Preparation for 2018 Fiscal Year-End SEC Filings and 2019 Annual Shareholder Meetings

Securities & Capital Markets Practice

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As our clients and friends know, each year Mintz provides an analysis of the regulatory developments that impact public companies as they prepare for their fiscal year-end filings with the Securities and Exchange Commission (the "SEC") and their annual shareholder meetings. This memorandum discusses key considerations to keep in mind as you embark upon the year-end reporting process in 2019.

This year the SEC adopted several new rules that public companies should consider as they prepare their year-end reports and filings, including a requirement for disclosure of company hedging policies, a broadened definition of "smaller reporting company," and disclosure simplification amendments affecting Form 10-K. The Internal Revenue Service also published guidance on interpretive issues arising out of the 2017 Tax Cut and Jobs Act's changes to Section 162(m). In addition to summarizing those changes, we address below several other significant developments and considerations companies should focus on this year and provide an update on the policies and practices of the major proxy advisory firms.

SEC Adopts Final Rule on Disclosure of Hedging Policies

On December 18, 2018, the SEC approved final rules requiring registrants to disclose practices or policies regarding the ability of employees or directors to engage in certain hedging transactions. These long-awaited rules implement the requirement of Section 955 of the Dodd-Frank Act as originally enacted in 2015 by adding a new Item 407(i) to Regulation S-K.

All U.S. companies filing Exchange Act reports will be subject to the new disclosure requirement, which is first applicable for proxy statements covering the election of directors during fiscal years beginning on or after July 1, 2019. For calendar year companies, the disclosure is required to be included in the proxy statement filed in 2020. The rules are equally applicable to smaller reporting companies and emerging growth companies; however, those companies will have an additional year to comply. The rules do not apply to foreign private issuers or listed closed-end funds.

The Required Disclosure. New Regulation S-K Item 407(i) requires the company to describe any practices or policies it has adopted regarding the ability of its employees (including officers) or directors to purchase securities or other financial instruments, or otherwise engage in transactions, that hedge or offset, or are designed to hedge or offset, any decrease in the market value of equity securities granted as compensation, or held directly or indirectly by the employee or director. Companies may either disclose the practices or policies in full or provide summary disclosure, including a description of the categories of persons the policy covers and any categories of hedging transactions specifically permitted or disallowed. Companies without hedging practices or policies are required to disclose that fact or state that hedging transactions

We invite you to review our memorandum from last year, which analyzed regulatory changes that were new for fiscal year 2018, and we would be happy to provide you with another copy upon request. We also thank Cynthia Larose, Bret Leone-Quick, and Heidi Pemberton for their contributions to this memorandum.

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are generally permitted. Equity securities for which disclosure is required are those of the company, any parent or subsidiary or sister company. New Item 404(i) requires disclosure in proxy statements where action is to be taken on the election of directors. The disclosure is not required in the Part III disclosure of Form 10-K (even if the disclosure is being incorporated by reference from the proxy statement).

Relationship to CD&A Disclosure. Item 402(b)(2)(xiii) of Regulation S-K already requires companies to disclose in their Compensation Discussion and Analysis ("CD&A") any policies regarding hedging the economic risk of share ownership. The new rules do not eliminate this requirement, but an additional instruction has been added to Item 402(b) that allows companies to avoid duplicative disclosure in their proxy statements by a cross-reference to the hedging disclosure required by Item 407(i). Consequently, companies will have flexibility either to include the Item 407(i) hedging policy disclosure and Item 402(b)(2)(xiii) disclosure separately or incorporate the Item 407(i) disclosure into the CD&A, either by directly including the information or by providing the information outside of the CD&A and adding a cross-reference within the CD&A.

Considerations for 2019 Proxy Disclosure. Many companies already disclose their hedging policies on a voluntary basis, and the new disclosure requirements are not a significant departure from what had been expected to be covered by the SEC's rules. Although the rules do not require disclosure in this year's proxy statements, companies without hedging policies should consider adopting a policy now and deciding whether to include the relevant disclosure in this year's proxy statement. In considering whether to adopt a policy relating to hedging practices, it may be worth considering that under Institutional Shareholder Services ("ISS") policy, a company that allows its executive officers or directors to hedge company stock or pledge a significant portion of company stock may receive an "against" or "withhold" vote for directors individually, committee members, or the entire board of directors. ISS has not established a bright-line test for what constitutes "significant" pledging, but it has indicated that a determination of whether pledging is significant will be based primarily on the number of shares pledged as a percentage of the number of shares outstanding, market value and trading volume in the company's stock as well as the company's current views on future pledging arrangements.[1] ISS views both hedging and pledging as adverse to shareholder interests because, in their view, these practices sever the alignment of directors' and executive officers' interests with shareholders by reducing the director's or officer's economic exposure to company stock while maintaining their voting rights. ISS also believes that pledging, which often occurs in connection with a margin loan, can have a detrimental effect on a company's stock price in the event of a margin call, particularly if any forced sales after a margin call could also violate a company's insider trading policies. Therefore, if a company does allow hedging and pledging of company stock, and a pledge of securities is described in the company's beneficial ownership table, the company should be sure to address its policies on this practice in the CD&A section of its proxy statement.

SEC Amends Definition of Smaller Reporting Company

On June 28, 2018, the SEC amended the definition of "smaller reporting company" to expand the number of companies eligible for scaled disclosure requirements. The amendments, which took effect on September 10, 2018, did not change the scope of the disclosure required of smaller reporting companies. As under the prior rule, smaller reporting company status is unavailable to (i) a company that is a majority-owned subsidiary of a parent that is not a smaller reporting company, (ii) investment companies and (iii) asset-backed issuers.

Updated Tests. A company may qualify as a smaller reporting company under one of two updated tests:

- **Public float test.** A company must have less than $250 million in public float (under the old rule this threshold was less than $75 million) tested on the last business day of its most recently completed second fiscal quarter for fiscal years ending after September 10, 2018 (for companies with calendar fiscal years, this means June 29, 2018). If applicable, a qualifying company may begin applying the scaled disclosure requirements in all filings subsequent to its determination.

- **Revenue test.** A company with no public float or a public float of less than $700 million will qualify if it has annual revenues totaling less than $100 million (under the previous rule, the requirement had been less than $50 million) measured as of the most recently completed fiscal year before the last business day of the second fiscal quarter.

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Special Rules for Companies not Initially Qualifying Under New Rules. Once a company has determined that it does not qualify as a smaller reporting company under either test, it will remain unqualified until it can make a subsequent annual determination that it (i) falls below a threshold that is 80% of the applicable initial threshold for the criteria on which it previously failed to qualify and (ii) continues to meet any other threshold it previously satisfied.

Impact of New Rules on Accelerated Filer Status. The new rules amend the definitions of "accelerated filer" and "large accelerated filer" to eliminate the exclusion of smaller reporting companies from those definitions to reflect that the standard for determining non-accelerated filer status continues to be $75 million of public float. This change will result in some smaller reporting companies also qualifying as accelerated filers and becoming subject to the related compliance obligations, including earlier filing deadlines and the Section 404(b) auditor attestation requirement. However, SEC Chairman Jay Clayton has directed his staff to make recommendations for possible changes to the accelerated filer definition.

Technical Changes to Form 10-K and Disclosure Simplification

Several technical rule changes and disclosure simplification amendments became effective in 2018 that will affect upcoming Form 10-K filings for all public companies.

Technical Changes. Changes have been made to the Form 10-K cover page, as follows:

> 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
>
> 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 ☐ Smaller reporting company ☐ Emerging growth company
>
> ~~(Do not check if a smaller reporting company)~~

Disclosure Simplification. In order to eliminate requirements that had become duplicative, overlapping, or outdated as a result of amendments to other SEC disclosure requirements, changes to U.S. GAAP or changes in the information technology market, the SEC adopted a number of technical amendments to simplify disclosure. Companies are no longer required to disclose the following in the Description of Business and Market Price and Dividend Information sections of their Form 10-Ks:

- segment level financial information and financial information by geographic area, as such information already should be included in the financial statements and in the Management Discussion and Analysis section when appropriate;
- segment level geographical information, including risks of foreign operation and dependence of any segment on foreign operations;
- amount spent on research and development activities for all years presented;
- high and low trading prices for common equity as traded on a public trading market, but companies now must disclose the trading symbol for common equity traded on a public market when identifying those markets;
- reference to the SEC's Public Reference Room (replaced with the requirement that companies now must disclose their websites);
- frequency and amount of any cash dividends for its two most recent fiscal years and any subsequent interim period; and
- restrictions on the ability to pay dividends as such information should be included in the financial statements.

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IRS Publishes Guidance on Issues under Revised Section 162(m)

On August 21, 2018, the Internal Revenue Service published guidance (Notice 2018-68) on several significant interpretative issues under Section 162(m). The Notice focuses on uncertainties under the new rules with respect to two significant issues: (1) how to identify "covered employees" and (2) the operation of the grandfather rule for "written binding contracts in effect on November 2, 2017."

Covered Employees Subject to Section 162(m). As a result of the 2017 Tax Cut and Jobs Act, Section 162(m), as amended, defines a "covered employee" to include any employee of a publicly held company who: (1) is or was the principal executive officer (CEO) or principal financial officer (CFO) of the company during the taxable year; (2) is one of the three most highly compensated executive officers during the taxable year other than the CEO and CFO; or (3) was a covered employee of the company (or any predecessor) in any taxable year after 2016 (including years in which the company was not publicly held).

The Notice clarifies the definition of "covered employee" and in doing so confirms two ways in which the 162(m) definition differs from a company's identified "named executive officers" for purposes of executive compensation disclosure. First, the Notice confirms that a "covered employee" for a taxable year is any employee (or former employee) who has met the above definition at any time during the year (or any year after 2016). This guidance clarifies that the amendments to Section 162(m) do not impose an end-of-year employment requirement in determining the group of covered employees. Consequently, the Section 162(m) covered employee group will not necessarily match the group of executive officers whose compensation is required to be disclosed for the company's last completed fiscal year pursuant to SEC rules. For example, under SEC rules, the "named executive officer" group might not be required to include former executives who were no longer serving at year-end, depending on the amount of compensation received. Further, the group of covered employees for purposes of Section 162(m) deviates from the group of "named executive officers" under SEC rules in that the list of covered employees will be expanded for companies reporting fewer than five executives on an annual basis. In particular, SEC rules for smaller reporting companies and emerging growth companies may allow them to only report compensation for up to three named executive officers. Nevertheless, for purposes of Section 162(m) these companies will still have five covered employees for the year if they have five executive officers employed during the year.

Grandfathering of Prior Agreements. The Notice also provides guidance on how a plan or agreement can be grandfathered under amended Section 162(m). The Tax Act provides that a written binding contract in effect on November 2, 2017 is grandfathered from new Section 162(m), unless and until it is materially modified or renewed. The Notice provides some clarification about the applicability of the binding written contract exception, and confirms the following points:

- Compensation is treated as payable under a binding written contract if the company is obligated under applicable law (e.g., state law) to pay the compensation if the employee performs services or satisfies applicable vesting conditions.
- Any plan or contract amounts that are subject to discretionary reduction (e.g., bonus plans or long-term incentive plan awards) after November 2, 2017 do not qualify for grandfathering even if the company chooses not to exercise its discretion.
- The binding written contract exemption expires when a contract is renewed after November 2, 2017. A contract whose term automatically renews if neither party gives notice of non-renewal loses grandfathered status on the date that the agreement would have expired had such notice been given. Similarly, if a contract provides that it will terminate as of a certain date unless either the company or the employee elects to renew, the contract will be treated as renewed as of that date and no longer subject to the binding written contract exception.
- A change to a binding written contract is treated as a material modification if the contract is amended to increase amounts payable to the employee. There is an exemption if the additional amount is less than or equal to a reasonable cost-of-living increase (although the additional amount itself is not grandfathered).
- It is also a material modification to amend a contract to accelerate the payment of compensation (unless the accelerated amount is discounted to reasonably reflect the time value of money) or defer the payment of compensation (except any amount that was originally payable to the employee under the contract or any excess amount that is based on either a reasonable interest rate or a predetermined investment reference).

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- Only equity awards actually granted before November 2, 2017 (assuming they qualified as performance-based compensation or were granted to the company's CFO) are grandfathered. Equity awards anticipated or promised but still subject to board or compensation committee approval as of November 2, 2017 do not constitute binding written contracts under the grandfathering rules.

The amendments to Section 162(m) apply to taxable years beginning on or after January 1, 2018, and the guidance contained in the Notice applies to any taxable year ending on or after September 10, 2018 (i.e., the Notice applies to 2018 compensation for companies with a December 31, 2018 tax year-end).

Additional 2019 Considerations and Developments

Say-on-Frequency: Consider Need for Another Shareholder Vote. For companies that held their first say-on-pay vote pursuant to the Dodd-Frank Act six years ago, it is now time to revisit the say-on-frequency vote. Companies that first held a say-on-frequency vote at their 2013 annual meeting are required to again include a non-binding resolution in their proxy statements to ask shareholders how often they want to conduct say-on-pay votes for the next six years: once a year, once every two years, or once every three years. The trend toward annual say-on-pay voting is continuing and accelerating. In the 2017 proxy season, 94% of the 460 S&P 500 companies that held say-on-frequency votes voted in favor of an annual vote on frequency.[2] ISS believes that holding a say-on-pay vote every year enables the vote to correspond to the majority of the information presented in the accompanying proxy statement, and allows investors to comment on issues in annual incentive programs in a more timely fashion.

Companies that are required to conduct their say-on-frequency vote this year must remember to report, under Item 5.07 of Form 8-K, the company's determination as to how frequently it will hold the say-on-pay vote in the Form 8-K required to be filed within four business days of the shareholder meeting (or by amendment to that Form 8-K filed no later than 150 calendar days after the date of the shareholder meeting at which the say-on-frequency vote was taken), but in no event later than 60 days prior to the deadline for the submission of shareholder proposals under Rule 14a-8 of the Exchange Act for the subsequent annual meeting.

Update on Director Compensation. Last year, we highlighted how the Delaware Supreme Court, in *In re: Investors Bancorp, Inc. Stockholder Litigation*, held that when directors award compensation to themselves pursuant to a discretionary plan, those awards will be subject to the strict "entire fairness" standard of review, even where stockholders ratified the plan. This stricter standard with respect to discretionary compensation opens the door for opportunistic plaintiffs, but since the original decision, there have not been any notable decisions concerning stockholder challenges to discretionary director compensation plans. Nonetheless, boards should tread carefully when structuring and approving a discretionary plan.

Cybersecurity Risk Disclosure: Data Protection and Privacy Legislation. In the wake of many well-publicized cybersecurity breaches, cybersecurity disclosure is increasingly the focus of both shareholders and the SEC. Shareholders are calling for proactive management and transparency in cybersecurity risk mitigation. The SEC is also focused on cybersecurity risk disclosure. In February 2018, the SEC issued interpretive guidance on public company disclosure obligations regarding cybersecurity risk and incidents. Companies should carefully consider whether to include or augment disclosure of company-specific cybersecurity risks and the capacity to respond to those risks in their Form 10-K. The 2018 guidance carries more weight than the 2011 guidance issued by the SEC's Division of Corporation Finance, because it was issued by the SEC itself. It expands on the 2011 guidance by:

- stressing the importance of maintaining "comprehensive policies and procedures related to cybersecurity risks and incidents," in particular as incorporated into a company's disclosure controls and procedures;
- reminding companies and their directors, officers, and other corporate insiders of the laws and rules relating to insider trading and selective disclosure; and
- expanding the existing disclosure guidance to address how the board of directors oversees the management of cybersecurity risk, as well as management's discussion and analysis of how cybersecurity incidents affected reportable segments.

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The 2018 guidance reinforces prior guidance by reminding companies that the SEC's disclosure requirements apply to cybersecurity risks and incidents that could have a material impact on the company including: (i) risk factors; (ii) management's discussion and analysis of financial condition and results of operations; (iii) business description; and (iv) legal proceedings, and financial statement disclosures. The SEC expects companies to disclose material cybersecurity risks and incidents that are material to investors, including the financial, legal, or reputational consequences.

Companies should be aware of the increasing amount of data protection and privacy legislation in the jurisdictions in which they do business and the potential risks of noncompliance. Last May, the European Union's General Data Protection Regulation went into effect and has compliance costs and the potential for large fines and penalties. The California Consumer Privacy Act of 2018 (the "CCPA") is the most broad-reaching privacy legislation enacted in the U.S. and will impose new rules governing how businesses handle personal data of California residents (not just "consumers"). Companies that do business in California will be required to disclose the types of data they collect, the purpose for the data collection, how the data will be used, as well as expand organizational responsibilities pertaining to individual rights, accountability, and governance. The CCPA also includes a private right of action and steep fines for noncompliance.

Caution when using Non-GAAP Financial Measures. The SEC has renewed its focus on compliance with its rules regarding the use of non-GAAP financial measures. Under Regulation G, companies must include a reconciliation of the differences between each non-GAAP financial measure presented in public disclosure with the most directly comparable financial measurement presented in accordance with GAAP. Management also must disclose why it believes the non-GAAP measures provide useful information to investors about the company's financial condition and results of operations. Many proxy statements now include several non-GAAP financial measures relating to company performance. If non-GAAP financial measures are presented in the proxy statement for any purpose other than disclosure of target levels relating to compensation, such as to explain the relationship between pay and performance or to justify certain levels or amounts of pay, then those non-GAAP financial measures are subject to the requirements of Regulation G and Item 10(e) of Regulation S-K. However, in these pay-related circumstances only, the SEC allows a company to include the required GAAP reconciliation and other information in an annex to the proxy statement, provided the proxy statement includes a prominent cross-reference to such annex or, if the non-GAAP financial measures are the same as those included in the Form 10-K that incorporates by reference the proxy statement's Item 402 disclosure as part of its Part III information, by providing a prominent cross-reference to the pages in the Form 10-K containing the required GAAP reconciliation and other information.

In December 2018, the SEC announced that it had settled charges against ADT Inc. for having given disproportionate emphasis to the company's EBITDA, a non-GAAP financial measure, in two earnings releases. If companies do elect to include non-GAAP financial measures in proxy statements or other public disclosures, caution is warranted in light of the SEC's focus on this topic.

"Pay Ratio" Disclosure Rules Remain in Effect. The CEO pay ratio disclosure required by the Dodd-Frank Act and implemented through Item 402(u) of Regulation S-K became effective in time for last year's proxy season. All public companies are subject to this disclosure requirement, with the exception of emerging growth companies, smaller reporting companies and foreign private issuers, and most affected companies have now calculated and disclosed their first CEO pay ratio.

Assuming investors and employees raised no significant issues related to the pay ratio disclosure last year, the key issue for this year will be determining whether last year's median employee should be used again for this year's calculation. While there is no restriction on identifying a new median employee each year, the rules permit the median employee selected last year to be used for up to two additional years. However, in order to use the same median employee, companies, must reasonably believe that there have been no changes to the company's employee population or compensation arrangements that would result in a "significant change" to the pay ratio disclosure. Companies should consider the following factors in making that determination:

- **Change in company's overall employee mix.** One consideration in determining the appropriateness of continuing to use the prior year's median employee will be whether the company's overall employee mix has significantly changed, perhaps because of a shift in the business or as a result of

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acquisitions or divestitures. A significant change in the number of employees in different job categories or salary grades could impact the determination. Note, however, that the pay ratio rules allow exclusion of new employees resulting from business combinations or acquisitions in the year of the transaction, provided the disclosure identifies the acquired company and the number of employees excluded.

- **Foreign employee eligibility for exclusion.** Confirming that employees from a foreign jurisdiction who were excluded in last year's calculation will still be excludable under the rule's 5% de minimis test (allowing companies to exclude employees from a country where that country's employees represent less than 5% of total employees) will be another factor in the determination.

- **Relative median employee compensation.** Companies should confirm that the median employee's compensation has not changed in ways that are significantly different from changes to the pay of the general employee population. If the median employee's pay has increased or decreased by an amount significantly greater than the general level of change in employee pay, it may be appropriate to choose a new median employee.

Limited disclosure is required if a company determines that using the same median employee is warranted. The rule provides that if there have been no changes that the company reasonably believes would significantly affect its pay ratio disclosure, the company should disclose that it is continuing to use the same median employee in its pay ratio disclosure and briefly describe the basis for its reasonable belief.

Consider the Possibility of a "Virtual" Shareholder Meeting. Many of our clients have expressed interest in conducting their annual shareholder meetings as "virtual" meetings, in which shareholders are not physically present and the meeting is conducted solely by the company in a conference room at the company's office, with participation by shareholders via webcast or conference call. The vast majority of shareholders do not elect to attend meetings in person even when given the opportunity to do so, yet companies spend significant time and resources every year to reserve rooms at conference centers or hotels in anticipation of potential attendance. Making the shareholder meeting accessible by webcast may result in higher participation by shareholders if they can take part simply by logging in to their computers. However, a virtual meeting also eliminates the possibility for face-to-face interaction between shareholders and management. Proxy advisor Glass Lewis & Co. ("Glass Lewis") may recommend voting against members of the nominating committee under a policy effective in 2019 if a company does not provide robust proxy statement disclosure assuring shareholders that they will have the same rights and opportunities to participate that they would at an in-person meeting, including the ability to ask questions during the meeting, procedures for posting questions received during the meeting, and procedures for accessing technical support during the meeting. In addition, the company's charter or bylaws generally contain rules or restrictions on the conduct of shareholder meetings, which may include a requirement that a meeting be held at a particular physical location. Companies should consider these benefits and drawbacks of proceeding with a virtual meeting.

2018 Securities Litigation, Enforcement Actions, and Court Decisions Impacting Corporate Disclosures and Governance. The following is a summary of some of the key securities litigation, enforcement actions, and other court decisions from 2018 that implicate and expound on issues of corporate disclosures and governance.

- **Whistleblowers.** The Supreme Court struck another blow to efforts by companies to ensure that complaints or concerns about compliance with the federal securities laws are first raised internally rather than having employees go directly to the SEC with their complaints. In *Dig. Realty Trust, Inc. v. Somers*, the Supreme Court held that a whistleblower is ineligible to receive the anti-retaliation protections of Dodd-Frank unless he or she provides information to the SEC prior to the alleged retaliation. This provides a powerful incentive for employees to bring their complaints to the SEC prior to raising them internally (if at all). In light of this decision, and in light of the now staggering amounts whistleblowers have been receiving from the SEC (in March 2018 the SEC awarded $50 million to be shared by two individuals, and paid another $33 million to a single individual), companies will continue to face a heightened risk of whistleblower activity.

- **Cybersecurity.** In April 2018, the SEC brought its first enforcement action against a company for its failure to properly disclose a cybersecurity breach. The action was brought against Altaba (formerly

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known as Yahoo!), and the SEC imposed a $35 million civil penalty on Altaba as part of the settlement of the matter. The enforcement division noted that it would continue to credit good faith determinations by companies about whether to disclose a cybersecurity breach, but that "a company's response to such an event could be so lacking that an enforcement action would be warranted." The action was also premised on the facts that the company did not have proper controls or procedures in place to evaluate cybersecurity incidents, and did not share information about the breach to its auditors or outside counsel in order to assess its disclosure obligations.

- **When Can the Disclosure of an Opinion Be Actionable?** The Supreme Court's decision in *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, provided some guidance as to when statements of opinion by companies can be considered misleading under the federal securities laws. But in Omnicare's aftermath, the lower courts continue to grapple with the issue of when disclosures of opinions can be actionable in a securities fraud suit – sometimes reaching opposite conclusions in cases with similar facts. The unpredictability with which the federal courts are applying Omnicare is leaving the door open for plaintiffs to continue to base Section 10(b) suits on expressions of opinion, and companies should continue to carefully scrutinize any such disclosures of opinion, and not assume that such statements will receive more deference from the courts.

- **SEC Enforcement Proceedings: A New Tool for Setting Corporate Governance Standards?** The SEC Enforcement Division is jumping into the corporate governance arena. Two high-profile settlements in 2018 were notable for the fact that each of them included mandated changes to the company's corporate governance and structure. In the SEC's settlement with Elon Musk and Tesla, the SEC required that (a) Musk step down as chairman in favor of an independent chairman, (b) Tesla appoint two new independent directors to its board, and (c) Tesla establish a committee of independent directors to oversee new controls and procedures concerning Musk's communications. In the SEC's settlement with Theranos (a private company) and its founder Elizabeth Holmes, the SEC required several structural changes to Theranos' ownership, including Holmes relinquishing her voting control in the company, and ensuring that if Theranos is acquired or liquidated, Holmes would not be able to earn any profit on her ownership until $750 million is first returned to the defrauded shareholders. It appears that this may be the start of a trend where the SEC, in its own words, increasingly looks "to the wide range of other tools at our disposal, whenever possible, to supplement financial remedies by tailoring specific relief that best addresses the underlying charged conduct."

Board Gender Diversity in the Spotlight. The corporate governance community's focus on the need for increased female representation on public company boards intensified in 2018.

- **Institutional investor pressure mounts.** Institutional investors continued to use their leverage to pressure larger public companies to increase female representation on their boards in 2018.
  - BlackRock, the world's largest asset manager, announced its expectation that each of its portfolio companies will have at least two female board members and its intention to vote against nominating committee members who are responsible for failure to increase board diversity without a credible explanation for any lack of progress.
  - State Street Global Advisors, the world's third-largest asset manager, committed to voting against the entire nominating committee of portfolio companies with all-male boards beginning in 2020 if the companies have not engaged in successful dialogue with State Street's board diversity program for three consecutive years. This new commitment expands State Street's earlier commitment to vote against the chairs of these companies' nominating committees.
  - The New York City Comptroller and the New York City Pension Funds announced successful engagement with more than half of 151 major U.S. public companies targeted in their Boardroom Accountability Project 2.0 on issues of board gender diversity.
  - CalPERS, a $330 billion pension fund, sent more than 500 letters to companies without female board representation, requesting the development and disclosure of a corporate and board diversity policy and implementation plan.

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While the focus up until now has been primarily on large cap companies, investors are likely to focus on smaller public companies as gender diverse boards at larger companies become the norm.

- **New proxy advisory guidelines on gender diversity.** Proxy advisory firms ISS and Glass Lewis issued policy updates for 2019 that focus on gender diversity. Under its new policy guidelines, ISS will issue negative recommendations for nominating committee chairs at companies in either the Russell 3000 or S&P 1500 indices with all-male boards beginning on February 1, 2020 and may also recommend against voting for other directors who are responsible for the board nomination process on a case-by-case basis. Glass Lewis will begin recommending votes against nominating committee chairs of boards without female representation beginning on January 1, 2019, almost a year earlier than ISS. After taking into consideration other factors, such as company size, industry, state where headquartered, and governance profile, Glass Lewis may also recommend a vote against other nominating committee members at these companies. In making these recommendations, Glass Lewis will consider a board's disclosure of its diversity considerations and may refrain from a negative recommendation against directors of companies that are either outside of the Russell 3000 index or that have given a sufficient rationale for having an all-male board (e.g., a disclosed timetable for addressing the lack of diversity and any notable restrictions preventing the board from altering its board composition such as director nomination agreements with significant investors).

- **State gender quotas for corporate boards.** In September 2018, California became the first state to mandate gender diversity on public company boards. California's new law, *SB 826*, will be implemented in two steps: first, any public company headquartered in California, whether or not incorporated there, will be required to have at least one woman on its board by the end of 2019, and second, public company boards with five members will be required to have at least two female directors and public company boards with six or more members will be required to have at least three female directors, in each case by the end of 2020. Noncompliance with these standards could result in fines of $100,000 for a first violation and $300,000 for a second or subsequent violation. The constitutionality of the new law has been called into question by some observers because it purports to govern the relationship among companies not incorporated in California and their directors, and as such may be challenged in the coming year. However, companies that may become subject to this new law should give thought to recruitment of additional female directors with adequate time to comply in the event that the law is not overturned before the compliance deadlines. Both New Jersey and Massachusetts recently introduced bills based on the California law.

Say-on-Pay Considerations. As in past years, shareholder support of say-on-pay resolutions in the 2018 proxy season continued to average above 90% across all companies. Say-on-pay continues to be perceived as a year-to-year item, in which success in past years is no guarantee of success in the current or future years, and companies should not become complacent about achieving the necessary support, even if they have enjoyed strong support in prior years. The advent of say-on-pay continues to cause companies to reevaluate their compensation-related disclosures in their proxy statements, in particular, the CD&A, with both advocacy and disclosure in mind. In addition, issuer engagement with institutional shareholders has become an integral part of the say-on-pay process, with many companies reaching out to their largest shareholders in the months following the annual meeting to discuss pay practices.

We continue to see a trend of companies including an executive summary at the beginning of the proxy statement in an effort to highlight key messages, clearly define the company's views on pay for performance, and ensure the company has a reasonable narrative to support its decisions for last year's pay. A trend of disclosing "realized" or "realizable pay" has also continued to assist shareholders in understanding the executive compensation value actually transferred during a fiscal year and ISS' standard research report now generally shows three-year realizable pay compared to the three-year granted pay for S&P 1500 companies. ISS will discuss realizable pay in its report when its quantitative analysis results in a "high or medium" concern that a company's compensation policies are not linked to overall corporate performance and will also look at realized and/or realizable pay at smaller companies to assist it in determining whether the company demonstrates a strong commitment to a pay-for-performance philosophy.

In assessing executive compensation, boards of directors should continue to bear in mind that their ultimate goal is not to secure a successful say-on-pay vote, but rather to attract, retain, and incentivize executives

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who will contribute to the long-term value of the company. Directors should understand the executive compensation guidelines that ISS and similar groups promote, but should not allow this to override their own judgments as to the compensation programs and policies that are best for their companies. Directors should participate with management in soliciting favorable say-on-pay votes from major shareholders in order to overcome a negative recommendation by ISS.[3]

Class action lawsuits alleging that boards of directors breached their fiduciary duties by approving purportedly deficient proxy statement disclosure and claiming that shareholders need more information in order to cast an informed vote typically with respect to equity compensation plan approvals have continued but have not had much success in the courts. Plaintiffs typically bring these cases in state court and seek an injunction against the upcoming annual meeting until sufficient disclosure is provided in the proxy statement in order for shareholders to make an informed decision. The threat of an enjoined annual meeting has pushed many of these companies that have been sued into providing additional disclosures, thereby justifying a fee award to plaintiff's counsel. In many cases suits are never even filed, as before filing a complaint plaintiff's counsel will send a demand letter to the company based on what it believes is misleading or omitted information in a proxy statement and at the same time post on its webpage that it is looking for plaintiffs. Many of these demand letters target smaller companies that do not spend their resources on expansive proxy disclosure. Unfortunately, many of these companies still end up paying a fee to plaintiff's counsel to prevent litigation from being filed and spend additional time and resources filing proxy supplements in response to plaintiffs' demands.

Therefore, companies with a low or negative say-on-pay vote and companies seeking authorization for new or additional shares to be issued pursuant to equity incentive plans should take a careful look at their disclosure to ensure that it complies with proxy statement disclosure requirements as well as consider enhanced disclosures to reduce the possibility of litigation.

Proxy Advisory Voting Guidance Update

Proxy advisory firms ISS[4] and Glass Lewis[5] issued updated proxy governance and compensation policies for 2019. Following are some of the most noteworthy updates to their executive compensation and corporate governance policies instituted this year in addition to those discussed above:

Governance Updates

- **Environmental and social issues.** Both ISS and Glass Lewis updated their guidance on their review of social and environmental issues in corporate governance. ISS added the presence of significant controversies, fines, penalties, or litigation associated with a company's environmental and social practices as a new factor it will consider when making a determination as to whether an environmental or social shareholder proposal is likely to enhance or protect shareholder value. Glass Lewis codified its policy for reviewing board environmental and social risk oversight. "Material" oversight issues will trigger a review of the company's overall governance policies and those directors charged with oversight of the relevant risks and may result in a recommendation to vote against directors responsible for environmental and social matters if any mismanagement of such risks decreases or threatens to decrease shareholder value. Glass Lewis has not specified what constitutes a "material oversight issue" that will trigger review.
- **Director attendance.** ISS introduced a policy that codified its approach to directors with a pattern of absenteeism: ISS will generally recommend a vote against directors with "chronic poor attendance" defined as three or more consecutive years of poor attendance (attending less than 75% of board and committee meetings) without reasonable explanation. Nominating committee members who continue to nominate directors with poor attendance will also be impacted by this policy: when a director has a record of poor attendance over
  - a three-year period, ISS will recommend shareholders withhold their votes from the chair of the nominating or other responsible committee;
  - a four-year period, ISS will recommend shareholders withhold their votes from the entire nominating committee; or
  - a five-year period, ISS will recommend shareholders withhold their votes from all proposed nominees.

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- **Management ratification proposals**. ISS introduced a new policy intended to discourage management from using board-sponsored proposals to defeat shareholder proposals seeking more favorable shareholder rights.

  Under the new ISS policy, which is similar to Glass Lewis' policy on conflicting and excluded shareholder proposals, if management introduces a proposal seeking ratification of existing charter or bylaw provisions as an alternative to or instead of a more liberal shareholder proposal, ISS may recommend an "against" or "withhold" vote for directors individually, nominating committee members, or the entire board of directors. ISS will generally recommend voting against a proposal to ratify the company's existing charter or bylaws unless the management proposal is aligned with best practice and may recommend a vote "against" or "withhold" from directors, nominating committee members, or the full board. In making these determinations, ISS will consider factors including: the board's rationale for seeking ratification of existing provisions; board engagement with shareholders on the issues presented; whether the shareholder proposal was put forward in response to a conflicting shareholder proposal; and the past use of ratification to defeat shareholder proposals. In its similar policy, Glass Lewis has specified that when the subject of conflicting management and shareholder proposals relates to the right of shareholders to call a special meeting, Glass Lewis will generally recommend a vote for the lower threshold.

Compensation Updates.[6]

- **Smaller reporting companies disclosure of compensation.** Companies qualifying as smaller reporting companies under the SEC's amended definition may need to consider whether they should take full advantage of scaled disclosure because of new positions taken by ISS and Glass Lewis. Following the SEC's amendments, both firms advised that because completeness of disclosure is an important factor in evaluating pay for performance, some smaller reporting companies should consider providing CD&A in their proxy statements to adequately disclose compensation programs to investors and to avoid possible negative say-on-pay recommendations. Glass Lewis may also make a negative recommendation against compensation committee members if a reduction in disclosure substantially impacts shareholders' ability to make an informed assessment of executive pay practices.

- **Pay-for-performance.** ISS made no changes to its quantitative screens for 2019, and its Financial Performance Assessment Screen will continue to apply GAAP measures. ISS will be including various Economic Value Added ("EVA") metrics in its 2019 reports for informational purposes rather than as a replacement for GAAP financial metrics in its quantitative pay-for-performance screening. ISS' purchase of an EVA measurement firm early last year underscores its increased focus on EVA metrics as an important measure of and framework for evaluating performance.

- **Front-loaded awards.** Glass Lewis expressed concern that large up-front multiple year awards may limit a compensation committee's ability to effectively use awards to respond to changes in business strategy. They will look for firm commitments against grants of additional awards during the period covered by the front-loaded award and may make a negative recommendation against a company's compensation program if the company fails to abide by such a commitment.

- **Clawbacks.** Glass Lewis believes that boards should adopt detailed bonus recoupment policies that go beyond the requirements of Section 304 of the Sarbanes-Oxley Act even though the SEC has not yet finalized rules to implement the more stringent requirements of Section 954 of the Dodd-Frank Act. Glass Lewis believes that the terms of clawbacks should, at minimum, provide for recoupment in the event of a restatement of financial results or revision of performance indicators used to calculate bonuses. Failure of a clawback to meet this minimum standard may influence Glass Lewis' overall view of a company's compensation program.

- **Excessive non-employee director compensation policy delayed.** ISS introduced a policy in 2018 providing for negative recommendations against members of the compensation committee or other directors responsible for non-employee executive compensation if ISS finds a pattern of excessive non-employee director ("NED") compensation (top 2 to 3% of all comparable directors) in two or more years without disclosing a compelling rationale or other clearly explained mitigating factors. To identify these outliers, ISS will compare individual NED compensation totals within the

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same index and sector (the same two-digit CIGS group and within the same index grouping (i.e., S&P 500, combined S&P 400 and S&P 600, remainder of the Russell 300 Index and the Russell 300-Extended)). Under the updated methodology ISS also will compare NEDs who serve in board leadership positions to other directors serving in the same category of leadership position (still considering index and sector). Because of the delay in policy clarification, ISS will not be issuing negative recommendations under this policy in the 2019 proxy season.

ISS Scorecard Updates. ISS continues to use its equity plan scorecard (the "Scorecard") to determine whether it supports equity compensation plan proposals. ISS published several changes to the Scorecard at the end of 2018 as well as new Burn Rate Tables:

- **Change in control vesting factor updated.** The change in control vesting factor under ISS' "Plan Features" pillar has been updated to award points based on the quality of the related disclosure rather than on the vesting terms of the award. Full credit will now only be given for this factor if the plan specifically discloses the vesting treatment for both time and performance-based awards. Plans that are silent on vesting or that provide for discretionary vesting will receive no points for this factor. ISS also clarified that it will view a change in control definition that permits vesting without a related termination of employment as a problematic practice that may result in an adverse recommendation.

- **New dilution overriding factor.** Excessive dilution (more than 20% for S&P 500 companies or more than 25% for Russell 3000 companies) was added as a new negative overriding factor in evaluating equity compensation plans. This overriding factor examines share capital dilution (as opposed to voting power dilution) calculated as:

  $$(A + B + C) \div CSO$$

  where "A" equals number of new shares requested; "B" equals number of shares that remain available for issuance; "C" equals number of unexercised/unvested outstanding awards; and "CSO" means common shares outstanding. Sectors with higher burn rates (e.g. life sciences and technology) or high overhang due to underwater stock options may be disproportionally affected by this change.

- **Weighting adjustments.** Although the passing scores under the Scorecard for all scoring models remain the same, ISS intends to make some weighting/point reallocations between factors within each scoring model. Weighting on the plan duration factor has been increased to encourage plan resubmission to shareholders more often than required by the listing exchanges and following the changes to 162(m) that diminished incentive for periodic shareholder reapproval. Plan duration is calculated based on the proposed share reserve (new shares and currently available shares) using the company's three-year average burn rate and based on assumptions about expected growth in the number of shares of outstanding common equity. Full points will be awarded for plan durations of five years or less. Half points will be awarded for plan durations in excess of five years, but less than or equal to six years. No points will be awarded for plans with durations in excess of six years.

2019 Periodic Report Filing Deadlines

For companies that qualify as large accelerated filers and have fiscal years ending on December 31, annual reports on Form 10-K are due 60 days after fiscal year-end (Friday, March 1, 2019).[7] Form 10-K reports continue to be due 75 days following fiscal year-end for accelerated filers[8] (Monday, March 18, 2019 for December 31 year-end companies) and 90 days after fiscal year-end for non-accelerated filers (Monday, April 1, 2019 for December 31 year-end companies).

In addition, Form 10-Q reports filed by accelerated filers and large accelerated filers continue to be due 40 days after the close of the fiscal quarter. The deadline for Form 10-Q reports for non-accelerated filers continues to be 45 days after the close of the fiscal quarter.

These changes do not affect the existing proxy statement filing deadline of 120 days after fiscal year-end for companies that choose to incorporate by reference from their definitive proxy statements the disclosure required by Part III of the Form 10-K.

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Other Year-End Considerations

We also recommend that companies take the opportunity while planning their year-end reporting to consider what amendments may be necessary or desirable to their corporate documents over the coming year that may require shareholder approval. Some questions to consider are:

- Does the company have enough shares authorized under its charter to achieve all of its objectives for the year, including acquisitions for which it may want to use its stock as currency?
- Does the company have adequate shares available under its equity compensation plans to last throughout the year?
- Has the company reviewed its charter and bylaws to assess any anti-takeover measures in place?
- Has the company promised any disclosure changes pursuant to SEC comments or discussions with shareholders?

To the extent that a company expects any proposal in its proxy statement to create controversy among its shareholder base, it may want to consider hiring a proxy solicitor to assist with the process of seeking the requisite shareholder vote.

Please contact the Mintz attorney who is responsible for your corporate and securities law matters or either of the undersigned attorneys if you have any questions or comments regarding this information. We look forward to working with you to make this year's annual reporting process as smooth as possible.

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ENDNOTES

1 Item 403 of Regulation S-K requires the addition of a footnote to the beneficial ownership table if a director or executive officer has stock that is subject to a pledging arrangement.

2 Say on Pay Vote Results (S&P 500) report, Compensation Advisory Partners (January 25, 2018).

3 Companies must be mindful of Regulation FD (Fair Disclosure) and not disclose material nonpublic information selectively nor risk sending mixed messages from the disclosures contained in the company's proxy statement or other SEC filings when speaking with stockholders.

4 The ISS 2019 US policy guidelines are available on its website at: https://www.issgovernance.com/file/policy/latest/americas/US-Voting-Guidelines.pdf.

5 Glass Lewis' US proxy guidelines are available on its website at: http://www.glasslewis.com/wp-content/uploads/2018/10/2019_GUIDELINES_UnitedStates.pdf.

6 In addition to the 2019 policy updates by ISS and Glass Lewis referenced in notes 4 and 5 above, ISS' U.S. Equity Compensation Plans Frequently Asked Question updated December 19, 2018 is available on the ISS website at: https://www.issgovernance.com/file/policy/latest/americas/US-Compensation-Policies-FAQ.pdf.

7 Large accelerated filers are domestic companies that meet the following requirements as of their fiscal year-end:

- *have a common equity public float of at least $700 million, measured as of the last business day of their most recently completed second fiscal quarter (i.e., for calendar fiscal year-end companies, this test would be applied as of June 30, 2018);*
- *have been subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act for at least 12 months;*
- *have previously filed at least one Annual Report on Form 10-K; and*
- *do not qualify as small business issuers under SEC rules.*

8 Accelerated filers are those that meet all of the above tests but have a common equity public float of at least $75 million, but less than $700 million, measured as of the last business day of their most recently completed second fiscal quarter (i.e., for calendar fiscal year-end companies, this test would be applied as of June 30, 2018).

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