative period presented (*e.g.*, at January 1, 2017, for a calendar year-end company that adopts the new standard on January 1, 2019). Companies also would be required to adjust equity at the beginning of the earliest comparative period presented as if the standard had always been applied, subject to certain practical expedients and other transition relief prescribed by the standard.

In July 2018, the FASB issued ASU 2018-11, which provides an alternative adoption method where a company applies the new leases standard at the adoption date rather than the beginning of the earliest period presented. To illustrate this "effective date" approach, a calendar year-end entity with an initial adoption date of January 1, 2019, would apply the old leases standard (ASC Topic 840) in the comparative periods and recognize the effects of applying the new leases standard as a cumulative adjustment to retained earnings as of January 1, 2019. If an entity elects this alternative approach, it will be required to provide the old ASC Topic 840 disclosures for all prior periods presented that remain under the legacy leases guidance.

[16] The new leases accounting standard is set forth in Accounting Standards Update No. 2016-02, "Leases (Topic 842)," and IFRS 16, "Leases."

## Transition Disclosure

Companies should be mindful of the application of Staff Accounting Bulletin No. 74 (SAB 74), which requires certain transition disclosures regarding the potential impacts of adopting a new accounting standard. Thankfully, with the implementation efforts related to the new revenue recognition standards so fresh in their minds, many companies appear to have properly used their recent periodic reports to provide expanded disclosure of their progress on implementation of the new leases standard, as well as the quantitative (to the extent reasonably estimable) and qualitative impacts of the new standard. In any event, the 2018 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 will need to consider the impact, if any, of the adoption of the new leases 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 principles for which retrospective application is either required or elected. As applied here, assuming the impact is material, companies that elect the modified retrospective method 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 2019 or later).

Note, these companies will not be required to retrospectively revise the financial statements for all three annual periods that are incorporated by reference in the filing. This is because the filing of a new registration statement will not change the date of the initial application. The SEC staff has provided the following illustrative guidance. A calendar year-end company adopts the new standard on January 1, 2019, using the modified retrospective approach. The beginning of the earliest comparative period presented is January 1, 2017. In May 2019, the company files its first quarter Form 10-Q, which reflects the adoption of the new standard. Shortly after, the company files a Form S-3 that incorporates by reference the financial statements for the years ending December 31, 2018, 2017, and 2016, as well as the quarters ending March 31, 2019, and 2018. The reissuance of the financial statements on Form S-3 requires the financial statements for the years ended December 31, 2018, and 2017, to be retrospectively revised under the new standard, but it does not change the date of initial application from January 1, 2017. Accordingly, the financial statements for the year ended December 31, 2016, do not need to be restated to reflect the application of the new leases standard.[17]

[17] *See* Section 11210.1, the SEC's Division of Corporation Finance "Financial Reporting Manual" (Oct. 3, 2018), available here.

# Prepare for 2019 Pay Ratio Disclosures

As a result of the SEC's pay ratio rules that went into effect last year, companies began providing pay ratio information in their registration statements, annual reports on Forms 10-K or proxy statements filed in 2018, based on 2017 compensation. The pay ratio rules require applicable companies[18] to disclose the ratio of the annual total compensation of the median company employee to the annual total compensation of the CEO. In addition, companies are required to provide a brief description of the methodology used to identify the median employee, as well as any material assumptions, adjustments or estimates used to determine the median employee or annual total compensation.

As companies prepare for the second year of mandatory pay ratio disclosures, three questions are top of mind:

- What were the key findings from the 2018 pay ratio disclosures?
- Can the same median employee be used this year?
- What else do companies need to know for 2019?

## Key Findings From the 2018 Pay Ratio Disclosures

Many stakeholders eagerly awaited last year's initial pay ratio disclosures, from proxy advisory firms to investors, the press, special interest groups and employees themselves. However, the results, once released, received less attention than anticipated. That being said, it is possible that the focus on pay ratio results will increase in future years. Stakeholders recognize that a company's pay ratio will become more useful once it can be analyzed over time and against a company's industry peers. For example, both Institutional Shareholder Services (ISS) and Glass Lewis began displaying CEO pay ratio information in their research reports, but neither used it as a determinative factor in its 2018 voting recommendations. Employees themselves were especially interested in 2018 pay ratio data, but they largely focused on how their compensation compared to the median employee's compensation, rather than their company's pay ratio as a whole.

Companies that disclosed their numbers in 2018 may wonder how they measured up. In the wake of the 2018 proxy filing deadline, Equilar analyzed 2,000 pay ratio data points that were available on May 10, 2018, and found that the median pay ratio was 166:1 for Equilar 500 companies[19] and 70:1 for Russell 3000 companies.[20]

Pay ratio varied significantly by market capitalization, employee headcount and industry sector:

- Higher market capitalizations were linked to higher pay ratios. Companies with market capitalizations that exceeded $25 billion had a median ratio of 213:1, while those with market capitalizations under $1 billion had a median pay ratio of 32:1.
- Companies with more employees tended to have lower median employee compensation, higher CEO pay and higher pay ratios. The median employee at a Russell 3000 company, which typically employs between 1,000 and 5,000 employees, earned approximately $14,024 more than the median employee who worked for a company with more than 10,000 employees.

[18] 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.

[19] The Equilar 500 is an index that consists of the largest revenue-grossing companies trading on the NYSE, Nasdaq or NYSE American, adjusted to reflect a proportionate industry mix. More information on the industry breakdown is available here.

[20] Unless otherwise noted, pay ratio statistics discussed in this section come from Equilar's report "CEO Pay Ratio: A Deep Data Dive" (May 22, 2018), available here.

- Analyzing pay ratio by industry reveals that use of seasonal or part-time workers and collective bargaining impacts pay ratios. For example, the consumer goods and services industries rely heavily on part-time workers and had the highest pay ratios, at 142:1 and 127:1, respectively. In contrast, Semler Brossy's recent report[21] revealed that the utilities industry had relatively low pay ratios, at 47:1 for the Russell 3000 and 94:1 for the S&P 500, because union efforts boost median employee compensation.

SEC guidance issued in September 2017 provided companies with flexibility on their pay ratio calculations. Companies' computations reflect varying inputs and methods accordingly:

- Common inputs to companies' consistently applied compensation measure (CACM) included base salary, annual bonus/incentive pay, overtime and equity grants. Other benefits, such as health or retirement benefits, were included less frequently.[22]
- 24.5 percent of Russell 3000 companies took advantage of the *de minimis* exception, which allows a company to exclude non-U.S. employees when identifying their median employee, if excluded non-U.S. employees constitute 5 percent or less of their workforce.
- Companies disclosed supplemental ratios to mitigate concern over high CEO payouts, especially when CEOs were offered unusual compensation, such as signing bonuses.
- Only 6.8 percent of Equilar 500 companies and 2.9 percent of Russell 3000 companies used statistical sampling to pinpoint their median employee.

## Determining Whether to Use the Same Median Employee

Under Item 402(u) of Regulation S-K, companies only need to perform median employee calculations once every three years, unless they had a change in the employee population or compensation arrangements that could significantly affect the pay ratio. This requires companies to assess annually whether their workforce composition or compensation arrangements have materially changed. Even if a company uses the same median employee in Year 2 as in Year 1, 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 evaluate the following:

- How has workforce composition evolved over the past year?
  - Review hiring, retention and promotion rates.
  - Consider the applicability of exceptions under the pay ratio rules:
    - Determine whether to incorporate employees from recent acquisitions or business combinations into the CACM. For example, a company may exclude employees from a 2017 business combination from its 2018 pay ratio calculations, but those excluded employees should probably factor into the company's 2019 median employee calculations.
    - Determine whether the *de minimis* exception applies within the context of the company's 2018 workforce composition. Under this exception, non-U.S. employees may be disregarded if the excluded employees account for less than 5 percent of the company's total employees or if a country's data privacy laws make a company's reasonable efforts insufficient to comply with 402(u).
  - Finally, 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 the introduction of special commission pay limited to a company's sales team would do so.
- Have the median employee's circumstances changed since Year 1? 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

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

- Annualized pay for new hires (but not seasonal or part-time workers).

[21] Semler Brossy's report "2018 Say on Pay and Proxy Results" (Oct. 4, 2018) is available here.

[22] This data comes from Pearl Meyer's research report "The CEO Pay Ratio: Data and Perspectives From the 2018 Proxy Season" (2018), available here.

- Personal benefits that amount to less than $10,000 per employee, such as health or retirement benefits, derived from nondiscriminatory benefit plans.
- Cost-of-living adjustments.
- A new date for identifying the median employee.

The SEC provides companies substantial flexibility in calculating their pay ratios. To remain in the SEC's good graces and engage investors, employees and other stakeholders, we recommend that companies diligently document and thoughtfully disclose their pay ratio methodology, analyses and rationale.

Companies should also clearly disclose any changes to their pay ratio methodology and be thoughtful about electing to make optional disclosures, such as alternative pay ratios or comparisons to peer pay ratios.

Finally, companies should keep an eye on pending state and local legislation. Some states, including California, Connecticut, Illinois, Massachusetts, Minnesota and Rhode Island, have proposed legislation that would impose additional taxes or fees on corporations that report a pay ratio in excess of certain thresholds. Several cities are considering similar measures.

# Incorporate Lessons Learned From the 2018 Say-on-Pay Votes and Compensation Disclosures

We recommend that companies consider recent annual say-on-pay votes and disclosure best practices when designing their compensation programs and communicating about their compensation programs to shareholders. This year, companies should understand key say-on-pay trends, including overall 2018 say-on-pay results, factors driving say-on-pay failure, say-on-golden-parachute results and equity plan proposal results. In this section, we discuss recent proxy firm guidance from ISS and Glass Lewis and proxy advisory firm takeaways, including details about ISS' revised metrics for evaluating say-on-pay.

## Overall Results of 2018 Say-on-Pay Votes

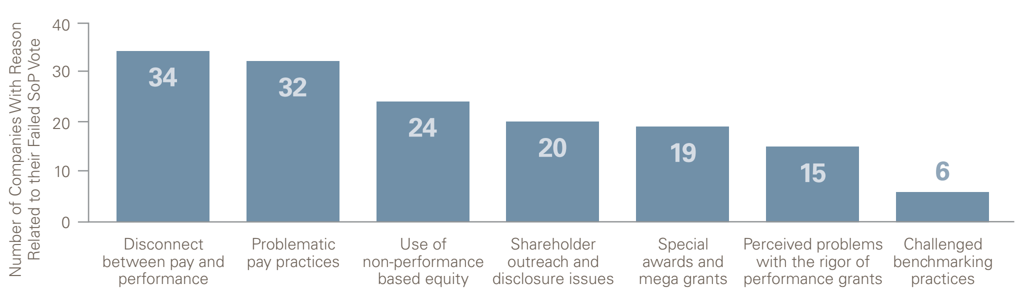
Below is a summary of the results of the 2018 say-on-pay votes from Semler Brossy's annual survey[23] and trends over the last seven years since the SEC adopted the say-on-pay rules:

- Despite stock market gains across all industries in 2017,[24] average support for the 2018 season was near 90.3 percent, which is the lowest since 2012.
- Approximately 97.3 percent of companies received at least majority support, with approximately 93 percent receiving above 70 percent.
- Approximately 2.7 percent of say-on-pay votes failed in 2018, which is higher than year-end failure rates for the past three years. The year 2017 had the smallest failure rate ever, at 1.3 percent.
- Eight percent of Russell 3000 companies and 7 percent of S&P 500 companies surveyed have failed to receive a majority support for say-on-pay at least once.
- Almost one-third of companies with annual say-on-pay votes have received less than 70 percent support at least once during the preceding seven years.
- ISS approval continues to sway say-on-pay votes. Say-on-pay results were 31 percent lower for companies that received an ISS "against" recommendation in 2018, exceeding the historical average of 25 to 30 percent and suggesting increased alignment between institutional shareholder voting and ISS recommendations. Moreover, ISS' "against" recommendation rate increased from 12.2 percent in 2017 to 13.9 percent in 2018.

## Factors Driving Say-on-Pay Failure

Overall, the most common causes of say-on-pay failure were a disconnect between pay and performance, problematic pay practices, use of nonperformance-based equity, shareholder outreach and disclosure issues, special awards and mega grants, perceived problems with the rigor of performance goals, and challenged benchmarking practices, as summarized in the following chart:

**Likely Causes of Failed Say-on-Pay (SoP) Votes in 2018***




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

[23] Semler Brossy's report "2018 Say-on-Pay and Proxy Results" (Oct. 4, 2018) is available here.

[24] Aon's article "Lessons From the 2018 Proxy Season for Say-on-Pay and Equity Plan Votes" (July 2018), available here, discusses the link between stock market performance and say-on-pay results in greater depth.

When evaluating pay practices, proxy advisory firms tend to focus on whether a company's practices are contrary to a performance-based pay philosophy. In December of each year, ISS publishes Frequently Asked Question (FAQ) documents to help stakeholders understand changes to ISS compensation-related methodologies. In December 2017, ISS published FAQs[25] summarizing which problematic practices are most likely to result in an adverse ISS vote recommendation, including:

- Repricing or replacing of underwater stock options/SARs without prior shareholder approval (including cash buyouts and voluntary surrender of underwater options);
- Extraordinary perquisites or tax gross-ups, likely including gross-ups related to a secular trust or restricted stock vesting, and home loss buyouts, or any lifetime perquisites;
- New or extended executive agreements that provide for (i) change in control payments exceeding three times the executive's base salary and bonus, (ii) change in control severance payments that do not require involuntary job loss or substantial diminution of duties, (iii) change in control payments with excise tax gross-ups, including modified gross-ups, multiyear guaranteed awards that are not at-risk due to rigorous performance conditions or (iv) a liberal change in control definition combined with any single-trigger change in control benefits; and
- Any other egregious practice that presents a significant risk to investors.[26]

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

- Inadequate disclosure around incentive goals and lowered incentive goals without explanation.
- High-target incentives for companies that are underperforming relative to their industries.
- Special bonuses and mega equity grants without sufficient rationale or risk-mitigating design features.
- Targeting compensation above the 50th percentile of peer compensation groups, especially when using outsized peers.
- Insufficient shareholder outreach and disclosure, including inadequate response to compensation-related concerns raised by shareholders.

[25] ISS' Frequently Asked Questions (FAQ) "U.S. Compensation Policies" (Dec. 14, 2017) is available here.

[26] *See id.* FAQ #48.

When companies have not changed their compensation plans or programs in response to major shareholder concerns, a best practice is to include the following in the proxy materials: (i) a brief description of those concerns; (ii) a statement that the concerns were reviewed and considered; and (iii) if appropriate, an explanation why changes were not made. In addition, many companies incorporate useful features into their executive compensation disclosures, including executive summaries, charts, graphs and other reader-friendly tools. A number of companies also have added a summary section to the proxy statement, generally located at the beginning of the document, that highlights, among other things, business accomplishments and key compensation elements, features and decisions.

In the year following a say-on-pay vote, proxy firms conduct a thorough review of companies whose say-on-pay approval votes fall below a certain threshold: below 70 percent approval for ISS and 80 percent for Glass Lewis. In its FAQs, ISS explained 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, and the company's ownership structure. Overall, companies that fell below ISS' and Glass Lewis' thresholds in 2018 should provide enhanced disclosure of their stakeholder engagement efforts in 2019 and actions they took to address concerns. Companies who fail to conduct sufficient stakeholder engagement efforts and to make these disclosures may receive negative vote recommendations from proxy advisory firms on say-on-pay and compensation committee member reelection.

### Say-on-Golden-Parachute Proposal Results

Say-on-golden-parachute votes have historically received lower support than annual say-on-pay votes, but approval rates are increasing among shareholders and ISS. As of August 2018,[27] average support for golden parachute proposals rose to 86 percent, the highest in the past five years. The 2017 failure rate of 17 percent was the highest since the advent of the vote and more than double the failure rate of 7 percent in 2016. Fortunately, in 2018 the failure rate dropped to 4 percent, and ISS "against" vote recommendations dropped from 49 percent in 2017 to 20 percent in 2018. Improvements in say-on-golden-parachute approval rates can be credited to investors voting along their own guidelines and lower opposition from advisers.

[27] Say-on-golden-parachute data comes from Willis Towers Watson's report "U.S. Executive Pay Votes — 2018 Proxy Season Review" (Aug. 2018), available here.

## Equity Plan Proposal Results

Equity plans continue to be widely approved, with less than 1 percent of equity proposals receiving less than a majority vote in 2018 and since 2011. However, the percentage of equity proposal votes that received above 90 percent support dropped from 65 percent in 2017 to 59 percent in 2018. Companies with low say-on-pay approval rates should brace for lower equity plan approval rates. Data over the past five years shows that companies with say-on-pay votes lower than 70 percent received approximately 11 percentage points less support on equity plan votes that same year.[28]

The year 2018 marked the fourth year in which ISS applied its Equity Plan Scorecard (EPSC). ISS' application of the EPSC changed in important ways in 2018 and continues to evolve in 2019:[29]

- In 2018, for companies subject to the S&P 500 scoring model, the passing score for the EPSC increased to 55 points. For other companies, the passing score remained at 53 points. These passing scores will remain the same for 2019.
- In 2018, the change in control vesting factor was simplified, scoring companies on a basis of full or no credit. A company earned full credit if its equity plan contained both of the following provisions: (x) for performance-based awards, acceleration is limited to actual performance achieved, a pro rata of the target based on the performance period, or a combination of both and (y) for time-based awards, acceleration upon a change in control cannot be discretionary or automatic single-trigger. However, effective for meetings on and after February 1, 2019, equity plans that disclose with specificity the change in control vesting treatment for both performance- and time-based awards will earn full credit. Credit is earned based on quality of disclosure, rather than based on actual vesting treatment of awards. Plans that fail to address change in control vesting treatment for either type of award or provide merely for discretionary vesting will earn no credit.
- In 2018, the holding requirement factor was simplified, permitting a company to earn either full or no credit. The timeline for receiving full credit on this factor changed from a 36-month holding period to a 12-month holding period. Accordingly, any holding period of less than 12 months results in no credit.
- In 2018, the CEO vesting requirement factors were also simplified, scoring full credit or no credit. To receive full credit, the vesting requirement threshold decreased from greater than four years to at least three years from the date of grant until all shares from the award vest.
- Effective for meetings on and after February 1, 2019, ISS may apply a new negative overriding factor relating to excessive equity dilution. This factor will be triggered when a company's equity compensation program is estimated to dilute shareholders' holdings by over 20 percent for S&P 500 companies or 25 percent for Russell 3000 companies.

As of July 2018, ISS recommended against approximately 36 percent of all share plan requests that came to a vote in 2018, while Glass Lewis advised against approximately 20 percent. Companies have nevertheless largely gained shareholder approvals for these plans, in part because they invest in shareholder engagement and often seek reasonable share requests over a limited time period.

Companies should continue to pay careful attention to the EPSC. If a company pursues a share plan that is not compliant with proxy advisory standards, it should conduct robust stakeholder engagement efforts and make a persuasive case for the plan in the proxy statement, to increase the chances of approval.

## Other Proxy Advisory Firm Takeaways

ISS' Preliminary FAQs for 2019[30] confirmed that there are no further changes to the quantitative screens for pay-for-performance calculations for the 2019 proxy season. Key changes that took effect in 2018 and carry through to 2019 include the following:

- **A Financial Performance Assessment (FPA):** Through the FPA, ISS' quantitative screen now measures relative alignment between CEO pay and key financial metrics on a long-term basis, relative to the company's ISS peer group. This analysis was previously limited to ISS' qualitative evaluation. The FPA uses three or four financial metrics, which it selects and weights depending on the company's industry. Potential metrics include return on invested capital, return on assets, return on equity, EBITDA growth and cash flow growth from operations. Although ISS continues to study Economic Value Added (EVA) measures, it will continue to use only GAAP/accounting performance measures in the FPA in 2019. The

28 Semler Brossy's report "2018 Say on Pay and Proxy Results" (Oct. 4, 2018) is available here.

29 ISS' Frequently Asked Questions "U.S. Equity Compensation Plans" (Dec. 14, 2017) is available here.

30 ISS' Preliminary Frequently Asked Questions "U.S. Compensation Policies for 2019" (Nov. 21, 2018) is available here.

FPA can be a tipping factor for the final quantitative concern level if at least one of the initial quantitative measures (relative degree of alignment, multiple of median or pay-TSR alignment) triggers a medium concern finding or borders the medium concern threshold. When the initial three measures do not border a medium concern threshold, the overall quantitative concern level may not be modified by the FPA. ISS anticipates that the FPA will modify less than 5 percent of companies' overall quantitative concern levels.

- **Revised Screen Thresholds:** S&P 500 companies' Multiple of Median (MOM) threshold for a medium level of concern dropped from 2.33, the median pay of peer companies, to 2.00. The MOM threshold for non-S&P 500 companies remains at 2.33.
- **Adjustments to Total Shareholder Return (TSR) Calculations:** ISS now averages the daily closing prices for the first and last months of the TSR measurement period, smoothing the calculations.
- **Acknowledgment of CEO Pay Ratio:** The new CEO pay ratio disclosure requirement did not impact ISS vote recommendations in 2018. ISS will continue to assess the pay ratio's usefulness and application as data becomes available.

In 2017, ISS provided guidance about its 2018 policy for evaluating whether nonemployee director pay is excessive. Under that policy, an ISS finding of excessive nonemployee director pay over two or more consecutive years without a compelling rationale or mitigating factors could result in an adverse vote recommendation starting in 2019. However, ISS announced in its Preliminary FAQs for 2019[31] that it is revising its methodology for identifying nonemployee director pay outliers, and the first possible adverse vote recommendations under ISS' nonemployee director pay policy are delayed from 2019 to 2020.

Companies should consider whether to make any updates to the compensation benchmarking peers included in ISS' database. ISS uses these company-selected peers when it determines the peer group it will use for evaluating a company's compensation programs. ISS will accept these updates through Friday, December 7, 2018.[32]

[31] *See id.*

[32] ISS' article "Company Peer Group Feedback" (2018) is available here.

# Plan for Grandfathering and Other Potential Changes in Pay Practices Due to the Tax Cuts and Jobs Act

On December 22, 2017, the Tax Cuts and Jobs Act (TCJA) became law, altering Section 162(m) of the Internal Revenue Code for taxable years beginning on or after January 1, 2018. On August 21, 2018, the Internal Revenue Service issued Notice 2018-68[33] to clarify how the TCJA amended Section 162(m) and impacts many compensation arrangements. However, the TCJA has a transition rule that allows certain existing compensation arrangements to remain subject to the pre-TCJA version of Section 162(m) (in other words, to be "grandfathered"). Companies should assess the impact of the changes to Section 162(m) on their compensation arrangements, including the application of the transition rule.

## Key Amendments

Important highlights of the Section 162(m) amendments include the following:

- Performance-based compensation counts toward the $1 million deduction limit per employee, because the performance-based compensation deduction was eliminated.
- The definition of a covered employee was expanded to include principal financial officers and the three most highly compensated officers for the taxable year, regardless of their year-end titles and SEC disclosure rules. Covered employee status carries forward each year.
- Section 162(m)'s reach extended to companies with publicly traded debt issuers and foreign private issuers that meet the new definition of a publicly held corporation.

## Grandfathered Arrangements

Certain existing compensation arrangements fall within the scope of Section 162(m)'s transition rule and are grandfathered under the pre-TCJA version of Section 162(m):

- Section 162(m) does not apply to compensation under written binding contracts in effect as of November 2, 2017, so long as the contracts are not materially modified thereafter. Awards are not grandfathered if companies are permitted to exercise negative discretion to reduce or eliminate the award amount, regardless of whether the discretion is exercised, unless the employee is entitled to the amount under applicable state law.
- A written binding contract that was in effect on November 2, 2017, and is materially modified on or after that date is treated as a new contract entered into as of the date of material modification. Amounts an employee receives under the contract before the material modification remain grandfathered, while amounts received after are not grandfathered.
- Not all modifications are material, including the following: accelerating a payout under a grandfathered contract as discounted to reflect the time value of money; deferring payment under a grandfathered contract with earnings based on a reasonable rate of interest or predetermined actual investment; or paying increased or additional compensation under a grandfathered contract that is paid on substantially the same elements or conditions and limited to a reasonable cost-of-living increase.
- Grandfathered performance-based compensation generally includes stock options and stock appreciation rights that were outstanding on November 2, 2017. Performance stock units, performance shares and other long-term incentive awards that were outstanding on November 2, 2017, should qualify as grandfathered, except to the extent the plan or the award (and state law) permits the company to reduce or eliminate the payout.
- If an employment agreement was entered into on or before November 2, 2017, and provides for grants after November 2, 2017, which are subject to approval by the company's board of directors, the potential grants do not constitute a written binding contract and therefore are not grandfathered.

[33] The IRS Notice 2018-68 (Aug. 21, 2018) is available here.

- Employment, severance, change in control and similar agreements that were entered into on or before November 2, 2017, should qualify as grandfathered, except if they are subject to "renewal," which is broadly defined in Notice 2018-68. Grandfathered status is lost upon occurrence of the applicable renewal date.

### Practical Implications

The TCJA is causing some leading companies to reconsider the timing and form of their incentive compensation payouts. Section 162(m)'s new definition of covered employee may inspire companies to implement longer vesting schedules for equity awards or to extend the timing for other awards by spreading payments over multiple years. Companies may also consider changing the mix of fixed and variable compensation or moving compensation into a supplemental executive retirement plan or other nonqualified deferred compensation plan.

In addition, the elimination of the qualified performance-based compensation exception comes with a silver lining: companies now have greater flexibility to design new performance awards with goals that are aimed entirely at achieving business objectives. For example, companies can now establish performance goals and adjustment provisions for new awards that are not objectively determinable and pre-established, and they can retain discretion to adjust payouts based on actual performance and unforeseen events.

Performance-based awards remain important to incentivizing executives and continue to be a key focus of shareholders and proxy advisory firms. ISS recently indicated that it does not expect to change its framework for analyzing pay-for-performance as a result of the changes to Section 162(m). Therefore, the mix of time-based and performance-based awards to executives will likely remain largely the same, despite the recent changes under Section 162(m).

### Key Takeaways to Consider

Companies should consider the following key takeaways for the annual reporting season:

- Monitor covered employees and the extent to which their covered compensation may exceed $1 million per year.
- Take inventory of performance-based compensation arrangements in effect on November 2, 2017, and determine which ones may be grandfathered. Companies should consult with legal advisers to determine how the transition rule applies to the company's arrangements and avoid inadvertent material modifications that jeopardize the deductibility of compensation paid to covered employees for current and future taxable years.
- Review existing equity and cash incentive plans to assess flexibility to grant performance awards that are not intended to qualify as performance-based compensation under Section 162(m) and changes to make to plan designs. To protect grandfathered status for outstanding awards, some companies are adopting new plans reflecting the Section 162(m) changes rather than amending existing plans.
- Continue to comply with operational requirements for awards that are intended to be grandfathered. For example, companies with outstanding grandfathered awards should retain old performance award provisions in their equity and cash incentive plans.
- Make a thoughtful disclosure about Section 162(m)'s impact on executive compensation policies in the Compensation Discussion and Analysis (CD&A) section of the proxy statement. For example, consider noting that the compensation committee has assessed and will continue to assess the impact of the changes on executive compensation while retaining discretion to establish nondeductible compensation.
- Companies may also state that compensation programs are no longer being designed to comply with repealed Section 162(m) provisions while accurately describing compensation programs in their proxy statements. We advise companies to avoid specifying that any particular payments are in fact grandfathered, given the uncertain and complex application of the rules in certain circumstances.
- Companies should plan to eventually update equity plans, prospectuses and compensation committee charters to eliminate references to Section 162(m) performance-based requirements.
- Companies should consider the extent to which compliance with independence requirements for compensation committee members under the NYSE and Nasdaq listing standards and the rules under Section 16(b) of the Exchange Act is still required, notwithstanding the changes to Section 162(m).

# Consider Recent Director Compensation Litigation

On December 13, 2017, the Delaware Supreme Court issued its opinion in *In re Investors Bancorp, Inc. Stockholder Litigation* (Bancorp),[34] opening the door for more stringent review of director compensation awards and costly litigation.

Delaware courts generally review director decisions about their own compensation under one of the following standards of review: (i) the business judgment standard, which is deferential to directors, or (ii) the more onerous entire fairness standard, where courts consider whether the decision is entirely fair to the corporation. Director compensation is typically reviewed under the entire fairness standard because directors derive personal financial benefits from their decisions about their own compensation. Prior to *Bancorp*, courts typically applied the business judgment standard of review instead of entire fairness if a director compensation decision was ratified by a vote of fully informed shareholders, even if the compensation plan in question gave directors discretion to award themselves compensation, as long as the plan had meaningful limits. Shareholder ratification therefore also made it easy for courts to dismiss director compensation suits early in the litigation process.

In *Bancorp*, the Delaware Supreme Court limited the shareholder ratification defense, making it more difficult to secure business judgment review and easier for plaintiffs to sustain breach of fiduciary duty claims against directors regarding their compensation. Specifically, the court found that, where shareholders have approved an equity incentive plan that gives directors discretion to grant themselves awards within general parameters, and a shareholder properly alleges that that discretion was inequitably exercised (the *Bancorp* plaintiff had alleged that directors' compensation exceeded pay at peer companies), then the shareholder ratification defense is unavailable to dismiss the suit and the entire fairness review applies. However, shareholder ratification remains a viable director defense and grounds for business judgment review in two scenarios, where shareholders approve (i) specific director awards or (ii) a plan with a self-executing formula, so directors have no discretion as to their awards.

Companies should reduce their risk of director compensation litigation by:

- Working with a compensation consultant to conduct a peer review of director compensation, being mindful of the choice of peers, which plaintiffs frequently criticize.
- Separating employee and nonemployee director compensation decisions and reevaluating compensation decision-making processes to mitigate self-dealing concerns. Boards should consider using separate plans for director and executive awards.
- Carefully documenting the review of director compensation programs and considering expanded proxy disclosure about both the process for determining compensation and the actual amount of compensation paid to directors.
- Considering whether to grant director compensation equity awards pursuant to a shareholder approved formula plan or seek shareholder approval of specific awards.

[34] *In re Investors Bancorp, Inc. Stockholder Litig.*, 177 A.3d 1208 (Del. 2017).

# Review and Consider Updates to D&O Questionnaires

Although there have been no significant regulatory changes in 2018 that should impact director and officer (D&O) questionnaires, companies may want to consider the following recent developments as they finalize their questionnaires.

## 'Outside Director' Status Under Section 162(m)

Companies that do not have any grandfathered compensation arrangements under the TCJA amendments to Section 162(m) may want to update their D&O questionnaires to omit any questions concerning "outside director" eligibility for membership on the compensation committee. For additional information, see the section above titled "Plan for Grandfathering and Other Potential Changes in Pay Practices Due to the Tax Cuts and Jobs Act."

## Board Diversity and Skills Matrix

Companies that plan to provide more robust disclosures in their annual proxy statements regarding board composition (see the section below titled "Consider Recommendations to Increase Board Diversity and Enhance Related Disclosures") should consider any necessary updates to their D&O questionnaires. For example, if companies intend to disclose a form of the diversity and skills matrix, the company may need certain additional information from directors, such as specific types of skills and experiences, sexual orientation, gender, age, race or ethnicity.

## Perks Disclosures

The D&O questionnaire can supplement a company's internal processes and procedures to identify perks disclosable as executive compensation. The SEC enforcement action relating to improper disclosures of executive perks serves as a reminder for companies to ensure that the D&O questionnaire adequately solicits information and the questionnaires are completed on a timely basis by all directors and officers.

For example, in July 2018, the SEC charged the former CEO of an energy company[35] with hiding personal loans that should be reported as related person transactions and submitting personal expenses for reimbursement that should be reported as perks. The SEC noted in its complaint that the former CEO had not completed his D&O questionnaires.

[35] The SEC's press release "SEC Charges Oil Company CEO, Board Member With Hiding Personal Loans" (July 16, 2018) and related SEC complaint and order are available here.

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

Proxy advisory firms ISS[36] and Glass Lewis[37] have updated certain of their voting guidelines for the 2019 annual meeting season. Companies should assess the potential impact of such updates, summarized below, when considering changes to corporate governance practices, including shareholder engagement, as well as proxy statement disclosures, which could serve as a basis for recommendations by ISS.

## Board Gender Diversity

ISS announced that, effective for meetings on or after February 1, 2020, it will generally recommend that shareholders vote against or withhold from the nominating committee chair (or other directors on a case-by-case basis) at companies in the Russell 3000 or S&P 1500 indices if no women serve on the company's board.

Glass Lewis will begin implementing its updated board gender diversity policy for meetings held after January 1, 2019. As previously announced, under the new policy Glass Lewis will generally recommend voting against the nominating committee chair of a board that has no female directors and may also vote against other members of the nominating committee in certain circumstances.

When making voting recommendations, Glass Lewis will review a company's disclosure of diversity considerations and may not recommend votes against directors in cases where the board has provided a "sufficient rationale" for not having any female directors. Such rationale may include a disclosed timetable for addressing the lack of diversity on the board and any notable restrictions in place regarding the board's composition (for example, director nomination agreements with significant investors).

## Environmental and Social Risk Oversight

As part of its review of how boards are overseeing environmental and social issues, Glass Lewis clarified that it may consider recommending that shareholders vote against directors who are responsible for oversight of environmental and social risks in cases where it determines that companies have not properly managed or mitigated such risks to the detriment of shareholder value, or where such mismanagement has threatened shareholder value.

## Auditor Ratification

Glass Lewis updated its guidelines for situations in which it may recommend votes against ratification of a company's outside auditor. Glass Lewis will consider factors including auditor tenure, any pattern of inaccurate audits and any ongoing litigation or significant controversies that call into question the auditor's independence. Glass Lewis indicated that these factors may lead to a recommendation against auditor ratification in limited cases.

## Virtual-Only Shareholder Meetings

Glass Lewis will begin implementing its new policy on virtual-only shareholder meetings for meetings held after January 1, 2019. As previously announced, for companies that hold virtual-only shareholder meetings, Glass Lewis will examine the company's disclosure of its

[36] ISS' 2019 Americas Policy Updates (Nov. 19, 2018) is available here.

[37] Glass Lewis' proxy paper "2019 Guidelines: An Overview of the Glass Lewis Approach to Proxy Advice — United States" (2018) is available here, and Glass Lewis' proxy paper "2019 Guidelines: An Overview of the Glass Lewis Approach to Proxy Advice — Shareholder Initiatives" (2018) is available here.

virtual meeting procedures and may recommend votes against directors on the nominating committee if the company does not provide disclosure assuring that shareholders will have the same opportunities to participate at the virtual meeting as they would at an in-person meeting.

## Director Qualifications

ISS codified its approach to evaluating director attendance, indicating that when a director exhibits chronic poor attendance without reasonable justification, ISS will generally vote against the director with poor attendance and may also recommend a vote against or withhold from appropriate members of the nominating committee or the full board. ISS defines "chronic poor attendance" as three or more consecutive years of poor attendance without reasonable explanation.

As part of its assessment of directors' conflicts of interest, Glass Lewis recommends that shareholders vote against directors who provide, or whose immediate family members provide, material professional services to the company (such as legal, consulting or financial services). For meetings held after January 1, 2019, Glass Lewis will "generally refrain" from recommending against a director who provides consulting services if the director does not serve on the audit, compensation or nominating committees and Glass Lewis has not identified "significant governance concerns" with the board.

## Shareholder Proposals

In response to developments during the 2018 proxy season that allowed companies to secure from the SEC staff no-action relief to exclude shareholder proposals from their proxies by including a conflicting management-sponsored proposal to ratify an existing governance provision (particularly regarding shareholder proposals to create special meeting rights), ISS adopted a new policy on management proposals to ratify existing charter or bylaw provisions. In addition to generally recommending a vote against ratification proposals regarding governance matters that do not represent best practices, ISS may recommend a vote against or withhold from individual directors, members of the nominating committee or the full board when boards ask shareholders to ratify existing charter or bylaw provisions. In making its recommendation, ISS will consider the following:

- the presence of a shareholder proposal addressing the same issue on the same ballot;
- the board's rationale for seeking ratification;
- disclosure of actions to be taken by the board should the ratification proposal fail;
- disclosure of shareholder engagement regarding the board's ratification request;
- the level of impairment to shareholders' rights caused by the existing provision;
- the history of management and shareholder proposals on the provision at the company's past meetings;
- whether the current provision was adopted in response to the shareholder proposal;
- the company's ownership structure; and
- previous use of ratification proposals to exclude shareholder proposals.

Glass Lewis also updated its guidelines regarding a number of specific shareholder proposal topics and regarding company responses to shareholder proposals more generally.

**Special Meeting Proposals.** Glass Lewis generally favors a 10 to 15 percent special meeting right and will generally recommend that shareholders support proposals within this range. Glass Lewis also codified its approach to conflicting shareholder proposals addressing special meeting rights.

- When a company's proxy statement contains both a management and shareholder proposal requesting different thresholds for the right to call a special meeting, Glass Lewis will generally recommend voting for the lower threshold (in most instances, the shareholder proposal) and recommend voting against the higher threshold.
- When a company's proxy statement contains conflicting management and shareholder special meeting proposals and shareholders do not currently have a special meeting right, Glass Lewis may consider recommending that shareholders vote in favor of the shareholder proposal and abstain from voting on management's proposal.
- Although Glass Lewis generally states that it will recommend voting against members of the governance committee on the basis of the company's exclusion of a shareholder proposal only in "very limited circumstances" where the exclusion is "detrimental to shareholders," in the specific context of a company exclusion of a special meeting shareholder proposal in favor of a management proposal ratifying an existing special meeting right, Glass Lewis will typically recommend against the ratification proposal, as well as members of the nominating committee.

**Written Consent Proposals.** Glass Lewis will generally recommend that shareholders vote against a shareholder proposal seeking the right for shareholders to act by written consent if the company has adopted a special meeting right of 15 percent or lower and has adopted reasonable proxy access provisions.

**Workforce Diversity Proposals.** Glass Lewis has revised its policy concerning shareholder proposals that request a report on a company's workforce diversity or efforts to promote diversity at the company. Glass Lewis will generally support such proposals and, when making its determination, will consider the company's industry and operations, the company's current disclosure on issues related to workforce diversity, the level of such disclosure at the company's peers and any lawsuits or accusations of discrimination within the company.

**Environmental and Social Proposals.** Glass Lewis amended its guidelines to reflect that, in evaluating environmental and social shareholder proposals, it places "significant emphasis" on the financial implications of a company adopting, or not adopting, the proposal. To assist in determining such financial materiality, Glass Lewis will consider the standards developed by the Sustainability Accounting Standards Board (SASB).

# Consider Recent Requests and Trends for Increased Environmental, Social and Governance Reporting

In response to increasing requests and demands from various environmental, social and governance (ESG) constituents to understand the long-term performance and risk management strategies of companies, boards of directors and management should be aware of the rapidly evolving ESG landscape in which ESG stakeholders are operating in order to effectively evaluate stakeholder preferences and ESG reporting processes, oversight and disclosures. Although "ESG" generally encompasses a wide range of issues, including water management, renewable energy, labor and human rights policies, supply chain management and, with greater frequency, board diversity, the opioid crisis and gun control, as well as shareholder engagement initiatives under the corporate governance component, we expect climate change and sustainability, in addition to employment discrimination and equitable pay, to be key topics during the 2019 proxy season. For additional discussion of proposals on these topics, see the section below titled, "Consider Shareholder Proposal Trends and Developments."

## Reporting Transparency

According to ISS, the most frequently submitted shareholder proposals during the 2017 and 2018 proxy seasons related to environmental and social (E&S) issues, representing 45 and 44 percent, respectively, of all proposals submitted. The largest category (approximately 25 percent) of those proposals submitted during the most recent season related to climate change and averaged 31 percent support, and during the same time period requests for sustainability reporting accounted for approximately 8 percent of all E&S proposals submitted and averaged 37 percent support. The data suggests that E&S matters, particularly climate change and sustainability reporting, are not only being pursued aggressively but are also receiving unprecedented levels of support. During the 2018 proxy season, a record 10 E&S proposals received majority support, including four on climate change-related issues and two on sustainability reporting.

Institutional investors are becoming increasingly more vocal in their expectations of increased transparency and disclosure regarding ESG preparedness and reporting. In 2017, 85 percent of S&P 500 companies published sustainability or corporate responsibility reports, a significant increase from only 20 percent of such companies in 2011, according to the Governance and Accountability Institute. Notwithstanding this increase, 63 percent of respondents state that they "don't spend much time" with corporate sustainability reports; the lack of standardization and comparability across peers and industries may in part explain why respondents opine that annual report to shareholders (56 percent) and direct questions to the company (46 percent) provide more helpful ESG information than companies' sustainability or corporate responsibility reports (44 percent), according to a 2018 Clermont Partners' survey exploring how investment professionals view ESG factors when making investment decisions. As a result, the data suggests that respondents will continue to demand greater shareholder engagement activities related to ESG matters.

In the absence of a mandatory SEC disclosure framework, and due to the inability of ESG stakeholders to coalesce around a standardized comprehensive reporting and disclosure framework — such as the SASB, the Task Force on Climate-Related Financial Disclosures or the Principles for Responsible Investment — companies continue to engage with ESG constituents and consider the materiality of potential ESG issues specific to company operations and financial results to determine the level of disclosure. As a result, we expect ESG-related disclosure to continue to vary within each industry, reflecting primarily a mix of voluntary disclosures in periodic reports, annual proxy statements and corporate sustainability reports.

In addition, a number of businesses are engaged in collecting, aggregating, synthesizing and ranking ESG data. For example, ISS has integrated Environmental and Social QualityScore (E&S QualityScore) into its current corporate profiling solutions since February 2018. E&S QualityScore analyzes and measures the quality of a company's disclosures and transparency relating to its management of E&S issues and risks relative to its industry peers based on more than 380 unique E&S factors. As with ISS' Governance QualityScores, E&S QualityScores have no impact on ISS' benchmark proxy voting recommendations but do appear in ISS' published voting reports. Similarly, in September 2018, Glass Lewis announced that guidance on material ESG topics from the SASB will be integrated into its proxy research reports and vote management application in advance of the 2019 proxy season.

A major challenge arises from the fact that each ESG ratings provider has its own methodology, and a company may receive widely divergent ratings from different organizations. Moreover, the ESG rating agencies may use different combinations of data sources other than company disclosures, even where companies may not agree with the veracity or accuracy of those data sources, resulting in disparities in ratings due to reliance on a number of subjective factors, including company size, geography and industry-specific criteria, and a lack of standardization or controls and procedures to verify company data.[38]

[38] For additional detail, refer to our October 18, 2018, publication in Harvard Law School Forum on Corporate Governance and Financial Regulation titled "Making Sense of the Current ESG Landscape" (Oct. 18, 2018), available here.

## Regulatory Developments

As for regulatory ESG initiatives, in October 2018, two law professors, joined by other securities law experts, government officials, non-governmental organizations, and numerous investors and associated organizations representing more than $5 trillion in assets under management, submitted a petition for rulemaking to the SEC in response to the 2016 Concept Release on Business and Financial Disclosure Required by Regulation S-K, requesting that the SEC develop a standardized framework under which companies would be required to disclose identified ESG factors relating to their operations. Specifically, the petition requests that the SEC develop a "comprehensive framework for clearer, more consistent, more complete, and more easily comparable information relevant to companies' long-term risks and frameworks" in order to better inform investors and provide clarity to companies' ESG reporting processes and disclosures. However, given the political climate and current SEC leadership, we do not expect the SEC to initiate a rulemaking process addressing ESG disclosures.

# Consider Recommendations to Increase Board Diversity and Enhance Related Disclosures

In recent years, directors have been subject to increasingly pointed expectations and scrutiny regarding board composition, including individual and aggregate skills and diversity, with similar pressure regarding the executive ranks. Investors and advocates have voiced these expectations to enhance board and executive effectiveness, along with workplace talent recruitment and retention, hoping to maintain or increase competitiveness in a complex and changing marketplace, and, according to some diversity stakeholders, optimize financial results. While the gender of board members has traditionally been the primary focus of these diversity efforts, various stakeholders are increasingly demanding that companies address other important director characteristics and considerations including, age, race, ethnicity, education and experience, as well as composition, refreshment, oversight and the board evaluation process.

We expect board diversity and these other concerns to continue to be a key corporate governance focus for the upcoming 2019 proxy season. Accordingly, we continue to recommend that companies consider requests to increase the diversity in the boardroom and to adopt more prominent annual proxy statement disclosure regarding director and board characteristics.

## Institutional Investor Activism

The push to enhance board diversity remains a point of emphasis for a number of historically ESG-focused institutional investors. Additionally, shareholder proposals, including the discussions and negotiations incidental to such submissions, remain an important engagement tool with many companies. During the 2018 proxy season, shareholders submitted 27 proposals requesting the adoption of a board diversity policy or a report on board diversity, compared to 32 in 2017, according to ISS. Consistent with prior years, a significant number of these proposals (81 percent) were withdrawn, often as a result of engagement between proponents and companies. These engagement activities have resulted in a number of commitments by companies, including an increasing frequency in which companies have adopted a variant of the "Rooney Rule" — originated as a National Football League (NFL) policy, named for Dan Rooney, former owner of the Pittsburgh Steelers and former chair of the NFL's diversity committee, requiring teams to interview ethnic minority candidates for senior executive positions — for director recruitment and a commitment to include women and ethnically diverse candidates to increase the diversity in the pool from which board nominees are selected.

While shareholder proposals continue to provide a useful forum for engagement, some traditional investors have taken a different approach. In September 2017, the Office of the New York City Comptroller (the New York City Comptroller) and the New York City Pension Fund launched a campaign to push for greater board diversity and transparency reforms through its "Board Accountability Project 2.0" (BAP 2.0) — an iteration of the Boardroom Accountability Project from 2014 targeting enhanced proxy access. Specifically, BAP 2.0 targeted 151 companies — 80 percent of which are in the S&P 500 — asking them to adopt a prominent matrix table in the annual proxy statement describing the skills, gender, race, and ethnicity of individual directors and use refreshment opportunities to bring new viewpoints into the boardroom.[39] In June 2018, the New York City Comptroller announced the results, which revealed more than 85 of the 151 targeted companies had adopted "improved processes and increased transparency regarding board quality, diversity and refreshment," and over 35 companies adopted disclosure beyond board member qualifications to include

[39] New York City Comptroller's press release "Comptroller Stringer, NYC Funds: Unprecedented Disclosure of Corporate Boardroom Diversity Following Groundbreaking Campaign" (June 27, 2018) is available here.

details on gender, racial and ethnic diversity. In addition, since the launch of BAP 2.0, 49 targeted companies have elected 59 new diverse directors — including 44 women — 24 companies have publicly committed to include women and people of color in the candidate pool for every board search going forward and over 25 companies provided meaningful disclosure about their annual evaluation processes, according to the New York City Comptroller.

In addition to continued engagement from the New York City Comptroller and other historically ESG-focused institutional investors such as CalPERS and CalSTRS, several nontraditional ESG-focused institutional investors have increasingly taken steps to support enhanced gender diversity. In February 2018, BlackRock updated its proxy voting guidelines to include an expectation that at least two women serve on each board and indicated that it will continue engagement efforts, including potentially voting against nominating/governance committee members if it believes a company has "not adequately accounted for diversity in its board composition."[40] Similarly, State Street Global Advisors stated in its 2018 gender diversity guidelines that it expects boards to include at least some independent female directors and, if not, indicated that it may vote against the chair of a board's nominating/governance committee or the board leader in the absence of a nominating/governance committee.[41] And, in terms of engagement, Vanguard reported in its 2018 Investment Stewardship Annual Report that more than half of its engagements over the past year included discussions about a variety of board composition matters, including director independence, tenure, skills and diversity.[42]

## Proxy Advisory Firm Updates

Prior to the 2018 proxy season, ISS revised its "fundamental principles" regarding board composition to include a statement that boards should be sufficiently diverse to ensure consideration of a wide range of perspectives and noted that ISS would highlight in its proxy research reports those boards that lacked gender diversity, although no adverse voting recommendations were issued on directors' elections for this reason during the 2018 proxy season. In November 2018, ISS adopted a new voting policy on board gender diversity applicable for companies in either the Russell 3000 or S&P 1500 indices, effective for meetings on or after February 1, 2020.[43] This policy provides that beginning in 2020, ISS may recommend voting against the chair of the nominating committee (or on a case-by-case basis, the elections of other directors responsible for the board nomination process) where the board has no gender diversity. In addition, the policy provides for ISS to take into consideration mitigating factors that may temporarily excuse the absence of a female director, including: a firm commitment, as stated in the proxy statement and/or other SEC filings, to appoint at least one female director to the board in the near term (before the next annual meeting); the presence of at least one female director on the board at the immediately preceding annual meeting; and/or any other compelling factors considered relevant on a case-by-case basis.

ISS also recently updated its ISS Governance QualityScore, particularly in the areas of board composition and controversies. Notably, ISS created a new board diversity subcategory to further distinguish companies with significant diversity among their directors and named executive officers. The new diversity subcategory considers new factors — the number of women in board and committee leadership positions, director diversity by age and tenure, and the number of female named executive officers — as well as existing factors covering gender diversity, director refreshment and tenure.

Pursuant to its 2019 proxy voting guidelines, Glass Lewis will generally recommend voting against the nominating committee chair of a board that has no female members, and depending upon other factors — including the size of the company, the industry in which the company operates and the overall governance profile of the company — Glass Lewis may extend a vote against recommendation to other nominating committee members.[44] However, Glass Lewis notes that it may refrain from extending an adverse recommendation upon close examination of disclosure of the company's board diversity considerations and other relevant contextual factors, including, for example, a disclosed timetable for addressing the lack of diversity on the board, and any notable restrictions in place regarding board composition, such as director nomination agreements with significant investors.

40 BlackRock's guidelines "Proxy Voting Guidelines for U.S. Securities" (Feb. 2018) are available here.

41 State Street Global Advisors' release "Guidance on Enhancing Gender Diversity on Boards" (2018) is available here.

42 Vanguard's report "Investment Stewardship Annual Report" (2018) is available here.

43 ISS' 2019 Americas Policy Updates (Nov. 19, 2018) is available here.

44 Glass Lewis' proxy paper "2019 Guidelines: An Overview of the Glass Lewis Approach to Proxy Advice — United States" (2018) is available here.

## Recent Legislative Action

In September 2018, California became the first state in the nation to require that publicly held corporations headquartered within the state include female directors on their boards.[45] Any corporation subject to the law must have at least one female director by the end of 2019. By the end of 2021, subject corporations with five board members must have at least two female directors, while those with six or more board members must have at least three female directors. A corporation may increase the size of its board in order to comply with the new requirements.

## Trends and Outlook

As a result of the push for greater diversity, female representation on boards has increased in recent years, particularly at larger companies. For the second consecutive year, women and minorities represent half of the class of new S&P 500 directors, and women represent an unprecedented 40 percent of the incoming class, an increase from 36 percent in 2017, according to the 2018 Spencer Stuart Board Index.[46] In addition, on average, boards now have 2.6 female directors, compared with 1.7 a decade ago. However, smaller companies do not report a similar progression — approximately 90 percent of S&P 500 companies have two or more female directors, compared to 58 percent of Russell 3000 companies, according to ISS.[47]

In light of the sustained efforts on the part of traditional ESG-focused institutional investors, coupled with the recent updates from nontraditional ESG-focused institutional investors, we expect that diversity stakeholders will continue to seek dialogue, engagement and robust disclosure on diversity and related board composition matters.

[45] A copy of the California bill SB-826 is available here. For additional detail, please see our client alert "California to Require Inclusion of Female Directors at Public Corporations Based in the State" (Oct. 1, 2018), available here.

[46] Spencer Stuart's report "2018 United States Spencer Stuart Board Index" is available here. Highlights of the report "2018 US Spencer Stuart Board Index Highlights" (2018) are available here.

[47] For additional detail, see "An Early Look at US 2018 Proxy Season Trends," Harvard Law School Forum on Corporate Governance and Financial Regulation (May 2018), available here.

# Consider Shareholder Proposal Trends and Developments

Another wave of shareholder proposals submitted to companies for inclusion in their annual meeting proxy statements are expected this upcoming proxy season. The landscape is not anticipated to change significantly from past years. This means most governance proposals are expected to relate to special meeting and written consent rights, independent board chairs, majority voting in uncontested director elections, the removal of supermajority voting provisions, proxy access and board declassification. Proposals focused on environmental and social topics are expected to cover a wide range of issues again this season, most likely led by proposals focused on climate change risks, sustainability reporting, board diversity and gender pay equity issues. In addition, a number of companies can again expect proposals relating to their involvement in the political process and concerning their executive compensation pay practices. Below is a brief summary of observations from the 2018 proxy season on some of the more notable proposal topics that might shed more light on what to expect this upcoming season, as well as an overview of the SEC staff's recent guidance on the application of Exchange Act Rule 14a-8.

## Special Meeting Proposals

Special meeting proposals were the most frequent governance proposal topic submitted to companies during the 2018 proxy season. Indeed, almost triple the amount of special meeting proposals were submitted to companies last year versus the prior year. As with proposals seeking the ability of shareholders to act by written consent, average support for proposals that seek a new right to call special meetings remained slightly over 40 percent (two such proposals passed) during the 2018 proxy season.

Proposals seeking to amend an existing special meeting right to reduce the ownership threshold for calling a meeting similarly averaged almost 40 percent (five such proposals passed) during the 2018 proxy season. Given the potential for shareholder approval of these proposals, seven companies during the 2018 proxy season submitted a management-sponsored proposal asking for ratification of their existing special meeting bylaw provisions and obtained relief from the SEC staff to exclude a related shareholder proposal on the basis that it competed with management's proposal. Responding to concerns expressed by institutional investors, the SEC staff only allowed these companies to exclude the proposals on the condition that the companies provide additional disclosures in their proxy statements such as, among other things, a statement that the company omitted a shareholder proposal to lower the ownership threshold and an explanation of the company's expected course of action, if ratification of the management-sponsored proposal was not received. All of the management-sponsored ratification proposals submitted under those circumstances passed, although only one received greater than 60 percent support. Given statements by ISS and Glass Lewis that it will recommend a vote against these ratification proposals and nominating and governance committee members of companies that put forth such proposals, it is unclear whether companies will attempt a similar approach this season.

## Proxy Access Proposals

With at least 70 percent of S&P 500 companies currently having some form of proxy access, calls for a company to offer shareholders the ability to include their director nominees in the company's proxy statements dropped dramatically year-over-year, from 115 in 2017 to 55 in 2018. Companies without proxy access that receive such proposals typically decide to adopt their own form of proxy access and have been able to exclude a related shareholder proposal on the basis of substantial implementation. In the rare instance that a shareholder proposal seeking proxy access for the first time at a company went to a vote during the 2018 proxy season, it received on average 40 percent support (three passed; nine failed). During the 2018 proxy season, 30 companies received shareholder proposals to amend one or more provisions of their existing proxy access bylaws. Such proposals are more difficult to exclude on substantial implementation and other bases without a company revising to some extent its existing bylaws, so such proposals typically make it onto the ballot. Nevertheless, these so-called "fix it" proposals only averaged 28 percent support, with no such proposal passing, during 2018.

### Environmental and Social (E&S) Proposals

Despite the continued prevalence of governance-related shareholder proposals, the 2018 proxy season marked the second year in a row that E&S proposals outnumbered governance proposals. About 25 percent of the E&S proposals that made it on the ballot concerned climate change, such as requests for an assessment of the long-term impacts of public climate change policies aimed at reaching a 2 degree Celsius target and calls for companies to adopt goals to reduce their greenhouse gas emissions. While such proposals generally averaged 31 percent support during 2018, shareholders passed resolutions related to climate change at three companies in the oil and gas industry. Institutional investors, like BlackRock, Vanguard and State Street Global Advisors, as well as certain members of Congress, continue to call for additional disclosures related to climate change risks. Absent a congressional mandate, however, the SEC is unlikely to adopt an explicit disclosure requirement. As a result, and given ISS' consideration of E&S disclosures as part of its QualityScore rankings, climate change-related proposals are expected to increase in number over the coming years.

The remaining E&S proposals during the 2018 proxy season covered a wide range of topics such as drug pricing, opioids, cybersecurity risks, student loans and gun violence. Gender and ethnic pay equity and board diversity were among the most frequent topics. As discussed in the section above titled "Consider Recommendations to Increase Board Diversity and Enhance Related Disclosures," given the positions taken by proxy advisory firms and some institutional investors and initiatives like California's new mandate, shareholder proposals calling for increased board diversity perhaps not surprisingly increased in number and in terms of shareholder support during recent years. Nevertheless, such proposals still average only about 18 percent shareholder support. Unlikely to see these proposals pass, proponents often are willing to negotiate a withdrawal upon a company's agreement to revise its processes and/or provide additional disclosures.

### Lobbying and Political Contributions and Activities Proposals

For the first time in many years, the number of lobbying and political contributions and activities proposals fell below 100 (just over 90 proposals submitted in 2018). The steady decrease since 2015, when close to 125 were submitted, has been attributed to increased public disclosures made by companies, often on their websites, about their direct and indirect lobbying activities and political contributions. Still, many companies decline to expand their public disclosures in this regard, choosing instead to let these shareholder proposals go to a vote, with the knowledge that such proposals tend to receive only about 30 percent shareholder support, as they did again during the 2018 proxy season.

### Executive Compensation Proposals

Just fewer than 40 executive compensation-related proposals, roughly the same number as last year, were voted on by companies during the 2018 proxy season. Consistent with the prior season, none of these proposals received majority support, and the proposal that received the highest level of support — requests for the adoption of, or an amendment to, a clawback policy — averaged roughly 42 percent support. Notably, there were 11 proposals voted on by companies that sought to tie social and other non-financial performance issues, such as drug pricing, cybersecurity risks, social responsibility and environmental sustainability, to executive compensation decisions. As examples, one proposal asked the compensation committee to report annually on the extent to which risks related to public concern over drug pricing strategies are integrated into executive incentive compensation decisions, and another proposal asked the board to publish a report assessing the feasibility of integrating cybersecurity and data privacy metrics into executive compensation performance targets. While these types of proposals were difficult to exclude from company proxy statements under Rule 14a-8, given the SEC staff's general deference toward executive compensation proposals at the time, none of these socially-oriented proposals received majority support in 2018.

## New SEC Staff Guidance

**"Relevance" and "Ordinary Business" Exclusions.** Last year, the SEC staff published Staff Legal Bulletin No. 14I,[48] which invited companies to assist the staff by including in Rule 14a-8 no-action requests a discussion of the board's analysis of whether a proposal (a) is "otherwise significantly related" to a company's business, in the case of a "relevance" no-action request under Rule 14a-8(i)(5), or (b) focuses on sufficiently significant policy issues with a nexus to the company's business operations, in the case of an "ordinary business" no-action request under Rule 14a-8(i)(7). As described in our June 2018 *Insights*, although a number of companies attempted to utilize this guidance by including some discussion of the board's analysis in their no-action requests, virtually all of these attempts were unsuccessful.

In October 2018, the SEC staff published Staff Legal Bulletin No. 14J (SLB 14J),[49] which reiterated that a well-developed discussion of the board's analysis can assist the SEC staff in evaluating certain no-action requests. In particular, the SEC staff stated that a well-developed discussion "will describe in sufficient detail the specific substantive factors the board considered in arriving at its conclusion that an issue is not otherwise significantly related to its business … or is not sufficiently significant in relation to the company." The SEC staff then suggested a non-exclusive list of potential factors a board may consider:

- the extent to which the proposal relates to the company's core business activities;
- quantitative data, including financial statement impact, related to the matter that illustrates its lack of significance;
- whether the company already has addressed the issue in some manner, such that the difference between the proposal's specific request and the actions already taken does not present a significant policy issue for the company;
- the extent of shareholder engagement on the matter and level of shareholder interest expressed in that engagement;
- whether anyone other than the proponent has requested the type of action or information sought by the proposal; and
- whether the company's shareholders previously have voted on the matter and the board's views of the voting results, including whether any subsequent actions taken by the company or intervening events since the vote impact the significance of the issue to the company.

The SEC staff confirmed that the inclusion of a board analysis is not required in a no-action request and that the inclusion or absence of a board analysis does not create any presumption for or against exclusion of a proposal.

**Micromanagement.** The ordinary business basis for excluding a shareholder proposal has two distinct prongs. One prong looks to the substance of the proposal; the second prong relates to the degree to which a proposal "micromanages" the company "by probing too deeply into matters of a complex nature," which may occur if the proposal "involves intricate detail, or seeks to impose specific time-frames or methods for implementing complex policies." The SEC staff explains in SLB 14J that a proposal can relate to subject matter that is appropriate for shareholder consideration but can be excludable because it does so in a manner that micromanages the company.

As we observed in our June 2018 *Insights*, micromanagement arguments found new life during the 2018 proxy season. Although SLB 14J does not change the overall substance of the micromanagement prong of the ordinary business exclusion, the discussion of micromanagement suggests that its newfound vitality is likely to continue into the upcoming shareholder proposal season.

**Proposals Addressing Senior Executive or Director Compensation.** For some time, proposals concerning the workforce generally have been excludable as relating to ordinary business matters, and proposals focusing on senior executive or director compensation have not been excludable as ordinary business. SLB 14J addresses three aspects of this framework.

First, SLB 14J articulates the existing framework for analyzing proposals that address both senior executive or director compensation and ordinary business matters. It explains that the SEC staff analyzes the focus of the proposal to ascertain whether the underlying concern of the proposal is an ordinary business matter or is a senior executive and/or director compensation matter. Accordingly, SLB 14J says that proponents cannot avoid exclusion by including an aspect of senior executive or director compensation in a proposal that otherwise focuses on an ordinary business matter.

[48] SEC Staff Legal Bulletin No. 14I (Nov. 1, 2017) is available here.

[49] SEC Staff Legal Bulletin No. 14J (Oct. 23, 2018) is available here.

Second, SLB 14J articulates a new approach regarding proposals that address aspects of senior executive or director compensation that also are available or applicable to a company's general workforce. Where a proposal focuses on aspects of compensation available only to senior executives or directors, generally the proposal may not be excluded as relating to an ordinary business matter. On the other hand, if a proposal focuses on aspects of compensation that are broadly available to a company's general workforce, in addition to its senior executives and/or directors, and the company demonstrates that the executives' or directors' eligibility to receive the compensation does not implicate significant compensation matters, the proposal may be excluded on ordinary business grounds. It remains to be seen whether this distinction will prove to be of practical use to companies in arguing for the exclusion of proposals.

Third, and perhaps most significantly, SLB 14J expresses a reversal of the SEC staff's prior position that proposals addressing senior executive or director compensation could not be excluded on the basis of micromanagement under the ordinary business exclusion. Consistent with the micromanagement discussion above, SLB 14J states that going forward the SEC staff may agree that proposals addressing senior executive or director compensation that seek intricate detail or seek to impose specific timeframes or methods for implementing complex policies can be excluded on the basis of micromanagement. Where, precisely, the SEC staff draws the line on micromanagement and senior executive or director compensation only will become clear over time as these arguments develop.

# Consider Providing or Enhancing Disclosures of the Board Evaluation Process

With investors increasingly focused on the performance of boards of directors, boards have come to rely upon an annual evaluation process as an important tool to assess their performance and to identify areas for improvement. In recent years, an increasing number of companies have voluntarily provided disclosures about their board evaluation processes in their annual proxy statements. According to a recent EY survey of proxy disclosures by *Fortune* 100 companies:

- 93 percent included board evaluation disclosures in the most recent proxy statement;
- 40 percent disclosed subjects addressed in their evaluations; and
- 21 percent disclosed measures taken in response to the results of evaluations.[50]

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

> **Board and Committee Evaluations**
>
> Each year, your Board and its Committees perform a rigorous self-evaluation. As required by [the company's] Corporate Governance Guidelines, the Board Nominating and Governance Committee oversees this process. The performance evaluations solicit anonymous input from Directors regarding the performance and effectiveness of the Board, the Board Committees, and individual Directors and provide an opportunity for Directors to identify areas for improvement. In addition, the independent Lead Director has individual conversations with each member of the Board, providing further opportunity for dialogue and improvement. The Board Nominating and Governance Committee reviews the results and feedback from the evaluation process and makes recommendations for improvements as appropriate. The independent Lead Director leads a discussion of the evaluation results during an executive session of the Board and communicates relevant feedback to the CEO. Your Board has successfully used this process to evaluate Board and Committee effectiveness and identify opportunities to strengthen the Board.

[50] EY's survey "Improving Board Performance Through Effective Evaluation" (Oct. 2018) is available here.

**Our Board Evaluation Process**

Each year, our Board conducts a rigorous self-evaluation process, which includes individual director evaluations. This process is overseen by the Nominating and Governance Committee, led by our independent Lead Director and conducted by an outside facilitator with corporate governance experience. The outside facilitator interviews each director to obtain feedback regarding the Board's performance and effectiveness, as well as feedback on each director. This feedback, which is compiled anonymously, helps the Board identify follow-up items and provide feedback to management.

The Board evaluation process includes an assessment of both Board process and substance, including:

- the Board's effectiveness, structure, composition, succession and culture;
- the quality of Board discussions;
- the Board's performance in oversight of business performance, strategy, succession planning, risk management, ethics and compliance and other key areas; and
- agenda topics for future meetings.

The outside facilitator also compiles feedback regarding each individual director, which is provided to each director in individual discussion. The Board believes that this annual evaluation process supports its effectiveness and continuous improvement.

# Consider Best Practices for Virtual Shareholder Meetings

In recent years, an increasing number of companies have embraced the use of virtual annual shareholder meetings. Virtual meetings generally take on two forms: (i) a virtual-only meeting, which refers to a meeting of shareholders that is held exclusively through the use of technology (either online audio or video) without a corresponding in-person meeting component or (ii) a hybrid meeting, which refers to an in-person, or physical, meeting that shareholders are able to attend virtually through an online audio or video format and in which they cast votes online via the internet, if desired. During the 2018 proxy season, companies held 236 virtual meetings, an increase of 26 percent (187) over the prior year, of which 212, or 90 percent, were virtual-only meetings, as compared to 67 percent and 83 percent virtual-only meetings in 2015 and 2016, respectively, according to data from Broadridge Financial Solutions.

## Investor Perspectives

According to the results of the ISS 2017-18 Global Policy Survey, investor respondents generally view the increasing frequency of virtual meetings favorably.[51] Approximately 20 percent of investor respondents indicated that either virtual-only or hybrid meetings were acceptable, whereas only 8 percent indicated neither were acceptable. In addition, 32 percent of investor respondents expressed they would be comfortable with a virtual-only meeting if such meetings provided the same shareholder rights as physical meetings, and among non-investors, 42 percent viewed either virtual-only or hybrid meetings to be acceptable without reservation.

Despite these trends, there has been some notable public opposition to the small but growing contingent of companies electing to conduct virtual-only meetings. For example, beginning in 2017, the New York City Comptroller adopted a change to its proxy voting guidelines to vote against all incumbent directors of a governance committee subject to election at a virtual-only meeting because in-person meetings, according to the New York City Comptroller, provide shareholders the opportunity to engage with senior management and directors face-to-face at least once per year.[52] Similarly, the 2018 corporate governance policy of the Council of Institutional Investors provides that companies should incorporate a virtual component as "a tool for broadening, not limiting" shareholder meeting participation, thus taking the view that virtual meetings should only supplement, not substitute, in-person shareholder meetings, to "facilitate the opportunity for remote attendees to participate in the meeting to the same degree as in-person attendees."[53]

In addition, Glass Lewis' 2019 proxy guidelines indicate that the proxy advisory firm will closely analyze the governance profile of companies that choose to hold virtual-only meetings. Glass Lewis also expects robust disclosures regarding the virtual-only meeting in a company's proxy statement to assure shareholders that they will be afforded the same rights and opportunities to participate as they would at an in-person meeting. Because Glass Lewis believes virtual-only meetings have the "potential to curb the ability of a company's shareholders to meaningfully communicate with the company's management," beginning in 2019, it will generally recommend voting against members of the governance committee of a company planning to hold a virtual-only meeting without providing such disclosure.[54] ISS has not published a policy regarding virtual meetings.

[51] ISS' summary "2017-2018 ISS Global Policy Survey Summary of Results" is available here.

[52] New York City Comptroller's press release "Comptroller Stringer: Virtual Only Meetings Deprive Shareowners of Important Rights, Stifle Criticism" (April 2, 2017) is available here.

[53] Council of Institutional Investors' "Policies on Corporate Governance" (Oct. 24, 2018) are available here.

[54] Glass Lewis' proxy paper, "2019 Guidelines: An Overview of the Glass Lewis Approach to Proxy Advice — United States" (2018) is available here.

## Matters to Consider

In addition to taking into account the important investor perspectives described above, companies considering whether to add virtual components to their annual shareholder meetings should review the 12 best practices recommended by the Best Practices Committee for Shareowner Participation in Virtual Annual Meetings,[55] an industry working group representing retail and institutional investors, public companies and proxy service providers, including the following recommendations:

- ensure all shareholders have equal access by providing technical support and allowing remote participants to test their virtual access prior to participation;
- consider the items to be voted on at the meeting as well as other issues that may be of current concern to shareholders (*e.g.*, routine versus non-routine matters, whether a matter to be considered at the meeting may be subject to a counter-solicitation or a "vote no" campaign);
- establish rules and reasonable time guidelines for shareholder questions and communicate such rules to meeting participants in advance of the meeting; and
- post questions from shareholders received online during the meeting, post the questions and answers on the company's website following the meeting, and archive the meeting webcast for future viewing.

[55] The Best Practices Committee for Shareowner Participation in Virtual Annual Meetings publication "Principles and Best Practices for Virtual Annual Shareowner Meetings" (April 2018) is available here.

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

Long mired in delay, the SEC's work on the remaining Dodd-Frank Act corporate governance and disclosure rulemaking mandates recently has shown at least one sign of life. Specifically, finalizing proposed amendments to the proxy rules that would require companies to disclose whether they permit employees and directors to hedge the company's securities has returned to the near-term list on the SEC rulemaking agenda.[56] Because proxy advisory firms and many institutional investors recently have focused on hedging by insiders, many companies already have made voluntary disclosure of their hedging policies as a matter of good corporate governance. As such, any final rule amendments are unlikely to have a meaningful impact. On the other hand, pay-versus-performance and clawback provisions were not similarly upgraded from the long-term rulemaking agenda, which generally means the SEC does not intend to take action on the proposals in the next 12 months.

Outside of the Dodd-Frank Act mandates, the SEC near-term rulemaking agenda is ambitious. Notable near-term *final* rulemakings include amendments to implement recommendations made in the staff's 2016 Report on Modernization and Simplification of Regulation S-K, a report to Congress mandated by provisions of the Fixing America's Surface Transportation Act (FAST Act).[57] It remains to be seen whether the final rule amendments will go further than the modest proposals that were included in the 2017 proposed rulemaking to implement the FAST Act report but, in any event, any changes will continue the push by the SEC to reduce costs and burdens on public companies while continuing to ensure all material information is provided to investors.

Notable near-term *proposed* rulemakings include:

- Amendments to Regulation A to extend the securities offering safe harbor to all issuers, as mandated by Section 508 of the Economic Growth, Regulatory Relief, and Consumer Protection Act.
- Amendments to permit all issuers, not just emerging growth companies, to use testing-the-waters communications to make oral and written offers to qualified institutional buyers and institutional accredited investors before or after the filing of a registration statement to gauge investors' interest in the offering.
- Amendments to Rule 3-05 of Regulation S-X to ease the disclosure requirements for financial information of acquired businesses.
- Amendments to the "accelerated filer" definition in Exchange Act Rule 12b-2 that would have the effect of reducing the number of registrants that are subject to the Sarbanes-Oxley Act Section 404(b) attestation requirement.

Notable near-term concept releases (a prelude to proposed rulemakings) intend to solicit public comment on:

- The nature and content of quarterly reports and earnings releases issued by reporting companies.[58]
- Amendments to Securities Act rules to harmonize and streamline the SEC's regulation of exempt offerings in order to enhance their clarity and ease of use.
- Amendments to the requirements surrounding quarterly reporting obligations to ease companies' compliance burdens while maintaining appropriate levels of disclosure and investor protection.

[56] See our February 12, 2015, client alert "SEC Proposes New Rules on Hedging Policy Disclosures" available here.

[57] See our April 20, 2016, client alert "SEC Issues Concept Release Seeking Feedback on Business and Financial Disclosure Requirements" available here.

[58] The SEC announced that it would consider whether to issue a request for comment on December 5, 2018.

# Reconsider Company Policies Regarding Social Media Use

In an April 2013 Section 21(a) report of investigation,[59] the SEC made it clear that public companies may use social media, such as Twitter and Facebook, to announce information in compliance with Regulation FD. In issuing that report, the SEC encouraged companies to seek new forms of communication to better connect with shareholders and provided guidance, consistent with its 2008 Interpretive Release,[60] on the use of social media for that purpose, including that companies should sufficiently alert investors and the market to the channels it will use to disseminate material, nonpublic information. As a result, many companies that anticipated using social media to publish material information began identifying in their earnings releases and current and periodic reports specific forms of social media as methods for communicating important information.

As many will recall, in August 2018, the chairman and CEO of Tesla, Inc. tweeted, among other things, that he could take the company private at $420 per share and that funding had been secured. While he and Tesla were both sued by, and settled with, the SEC following these tweets, the SEC implicitly acknowledged in its complaint that the company had laid the groundwork for publishing material information on social media by filing a Form 8-K in November 2013 "stating that it intended to use [the chairman and CEO's] Twitter account as a means of announcing material information to the public about Tesla and its products and services and has encouraged investors to review the information about Tesla published by [him] via his Twitter account." Accordingly, neither the chairman and CEO nor Tesla were sued by the SEC for violations of Regulation FD. Instead, the SEC sued the chairman and CEO primarily for making alleged false and misleading statements and Tesla for alleged insufficient disclosure controls and procedures.

From the perspective of companies that use social media to disseminate material information, we believe that there are two primary takeaways here. First, when determining whether Regulation FD is satisfied, the SEC will continue to consider the steps a company has taken to alert investors to its potential use of social media as a means of communicating company information. Second, companies should ensure that they have appropriate disclosure controls and procedures (*e.g.*, social media policies) in place to review and confirm the accuracy of all communications prior to their dissemination, as well as assess whether such information is required to otherwise be disclosed in their SEC filings.

59 *See* SEC's "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Netflix, Inc., and Reed Hastings" (April 2, 2013), available here.

60 *See* SEC's "Commission Guidance on the Use of Company Web Sites" (Aug. 1, 2008), available here.

# 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 CEOs and CFOs to quarterly certify that such disclosure controls and procedures have been designed to ensure that material information is made known to them and that they have evaluated the effectiveness of the company's disclosure controls and procedures and presented their conclusions. The SEC has not provided specific guidance on how best to establish those controls and procedures. There have been, however, a number of recent SEC enforcement matters involving alleged disclosure violations that we believe companies should consider and determine whether any potential changes in their disclosures controls and procedures are advisable.

In September 2018, the SEC settled two disclosure-related matters. One of those matters was settled with an entertainment company and its CEO,[61] and the other matter was settled with a retail pharmacy company and its CEO and CFO.[62] Each of these matters involved disclosures by companies dealing with extraordinary events. The entertainment company was facing a high-profile publicity campaign against its core business and the pharmacy company was involved in a significant merger transaction. Notwithstanding the unique nature of the facts involved, we believe there are potential lessons to be learned.

In the pharmacy merger case, the key concern alleged by the SEC was that the disclosed combined projections expected as a result of the merger were materially misleading because the company did not update its disclosures when new information was identified that challenged the reliability of the projections. The company, however, publicly affirmed the initial projections. When the revised projections were announced, the company's stock price dropped over 14 percent on the day of announcement.

In the entertainment company case, the key concern alleged by the SEC was that the company's disclosures did not properly address risks to the company's reputation and business. Instead, the SEC alleged that insiders at the company remained silent regarding the potential negative impact to the company's business — even though those insiders were knowledgeable and considered the impact. In a statement about the settlement, the co-director of the SEC's Enforcement Division stated, in part, that "[t]his case underscores the need for a company to provide investors with timely and accurate information that has an adverse impact on its business."

Both of these matters, and the matter involving the technology company described in the section above titled "Consider SEC Cybersecurity Guidance and Enforcement Actions," are important reminders for companies that the SEC believes companies need to remain vigilant about their disclosure obligations. They also serve as an important reminder that, when the SEC believes companies have not satisfied their disclosure obligations, it will take enforcement action. We believe that companies should reassess their disclosure controls and procedures to ensure that they are designed to address, not just the specific SEC line item disclosure requirements, but also to more broadly consider the impact of evolving events on the prior and current disclosures of the company. The company's key risks should be monitored and analyzed by company personnel responsible for SEC disclosure decisions.

[61] The SEC's press release "SeaWorld and Former CEO to Pay More Than $5 Million to Settle Fraud Charges" (Sept. 18, 2018) and related complaints are available here.

[62] The SEC's press release "SEC Charges Walgreens and Two Former Executives With Misleading Investors About Forecasted Earnings Goal" (Sept. 28, 2018) and related order are available here.

## 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

**Richard J. Grossman**
New York
212.735.2116
richard.grossman@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 LaGrange**
Palo Alto
650.470.4575
josh.lagrange@skadden.com

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

**Rachel H. Berlage**
Washington, D.C.
202.371.7319
rachel.berlage@skadden.com

**John C. Hamlett**
Washington, D.C.
202.371.7641
john.hamlett@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

**Neil M. Leff**
New York
212.735.3269
neil.leff@skadden.com

**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



Four Times Square / New York, NY 10036 / 212.735.3000