Updates
December 11, 2018

Preparing for the 2019 Public Company Reporting Season

During 2018, the SEC issued rule updates and guidance that are intended to ease certain public reporting requirements and clarify the SEC's position with respect to the shareholder proposal process. While the SEC is taking steps aimed at decreasing public company disclosure burdens, the investor community is sharpening its focus on public company actions and reporting on environmental, social and governance issues. In anticipation of the upcoming reporting season, we highlight rule changes, guidance and trends for public companies to consider in preparing annual report and proxy disclosures in 2019.

Shareholder Proposal, Proxy Statement and Annual Meeting Matters

SEC Guidance on Shareholder Proposal No-Action Letter Process. On October 23, 2018, the SEC's Division of Corporation Finance (Division) issued Staff Legal Bulletin No. 14J (SLB 14J), providing important guidance for companies submitting no-action requests to exclude shareholder proposals from proxy statements. In SLB 14J the Division:

- Clarifies its views on board analyses in no-action requests that rely on the "economic relevance" (Rule 14a-8(i)(5)) or "ordinary business" (Rule 14a-8(i)(7)) exceptions to exclude shareholder proposals;
- Provides additional guidance on the scope and application of "micromanagement" as a basis to exclude a proposal under the ordinary business exception; and
- Provides additional guidance on the application of the ordinary business exception, including micromanagement, to proposals addressing senior executive or director compensation.

Board Analyses for No-Action Letters. Last year the Division of Corporation Finance issued Staff Legal Bulletin No. 14I (SLB 14I), which noted that the evaluation of whether a proposal raises an issue that is "otherwise significantly related" to a company's business, in the case of the "economic relevance" exception under Rule 14a-8(i)(5), or transcends ordinary business matters, in the case of the "ordinary business" exception under Rule 14a-8(i)(7), often raises difficult judgment calls that are matters the board of directors generally is well suited to analyze in the first instance. SLB 14I invited companies to include a discussion of the board's analysis of these matters in their no-action requests. See our 2018 reporting season update for further discussion of SLB 14I.

Attempts by companies to apply the SLB 14I guidance in the 2018 proxy season were not met with success: of the first 30 no-action requests that included a SLB 14I board analysis, the Division concurred with exclusion in only one instance.

The Division issued SLB 14J to provide clarity on its views on board analyses, noting that the most helpful discussions included detail on the specific substantive factors the board considered, and that the less helpful discussions were those that described the board's conclusions or process without discussing the specific factors considered. SLB 14J provides a non-exhaustive list of substantive factors that the board may consider in arriving at its conclusions, including the following:

- 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 whether or not a matter is significant to the company.

- Whether the company has already addressed the issue in some manner, including the differences—or the delta —between the proposal's specific request and the actions the company has already taken, and an analysis of whether the delta represents a significant policy issue for the company.
- The extent of shareholder engagement on the issue and the level of shareholder interest expressed through that engagement.
- Whether anyone other than the proponent has requested the type of action or information sought by the proposal.
- Whether the company's shareholders had previously voted on the matter and the board's views as to the related voting results.

SLB 14J makes clear that the board analysis should address the voting results where a previous shareholder proposal received "significant shareholder support," including whether the company has taken any subsequent actions and/or whether other intervening events have occurred since the vote that may have mitigated the issue's significance to the company. Although SLB 14J does not specify what percentage support would be deemed significant, the lowest threshold the Division referenced in denying no-action relief was 25%.

Micromanagement Exclusion Under the Ordinary Business Exception. SLB 14J reiterates that the policy underlying the ordinary business exception rests on two considerations: (1) whether the proposal's subject matter deals with the company's ordinary business operations and (2) the degree to which the proposal "micromanages" the company "by probing too deeply into matters of a complex nature upon which shareholders, as a group, would not be in a position to make an informed judgment." SLB 14J states that a proposal may probe too deeply into matters of a complex nature if it "involves intricate detail, or seeks to impose specific time-frames or methods for implementing complex policies." SLB 14J clarifies that the micromanagement exception also applies to proposals that seek an intricately detailed study or report relating to the imposition of specific timeframes or methods for implementing complex policies, and that a proposal may be excludable on the basis of micromanagement *even if* the subject matter raised by the proposal would otherwise be proper for shareholder consideration.

Application of the Ordinary Business Exception to Proposals Addressing Senior Executive and/or Director Compensation. Proposals that relate to the management of the workforce and general employee compensation and benefits are generally excludable as ordinary business, while proposals that focus on significant aspects of senior executive or director compensation are generally not excludable as they are viewed as significant policy matters. SLB 14J addresses two aspects of this framework.

If a proposal addresses aspects of senior executive or director compensation that are also available to the general workforce, exclusion of the proposal depends on the focus of the proposal. When the focus of the proposal is on aspects of compensation that are available only to senior executives or directors, companies generally may not rely on the ordinary business exception. When the focus is on aspects of compensation available to senior executive officers and directors that are also broadly available to the general workforce, the proposal may be excludable as ordinary business if the company demonstrates that the executives' or directors' eligibility to receive the compensation does not implicate significant compensation matters.

In a reversal of an existing position, SLB 14J also explains that the Division will now apply its micromanagement guidance to proposals relating to senior executive or director compensation if such proposals "seek intricate detail, or seek to impose specific timeframes or methods for implementing complex policies."

SEC Guidance on Exempt Solicitations. Notice of Exempt Solicitation filings—Edgar filings of materials intended to influence shareholders' votes, but that do not seek proxies—have long been used by certain shareholders seeking to increase support for their shareholder proposals. These filings, tagged PX14A6G on Edgar, are required for solicitations made by a person owning over $5 million of the subject company's stock.

But the filings can also be made *voluntarily* by anyone with Edgar codes, and can serve as easy publicity for a shareholder proponent or other interested party trying to raise awareness of their cause. The filings appear on the subject company's Edgar feed, so a shareholder who has signed up for alerts when company SEC filings are made would receive a notification of a Notice of Exempt Solicitation. In addition, they are sometimes picked up by media outlets.

In 2018, frequent shareholder proponents John Chevedden and James McRitchie each made exempt solicitation filings to raise support for their shareholder proposals. In addition, some organizations made such filings with respect to companies in which they did not hold any shares.

In response to the uptick in filings, including some practices that companies identified as confusing, such as failure to clearly identify the filer, the Division released two new Proxy Rules Compliance and Disclosure Interpretations in July 2018 (Questions 126.06 and 126.07). The first CDI confirms that the Division will not object to voluntary exempt solicitation filings, so long as they are filed under the required cover, including the name and address of the party making the filing, and clearly state that the filing is made on a voluntary basis. The second CDI clarifies that the required information must *precede* any written soliciting materials. These CDIs maintain the status quo in which non-shareholders can make exempt solicitation filings, and the filer is not required to clarify whether it is a shareholder.

Companies should anticipate possible increased usage of exempt solicitation filings in 2019. Companies are not required to respond to these filings, but can release and file additional proxy materials if they decide to respond. Company counsel and investor relations should monitor the company's Edgar feed and review any such filings in order to be aware of what is being said.

CEO Pay Ratio Disclosure—Year 2. The 2018 proxy season saw the first year of mandatory CEO pay ratio disclosure. The SEC's pay ratio rule requires companies to disclose the ratio of the annual total compensation of the median company employee to the annual total compensation of the CEO.

Key findings from the 2018 proxy season are that pay ratios varied widely by market capitalization, employee headcount and industry sector, with the median pay ratio ranging from 166:1 for the S&P 500 to 72:1 for the Russell 3000. The methodologies used were fairly consistent. The most widely used consistently applied compensation measure for determining the median employee was total direct compensation (salary, bonus and equity) followed by total cash compensation, and then base pay. The most widely used of the adjustments permitted by the rule was the de minimis exception, which allows a company to exclude non-U.S. employees if they constitute 5% or less of the workforce. The most widely used date for identifying the median employee was year-end. Supplemental ratios were used by about 14% of the S&P 500 and 19% of the Russell 3000, primarily to exclude special one-time CEO compensation or to adjust the workforce to include only U.S. employees or full-time employees. The most common (and recommended) placement for the pay ratio disclosure was after the end of the compensation tables.

In preparing for the 2019 proxy season, companies should consider whether re-calculation of the median employee is necessary or appropriate in view of material changes in the workforce composition or compensation arrangements. Generally, companies need to identify the median employee only once every three years. If using the same median employee, the company must disclose that fact and briefly describe the basis for its reasonable belief that no change occurred that would significantly affect the pay ratio. If the median employee's circumstances change or the median employee was terminated, companies may identify a new median employee whose compensation is substantially similar. Companies should also review the 2018 disclosure of peer companies and governance leaders and consider whether improvements could be made in the disclosure, including to explain why the company's ratio differs materially from peer companies.

Tax Reform Act Amendments to Section 162(m). Section 162(m) of the Internal Revenue Code limits the deductibility of annual compensation paid to certain "covered employees" of public companies to $1 million per executive. The Tax Reform and Jobs Act made significant changes to Section 162(m) effective for taxable years beginning after December 31, 2017. These changes include elimination of the performance-based exception from the $1 million deduction limit and broadening of the definition of "covered employees." The new law provides transition relief for compensation subject to certain written, binding arrangements in place as of November 2, 2017 and not materially modified thereafter. In August 2018 the Internal Revenue Service issued initial guidance clarifying the definition of "covered employee" and when grandfathering will be available. The guidance is limited, and uncertainty remains, including with respect to the grandfathered status of performance-based compensation that is subject to negative discretion.

For most companies, the tax reform act changes to Section 162(m) will require updating changes to the Compensation Discussion and Analysis (CD&A) section of the proxy statement, including the Section 162(m) policy statement and any other 162(m)-specific disclosures regarding various elements of compensation. The CD&A will also reflect changes in incentive compensation pay practices due to the tax reform act. Companies should continue to comply with the operational requirements for awards that are intended to be grandfathered, including maintaining a committee of "outside directors" until all outstanding performance awards are certified, and retaining performance award provisions in cash and equity incentive plans.

Institutional Investor and Proxy Advisor Areas of Focus

In October and November 2018, ISS and Glass Lewis released their 2019 proxy voting guidelines. The Glass Lewis 2019 Proxy Guidelines are available here. The ISS updates came in the form of an executive summary of its benchmark policy updates and a more detailed comparison showing changes to its policies. Below we highlight certain of these proxy advisors' guideline updates, as well as institutional investor areas of focus, for companies to consider as they draft their proxy statements and prepare for annual meetings.

Executive Compensation Matters. In Preliminary FAQs for U.S. Compensation Policies for 2019, ISS announced two changes to its Equity Plan Score Card (EPSC) for meetings on or after February 1, 2019. A new "overriding factor" relating to dilution will be added. Failure to meet the dilution limit will result in an automatic no vote recommendation even if the plan otherwise would pass the EPSC. The new dilution test will be triggered when a company's equity compensation program is estimated to dilute shareholders' holdings by more than 20% (for the S&P 500 model) or 25% (for the Russell 3000 model). The FAQs also revise the change in control (CIC) vesting factor so that points will be assigned based on the *quality of disclosure* of CIC vesting provisions, rather than based on the *actual* vesting treatment of awards. ISS will award full points for this factor where the company's equity plan discloses with specificity the CIC vesting treatment for both performance- and time-based awards. If the plan is silent on the CIC vesting treatment for either type of award, or if the plan provides for merely discretionary vesting for either type of award, ISS will award no points for this factor.

ISS has also announced that, based on investor feedback, it will not introduce Economic Value Added (EVA) based measures to its quantitative pay-for-performance screens for the 2019 proxy season, but will continue to explore the use of EVA measures by featuring them in ISS research reports on a phased-in basis over the 2019 proxy season for informational purposes only.

The Glass Lewis 2019 Voting Guidelines include the following compensation-related changes: consideration of added excise tax gross-ups, severance and sign-on arrangements in relation to market practice, grants of front-loaded awards, discretionary short-term incentives, equity plans that cover directors, reduced CD&A disclosure for smaller reporting companies, and clawback provisions.

Nonemployee Director Pay. Last year, ISS introduced a policy that provides for potential adverse vote recommendations for the board committee responsible for approving nonemployee director compensation when there is an established pattern (two or more consecutive years) of excessive pay levels without a compelling rationale or other clearly explained mitigating factors. This policy was to be effective in 2019, but ISS has announced that in light of recent feedback received through its policy survey and investor roundtables, it intends to revise its methodology for identifying nonemployee director pay outliers and will delay issuing adverse director recommendations under this policy until 2020. More details on the revised methodology will be provided in the ISS FAQ to be published in December 2018.

Social and Environmental Issues. Shareholder focus on environmental and social (E&S) issues has increased and sharpened through 2018, following a trend that has been building over the past several years. Both ISS and Glass Lewis announced policy updates with respect to these matters. ISS updated its policy on voting on E&S shareholder proposals. It added to its list of factors in considering such proposals whether there are significant controversies, fines, penalties or litigation associated with the company's environmental or social practices. In February 2018, ISS also announced that it is beginning to provide E&S QualityScores, in addition to its existing Governance QualityScore. Glass Lewis codified its policy for board oversight of E&S risk. In instances where Glass Lewis identifies poor management or mitigation of E&S risks to the detriment of shareholder value it may recommend against board or committee members identified by the company as having oversight over for E&S risks. If the company has not disclosed board oversight of these matters, Glass Lewis may recommend against audit committee members.

Institutional investors have been seeking sustainability-related disclosures from portfolio companies with greater interest in recent years, including as we reported ahead of the 2018 proxy season. There were several key developments on this front in 2018. Effective October 1, 2018, Delaware enacted a voluntary certification program allowing a company to commit to providing annual reports on sustainability consistent with identified principles, guidelines or standards for such reporting. In November, after a six-year standard setting process, the Sustainability Accounting Standards Board (SASB) published industry-specific standards for reporting on financially material sustainability topics and associated metrics. The five dimensions of reporting covered in various forms for the 77 industries are environment, social capital, human capital, business model and innovation, and leadership and governance. Some investors have focused on the SASB standards as a potential key development in increasing access to decision-useful information that is comparable within and across industries.

As companies consider the landscape of sustainability reporting and where to focus their efforts, keep in mind the following:

- Focus on issues and metrics that are material to the particular company
- Consider how best to communicate these topics to investors—through periodic reports and proxy statements filed with the SEC or through separate sustainability websites or reports
- Ensure that sustainability reporting is subjected to rigorous disclosure controls, similar to preparation of other reports to shareholders
- Consider assigning a board committee with oversight of E&S risk and disclose such committee oversight in the proxy statement

Board Diversity. Consistent with the significant focus from many institutional investors and other shareholders on increasing board diversity over the past several years, ISS announced that for the 2020 proxy season for companies in the Russell 3000 or S&P 1500, it will begin recommending votes against the chair of the nominating committee (or other appropriate directors) at companies where there are no women on the board. It will consider mitigating factors, such as a firm disclosed commitment to appointing at least one woman to the

board in the near term or the presence of a woman on the board at the prior annual meeting. As we reported last year, Glass Lewis announced a similar policy that will be effective in the 2019 proxy season.

Another key development in board gender diversity was California's passage of an amendment to the California Corporations Code requiring publicly traded companies formed or *headquartered* in California to include women on their boards of directors. The minimum diversity requirements will be phased in, with all covered companies required to have at least one woman director by the end of 2019. The minimum requirements increase to three, two and one women for boards of six or more directors, five directors and four directors, respectively, by the end of 2021.

Management Proposals and Board Responsiveness. During the 2018 proxy season, the Division granted several no action request letters allowing companies to exclude shareholder proposals calling for company bylaws thresholds for shareholders to request a special shareholder meeting to be lowered. The Division granted no action relief in several cases where the shareholder proposal to lower the threshold from 25% to 10% conflicted with a management proposal to ratify the existing bylaw. Many shareholder organizations objected to the Division's position, arguing that it would encourage companies to take a similar approach with respect to any shareholder proposal for a bylaw amendment.

In response to the SEC's position on this issue, ISS adopted a new policy to generally recommend a vote against certain directors when an annual meeting proposal put forth by the company asks shareholders to ratify existing charter or bylaw provisions, taking various factors into account. ISS also updated its board responsiveness policy to consider recommending votes against directors where a board fails to act on a management proposal that sought ratification of a charter or bylaw provision, and the proposal *failed* to receive majority approval. Glass Lewis adopted a related policy with respect to proposals for special shareholder meetings. Where the agenda includes a management and a shareholder proposal regarding special meetings with different thresholds, Glass Lewis will generally recommend voting for the lower threshold and against the higher threshold. Where there are conflicting proposals and the company does not already have a special meeting right, Glass Lewis may consider recommending in favor of the shareholder proposal and abstain from voting on the management proposal. Where a company proposes ratifying an existing special meeting right and excludes a special meeting shareholder proposal as conflicting with the management proposal, Glass Lewis will typically recommend against the ratification proposal and against members of the nominating and governance committee.

Companies that receive a shareholder proposal on special meeting thresholds for the 2019 proxy season should carefully consider whether a bylaw ratification and no action request approach would cause more negative shareholder reaction than simply including the shareholder proposal and providing a board argument for why shareholders should reject the proposal.

Other Updates. ISS adopted a new policy to generally recommend against members of the nominating and governance committee or full board in connection with chronic poor board and committee meeting attendance by directors. ISS also updated its policy with respect to voting on reverse stock splits to take into consideration various factors in connection with such reverse stock splits done to address possible stock exchange delisting or continuing as a going concern. Glass Lewis updated the factors that it reviews in considering auditor ratification proposals. In addition, Glass Lewis' virtual-only annual meeting policy announced in 2017 and discussed in our 2018 proxy season report will become effective for the 2019 proxy season.

Other 2019 Proxy and Annual Reporting Matters

Sharpened Focus on Cybersecurity, Brexit and LIBOR Phase-out Risk Disclosures. In February 2018, the SEC issued interpretive guidance on public disclosure obligations relating to cybersecurity. The guidance was generally consistent with prior SEC guidance on this topic, focusing on providing disclosure that is material to investors. The SEC emphasized two key areas for company focus in light of cybersecurity incidents in recent

years: (1) appropriate disclosure controls and procedures related to cybersecurity incidents and risks, including preventing insiders from trading on material nonpublic cybersecurity information, and (2) the board's oversight role with respect to cybersecurity, including discussion of the board's role in the company's cyber risk management program when material to the company's business. For further discussion of the interpretive guidance, see our February 23, 2018 update.

Last month, SEC Chairman Jay Clayton and SEC Division of Corporation Finance Chief Accountant Kyle Moffatt, speaking at Financial Executives International's Current Financial Reporting Issues Conference, highlighted the need for companies to ramp up disclosures related to cybersecurity risks, Brexit and the London interbank offered rate (Libor) phaseout. With respect to the U.K.'s anticipated departure from the EU, both Clayton and Moffatt underscored the SEC's expectation that companies provide "tailored disclosure" on the risks associated with Brexit as well as the potential impact on the company's business, if applicable and material to the company, and that these disclosures should be clear, concise and detailed. With respect to the transition away from Libor by British financial regulators expected to occur in 2021, Moffatt indicated that the SEC would expect companies to disclose when the Libor phase-out could be material, for example in connection with legacy financial instruments that use Libor as an interest rate benchmark.

Disclosure Simplification Rules Adopted. In August, the SEC adopted a series of technical amendments that update or eliminate discrete disclosure requirements that have become "redundant, duplicative, overlapping, outdated, or superseded." Notable changes include the following:

- *Description of the Business*: Eliminated the requirements to include financial information about segments, financial information by geographic area and amounts spent on R&D activities in the business section, which overlapped with MD&A or financial statement requirements.
- *MD&A*: Eliminated the requirement to include seasonality disclosure in interim reports.
- *Dividends*: Eliminated the requirement to disclose the amount and frequency of, and restrictions on, cash dividends on common equity under Reg S-K Item 201(c).
- *Market Price*: Eliminated the requirement to disclose high and low prices of common equity for issuers traded on established public trading markets.
- *Ratio of Earnings to Fixed Charges*: Eliminated the requirement to disclose the ratio of earnings to fixed charges in connection with registration of debt securities (and the analogous requirement for preferred equity securities).
- *Financial Statements*: Introduced a requirement to include changes in stockholders' equity in interim reports.

Updates to Form 10-Q and 10-K Cover Pages and Preparation for Inline XBRL. In connection with rule amendments related to the use of Inline eXtensible Business Reporting Language (XBRL), the SEC eliminated the requirement that companies post XBRL data on their corporate websites. These changes resulted in updates to the cover pages for Form 10-Q and 10-K to remove references to the posting requirements.

The inline XBRL requirements, which are intended to improve the quality and accessibility of XBRL data, will become effective on a phased-in basis for operating companies and funds. Inline XBRL requires filers to embed XBRL data directly into their Edgar filings instead of posting separate XBRL files. The effective dates for different filer types are listed below, and companies should start ensuring that they will have appropriate systems in place for compliance.

- For large accelerated filers, fiscal periods ending on or after June 15, 2019.
- For accelerated filers, fiscal periods ending on or after June 15, 2020.
- For all other filers, fiscal periods ending on or after June 15, 2021.

Changes to Smaller Reporting Company Definition. In June 2018, the SEC adopted amendments to the definition of "smaller reporting company" (SRC) to expand the number of companies eligible for certain scaled disclosure accommodations. Scaled disclosure, including providing two, rather than three, years of audited financial statements and less disclosure regarding executive compensation, allows smaller companies to generally decrease their public company reporting costs as compared with larger companies. The definition changes are summarized in the table below.

Old Definition	New Definition
SRC if either: 1. public float of less than $75 million, or 2. no public float and annual revenues of less than $50 million.	SRC if either: 1. public float of less than $250 million, or 2. public float of less than $700 million (including having no public float) and annual revenues of less than $100 million.

Additionally, amendments were made to preserve the existing public float thresholds to eliminate the exclusion of SRCs from the definitions of "accelerated filer" and "large accelerated filer." As a result, some registrants will qualify as both SRCs and accelerated filers. The amendments became effective on September 10, 2018, and also resulted in minor changes to the cover pages of Forms 10-Q and 10-K.

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