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Editor-in-Chief
AMY L. GOODMAN
(phone) 301-908-0938
agoodman16@verizon.net

EDITORIAL OFFICE
76 Ninth Avenue
New York, NY 10011
212-771-0600

Wolters Kluwer
Richard Rubin, Publisher
Kathleen Brady, Managing Editor

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CORPORATE GOVERNANCE

Preparing for the 2018 US Proxy and Annual Reporting Season—Are You Ready?

The 2018 proxy season will be the first time that CEO pay ratio disclosure will be required. Accordingly, companies should begin working on proxy statements, annual reports, and annual meetings this fall.

By Laura D. Richman and Michael L. Hermsen

Advance planning is a key component of a successful proxy and annual reporting season. While work on proxy statements, annual reports and annual meetings typically kicks into high gear in the winter, autumn is the ideal time to begin preparations. This is especially important for the 2018 proxy season because this will be the first time that pay ratio disclosure will generally be required in proxy statements.

Pay Ratio Disclosure

Most public companies will be required, for the first time, to include pay ratio disclosure in their 2018 proxy statements.

Briefly, pay ratio disclosure will require public companies to disclose:

- The median of the annual total compensation of all employees other than the chief executive officer;
- The annual total compensation of the chief executive officer; and
- The ratio of these amounts.

The pay ratio rule of the US Securities and Exchange Commission (SEC) contains many details regarding how this calculation should be made and disclosed.[1]

Laura D. Richman *is counsel and* **Michael L. Hermsen** *is a partner at Mayer Brown LLP. Jennifer J. Carlson, Kristen B. Ford, Robert F. Gray, Jr., Marjorie H. Loeb, Elizabeth Raymond, and David A. Schuette of Mayer Brown also contributed to this article.*

During the first half of 2017, many people were discussing whether the SEC's pay ratio disclosure rule would be repealed or have its implementation delayed. In early February 2017, then-acting SEC Chairman Michael S. Piwowar issued a statement seeking public input on any unexpected challenges companies were facing as they were preparing to comply with the rule and whether relief was needed. In addition, he directed the SEC staff to reconsider the pay ratio rule based on comments submitted and to determine whether additional guidance or relief may be appropriate.

In the spring of 2017, the House of Representatives approved the "Financial CHOICE Act," complex legislation that, among other things, would repeal the Dodd-Frank pay ratio requirement. Although it has been submitted to the Senate for its consideration, as of the time this article is being written, it is not certain when the House-approved bill will be debated by the full Senate. Given legislative priorities, it does not seem likely that action by the Senate on the Act, including its pay ratio repeal provision, will be considered before the 2018 proxy season. And, if the Financial CHOICE Act is considered by the Senate, there is no assurance that all of its current provisions, including the pay ratio repeal provision, will remain in what ultimately is adopted.

On September 21, 2017, the SEC and the staff of its Division of Corporation Finance (Staff) issued guidance on the pay ratio rule, which in addition to providing interpretations, effectively signaled that the SEC would not be delaying the implementation of this new disclosure requirement. The SEC issued an interpretive release providing guidance on using reasonable estimates, assumptions, methodologies, statistical samplings and internal records, as well as tests for determining independent contractor status, to assist companies in their efforts to comply with the new pay ratio disclosure requirements.[2] At the same time, the Staff provided additional guidance, including examples, to assist companies in determining how to use statistical sampling and other reasonable methods to identify the median employee's compensation.[3] Finally, the Staff revised one previously issued compliance and disclosure interpretation (CDI), added a new CDI and withdrew one previously issued CDI relating to guidance on the methodology for applying compensation measures and determining the employee population to identify the median employee.[4]

Pay ratio preparations can be time consuming. In addition to working through the complexities of the actual calculation and the required disclosure, companies should allow time to potentially modify the overall compensation discussion and analysis to put the ratio in context. They also should consider what, if any, implications this additional disclosure will have on the annual say-on-pay advisory vote and other compensation matters the issuer may be presenting to shareholders for consideration (e.g., revised equity plans or awards).

Say-on-Pay and Other Compensation Matters

Say-on-Pay

After being on proxy ballots for seven years, the advisory vote on the compensation of the named executive officers has become a regular feature of annual shareholder meetings, often involving year-round planning. This agenda item has shaped a new look for proxy statements as companies increasingly incorporate graphic design elements to explain their executive compensation programs. Say-on-pay has also driven shareholder engagement on executive compensation. Many companies have made changes to their compensation programs in response to their say-on-pay vote and related conversations with their key investors.

Although say-on-pay is an advisory vote, there are real consequences to a failed say-on-pay vote. Generally, if investors vote against executive compensation in large numbers, they will expect the company to make changes to its compensation program. If the company does not, its investors may cast a binding vote against compensation committee members or other directors in addition to voting against named executive officer compensation when the next say-on-pay vote is conducted. As a result, companies are very focused on receiving not only majority approval of their executive compensation, but achieving high levels of support.

There are real consequences to a failed say-on-pay vote.

For the most part, companies were successful with their say-on-pay votes in 2017. Executive compensation consultant Semler Brossy reports that through September 11, 2017, only 1.4 percent of Russell 3000 companies had failing say-on-pay votes during the 2017 proxy season. The average support for say-on-pay during this period was 91.7 percent, representing the highest average since the commencement of mandatory say-on-pay voting. The percentage of companies receiving support above 90 percent of the votes cast was 78 percent in 2017, which was slightly higher than in any other year.[5]

Proxy advisory firms such as Institutional Shareholder Services (ISS) have become very influential in the say-on-pay process. As a result, if a company receives a negative proxy voting recommendation from a proxy advisory firm, it often (but not always) prepares additional material in support of its executive compensation program. This material must file with the SEC as definitive additional soliciting materials not later than the date first distributed or used to solicit shareholders.

According to Semler Brossy, when ISS recommends an "Against" vote for a say-on-pay proposal, shareholder support for the proposal is 26 percent lower than at companies that receive a "For" recommendation. Although an "Against" recommendation does not always result in a failed say-on-pay vote, the drop in shareholder support may influence the ongoing level and tone of shareholder engagement on compensation matters and director nominees in the coming year.

Say-When-on-Pay

Many companies were required to conduct an advisory vote in 2017 to see if their shareholders preferred that the say-on-pay vote be conducted every year, every two years or every three years. An annual say-on-pay vote was supported as the desired frequency in the vast majority of these votes.

Equity Plan Voting

Semler Brossy reports that the failure rate for equity plan proposals during 2017 was 0.7 percent. While only a small number of companies had equity plans that failed to achieve the support of the majority of the votes cast, this percentage represents the highest failure rate for equity plans since mandatory say-on-pay was instituted in 2011. The failure rate serves as a reminder that investors may use the tool of a binding vote on an equity plan or equity plan amendment if they are not happy with how a company makes equity awards or on other matters.

Compensation Litigation

Because executive compensation sometimes has been the subject of litigation, compensation decisions should be made, and compensation disclosures should be prepared, with care, especially for companies that anticipate resistance to their compensation program. Compensation committee members should be able to demonstrate that they exercised due care in applying their business judgment to determine executive compensation by reviewing adequate information, asking questions and understanding the pros and cons of various alternatives, any or all of which can involve the assistance of company personnel or outside experts, as appropriate.

Director compensation potentially can raise additional litigation concerns because of self-dealing issues, requiring the application of an evaluation against a heightened "entire fairness" standard rather than the business judgment rule. To minimize this risk, companies and boards should review existing director compensation arrangements carefully (perhaps on a separate cycle from executive compensation) and consider adding shareholder approved annual limits or annual formula-based awards to current (or new) plans. Alternatively, companies and boards may choose to develop a factual record of these arrangements with a view to withstanding an "entire fairness" scrutiny, including by reviewing director compensation paid at a carefully selected group of comparable companies, possibly with the assistance of an outside expert.

Shareholder Proposals

There have been some efforts to change the shareholder proposal process. For example, the Financial CHOICE Act, as approved by the House of Representatives, would increase the share ownership and resubmission thresholds and would prohibit shareholders from authorizing other persons to submit a proposal on their behalf. As noted above, it is not yet known when, if at all, the House-approved bill will be considered by the full Senate. In addition, if the Senate does act, there is no assurance that they will not make changes to the Act as adopted by the House of Representatives. Therefore, at the present time, the current requirements of Rule 14a-8 continue to govern the shareholder proposal process.

Companies must be ready to react promptly when they receive any shareholder proposal and to evaluate their most appropriate course of action in response to the particular proposal. Under Rule 14a-8, if there are specified procedural deficiencies with a proposal (such as failing to provide the requisite proof of ownership) or if the proposal falls within one or more of the 13 substantive grounds that are set forth in the rule, the company can seek a no-action letter from the Staff concurring with the exclusion of the shareholder proposal from its proxy statement. Whether a company is seeking exclusion based on procedural or substantive grounds, it will need to comply with deadlines set forth in the rule. Alternatively, or in addition to submitting a no-action request, companies often attempt to negotiate with the proponent to see if an agreement can be reached, resulting in the withdrawal of the proposal.

Shareholder proposals do not only represent investor relations issues. They also may give rise to publicity if they become the subject of a no-action request or if they are included in a company's proxy statement. Accordingly, when shareholder proposals are received, companies should assemble teams comprised of members of management, investor relations and public and media relations, as well as the law department. The Board of Directors or appropriate committees also should be apprised of the proposals promptly.

On November 1, 2017, the Staff issued Staff Legal Bulletin No. 14I (SLB 14I) to provide guidance on shareholder proposals submitted pursuant to Rule 14a-8 under the Securities Exchange Act of 1934.[6] SLB 14I addressed four topics:

- The scope and application of the ordinary business grounds for exclusion under Rule 14a-8(i)(7);
- The scope and application of economic relevance grounds for exclusion under Rule 14a-8(i)(5) for proposals relating to less than 5 percent of a company's total assets, net earnings and gross sales;
- Proposals submitted on behalf of shareholders, sometimes referred to as proposal by proxy; and
- The use of graphs and images consistent with the 500 word limit of Rule 14a-8(d).

With respect to the first two items, the Staff noted that a company's board of directors is in a better position to determine these matters in the first instance. As a result, the Staff said incoming no-action requests seeking to rely on either of these bases for exclusion should include a discussion that reflects the board's analysis of the issue and a description in detail of "the specific processes employed by the board to ensure that its conclusions are well-informed and well-reasoned." With respect to the third item, the Staff outlined the specific information it expects proponents to provide when submitting a proposal by proxy. With respect to the final item, the Staff clarified the bases on which a company may look to when seeking to exclude graphs or images that are part of any shareholder proposal. (*Editor's note: For a more detailed discussion of SLB 141, see "SEC Staff Gives Boards Central Role in 14a-8 'Ordinary Business' and 'Economic Relevance' Exclusions" in this issue.*)

Because the guidance provided by SLB 14I is of immediate effect, companies that are, or that may soon be, in the process of responding to shareholder proposals for the 2018 proxy season need to consider the impact of these interpretations now.

Proxy Access

An increasing number of US companies have adopted proxy access bylaws over the past three years, largely as a result of shareholder proposals requesting companies to conduct shareholder votes on proxy access. This initiative gained traction when the New York City Comptroller and the New York City Pension Funds launched the Board Accountability Project in 2014 to push for proxy access. Many companies that received proxy access shareholder proposals for the 2017 proxy season adopted proxy access bylaw provisions before their 2017 annual meetings, with the proposals being withdrawn or otherwise omitted from the proxy statements.

When shareholder proposals requesting the adoption of proxy access were voted upon in 2017, they often received majority support of the votes cast. Currently, more than 60 percent of the companies in Standards & Poor's 500 Index have adopted proxy access bylaw or charter provisions and that percentage may increase by the end of 2017.

As the number of companies with proxy access has grown, a consensus has developed for what constitutes "market" practice for proxy access. Most of the US proxy access provisions have a 3 percent-for-3-year-ownership threshold, allow aggregation by groups of up to 20 holders to reach the designated threshold, limit the number of proxy access nominees to 20 percent of the board, but often with a minimum of two nominees, and specify a minimum level of support for re-nominations in future years. There are quite a few other details on which proxy access provisions vary, although there have been a sufficient number of US proxy access provisions adopted that there is general agreement as to which variations are viewed as customary.

The number of shareholder proposals relating to board diversity increased in 2017.

Some shareholders submitted proposals for the 2017 proxy season to companies that had already adopted proxy access. They sought to amend a number of specific proxy access features to broaden the right, such as by raising the maximum number of directors eligible for election through proxy access from 20 percent to 25 percent, removing a limit on the number of shareholders whose holdings could be aggregated to meet the proxy access ownership threshold or eliminating refinements such as ownership definitions or nominee qualifications. In response to no-action requests to exclude such "fix it" proposals, the Staff generally permitted the proposals to be excluded as substantially implemented if a company had already adopted a proxy access bylaw that conformed to market practice of a 3-percent-for-3-year ownership threshold, a 20 holder limit on aggregation and a 20 percent cap on proxy access directors. However, in July 2017, the Staff refused to permit the exclusion of a proxy access amendment proposal as substantially implemented where the proposal addressed only a single feature: the elimination of a cap on the number of shareholders that can aggregate their shareholdings for the purpose of satisfying the ownership requirement necessary to make a proxy access nomination.[7] Nevertheless, during the 2017 proxy season, proposals to amend proxy access provisions containing what is now considered the standard features have failed to receive majority support.

Companies that do not have proxy access provisions in place should be familiarizing themselves with the latest developments in this area. It would be useful for them to examine market provisions so that they are ready to react quickly if they receive a proxy access shareholder proposal for the 2018 proxy season. Companies in this position may want to develop a draft proxy access provision for internal discussion purposes to better understand the mechanics for such a nomination procedure and how it would interact with existing advance notice bylaws and other governing documents and law.

Although many US companies have adopted proxy access in the last few years, to date proxy access has not been successfully used to actually nominate directors. An asset management company and affiliated companies filed a Schedule 14N in November 2016 to disclose a proxy access nomination. However, the company determined that the nomination did not satisfy the "passive investment" requirement of its bylaws, the nominee withdrew and the investor group reported in an amended Schedule 13D that they were not pursuing proxy access.[8]

Other Shareholder Proposals

While proxy access proposals have garnered attention over the past few years, there are also other areas that have been a focus of shareholder proposals, especially in the environmental, social and governance areas. According to the database maintained by Proxy Monitor, 50 environmental shareholder proposals were voted on at Fortune 250 companies in 2017 through September 15, 2017. More than half of these proposals received support in excess of one quarter of the votes cast and three proposals requesting reports on the impact of policies to limit global warming received majority support.[9] The number of shareholder proposals relating to board diversity increased in 2017, although many were withdrawn after companies agreed to address board diversity through recruitment. Lobbying and political spending continued to be popular topics for shareholder proposals in 2017, often receiving in excess of one quarter of the votes cast. Requests that the chairman of the board be an independent director remained a relatively common topic for shareholder proposals in

2017, but none received majority shareholder support. Executive compensation shareholder proposals, on the other hand, have been declining.

The shareholder proposal topics described above are likely to be common subjects for shareholder proposals that companies receive for the 2018 proxy season, although there may be variations in approach or frequency of some of the submissions this year. Certain proposal categories may be refined in light of Staff no-action positions. Other proposal types may become more prevalent as a result of successful voting results in 2017. There also may be changes in the shareholder proposal landscape to reflect the fact that many of the 2017 shareholder proposals were sent to companies before the change in the US administration and related developments. For example, as a result of the US decision to withdraw from the Paris climate accord and changing environmental regulation, there may be an increase in climate change shareholder proposals as investors turn to "private ordering" to address global warming concerns on a company-by-company basis. And, as always, there may be some shareholder proposals submitted on subjects of concern to a limited number of companies or a small group of shareholders.

Institutional Shareholder Initiatives

Submitting shareholder proposals for inclusion in a company's proxy statement is one way shareholders attempt to force companies to take certain actions or to publicize particular issues. Institutional shareholders, by virtue of their larger holdings, have additional ways to influence companies, such as through their proxy voting policies and engagement practices. Therefore, companies should not only track who their large shareholders are but also pay attention to positions these investors have taken with respect to various topics.

While mandatory say-on-pay has made executive compensation a frequent subject of shareholder engagement, compensation is not the only issue of concern to institutional investors. For example, State Street Global Advisors has identified board diversity, and in particular gender diversity, as a key issue for its 2017 proxy voting.[10] State Street Global Advisors carried through on this policy during the 2017 proxy season, voting against the reelection of directors having the responsibility to nominate new board members at 400 companies that failed to make any significant effort to address the lack of a single woman on their board of directors.[11] And, the ISS 2017-2018 Global Policy Survey, published September 25, 2017, (ISS Survey) found that out of 129 investors who responded prior to the survey deadline, 69 percent consider it problematic for there to be no female directors on a public company board. The largest number of these investors identified engaging with the board and/or management as the most appropriate response for shareholders to take on this issue.[12]

There may be an increase in climate change shareholder proposals.

In its August 31, 2017, open letter to directors of public companies worldwide, Vanguard identified the functioning and composition of the board, governance structures, appropriate compensation and risk oversight as the four pillars that it considers in evaluating corporate governance.[13] In this letter, Vanguard articulated its increased focus on climate risk and related disclosure and gender diversity, making clear that these are ongoing priorities.

The New York City Comptroller and the New York City Pension Funds issued a press release on September 8, 2017, announcing the launch of their Boardroom Accountability Project 2.0 to "ratchet up the pressure on some of the biggest companies in the world to make their boards more diverse, independent, and climate-competent." This campaign is asking the boards of 151 US companies, 92 percent of which have adopted proxy access, to disclose race and gender of their directors, together with board members' skills, in a standardized matrix format and to enter into a dialogue on their board "refreshment process."[14]

Companies should remain aware of the topics that their large shareholders have identified as important to them. Even when such areas are not the subject of proposals being voted on at the annual meeting, companies may choose to add or expand disclosures in their proxy statements and annual reports as a form of shareholder engagement to highlight their efforts and progress.

Virtual Meetings

With technological advances, a growing number of companies have begun to hold virtual annual meetings, although such meetings have remained a minority practice. Online shareholder meetings can take a variety of forms. Some are hybrids, with in-person meetings supplemented by audio and/or video options. Other companies conduct fully virtual meetings.

The number of companies conducting virtual annual meetings has been increasing steadily over the past few years. According to the New York City Comptroller, the number of companies holding virtual-only meetings increased 700 percent since 2010, from just 19 in 2010 to 155 in 2016.[15] Broadridge reports that, during 2016, 187 companies held virtual meetings, of which 155, or 83 percent, were virtual-only.[16] Broadridge identifies approximately 200 companies that have held or scheduled virtual meetings in the first three quarters of 2017.[17] Some investors have criticized virtual-only meetings. A number of companies received shareholder proposals for the 2017 proxy season requesting in-person meetings, but on December 28, 2016, the Staff issued a no-action letter permitting a proposal requesting a corporate governance policy to initiate or restore in-person meetings to be excluded from a proxy statement as dealing with ordinary business operations in reliance on Rule 14a-8 (i)(7).[18]

In early spring 2017, the New York City Comptroller called upon more than a dozen major corporations to host in-person annual meetings rather than continuing to hold virtual-only meetings.[19] In addition, the New York City Pension Funds adopted a policy in its proxy voting guidelines in April 2017 to vote against incumbent directors serving on a nominating committee who are up for re-election at a virtual-only meeting.[20]

The ISS Survey found that 87 percent of its investor respondents generally consider holding hybrid shareholder meetings to be an acceptable practice. In addition, a majority of the investor respondents indicated that virtual-only meetings would be acceptable, at least in certain circumstances, with 19 percent of the investor respondents reporting that they generally consider virtual-only meetings to be acceptable and 32 percent indicating that they would be comfortable with virtual-only shareholder meetings if they provided the same shareholder rights as a physical meeting. On the other hand, the ISS Survey found that 44 percent of the investor respondents objected to virtual-only meetings.

Notwithstanding the concerns raised by some investors, many companies hosting virtual meetings often emphasize shareholder engagement as well as cost savings and observe that web participation may exceed physical attendance, allowing shareholders the ability to attend the annual meeting from any location around the world. Thus, using technology provides a platform that encourages meaningful shareholder engagement at the annual meeting.

Companies considering or planning a virtual meeting should begin preparations early. They should confirm that their governing law permits virtual meetings and that their charter and bylaws contemplate the practice. They should decide whether they will retain an in-person component of the meeting and whether the virtual component will be audio only or will include video. A very important aspect of a virtual meeting is how shareholder questions will be handled. Another issue is whether anyone will be permitted to observe the virtual meeting or whether only shareholders will be allowed access. Therefore, it is critical for companies conducting virtual meetings to be sure the technology is in place and adequately tested before the meeting.

Annual Report Risk Factors

Updating risk factors is an important part of a company's process for preparing its annual report on Form 10-K or Form 20-F. This section of the annual report must explain in plain English the specific risks that impact the company and its securities. The risk factors must be tailored for the specific issues affecting the company under current circumstances. While the prior year's risk factor presentation can be the starting place for analysis, companies must be sure the risk factors are current.

When drafting the risk factors that will appear in the current year's annual report, companies must consider whether it is appropriate to disclose new risks, to provide additional details on existing risks or to delete any risks. The answer will vary by company—there is no one-size-fits-all approach. Some key risk factor topics to consider at this time, either as stand-alone risk factors or in conjunction with other risk factor discussions, include the following.

Cybersecurity. Cybersecurity is now recognized as an issue that impacts companies of all types, with cybersecurity risks from both an economic and security perspective increasing. Therefore, companies should assess whether they need to expand or revise their cybersecurity disclosures to avoid potentially incomplete or misleading disclosures, especially in light of any events that may have occurred over the past year, whether or not such events affected them directly. Updated cybersecurity disclosure also can be helpful from a shareholder engagement perspective to demonstrate that the company is aware of the significant impact of cybersecurity risk and is taking steps to address it.

Political changes. Changes and potential changes in law, regulation and policy resulting from the Trump presidency and the dynamics of the majority-Republican Congress may impact the risk profile of certain companies, thereby requiring modifications to risk factor disclosure that consider the potential uncertainty in the regulatory environment. For example, travel and immigration policies may present risks to companies that rely on foreign employees or consultants. Some companies may be facing increased risks with respect to potential withdrawal or modification of international trade agreements. Other companies may be concerned about changes in tax policy, such as the elimination of renewable energy tax credits or significant changes to the current tax system. Companies in the health care or insurance industries may face risks relating to efforts to repeal and replace the Affordable Care Act. Some companies already have disclosed risks from such recent political changes in their SEC filings. It is a worthwhile disclosure control exercise for companies to consider whether they face particular risks as a result of the current political climate, even if they ultimately determine that they do not need to address this topic as a risk factor.

Brexit. Following the United Kingdom referendum in favor of leaving the European Union, some companies began including Brexit risk factors in their periodic reports to address political, social and economic uncertainty, as well as stock market volatility and currency exchange rate fluctuations. For example, Brexit has been mentioned in the context of risk factors on topics such as currency exchange rates, global economic conditions and international operations, as well as having been discussed as a separate risk factor. Brexit is an ongoing process that will still take some time to fully negotiate and implement. As Brexit negotiations progress, impacted companies should evaluate continually whether Brexit poses a risk to their business, what level of Brexit-related disclosure is appropriate under the circumstances and whether any prior Brexit risk factor needs to be updated.

Climate change and sustainability. Sustainability and climate change have garnered increasing attention, including in the context of risk factor disclosure. Climate change risk factor disclosure may discuss the impact of existing or pending legislation, regulation or international accords, as well as the physical impact of climate change or the impact of public awareness of sustainability issues on a company's business. To the extent deemed relevant, a risk factor also could discuss uncertainties with respect to a company's business from potential changes in climate change regulation and treaties, especially in light of the US withdrawal from the Paris climate accord. Because climate change is an evolving area, the necessity for and scope of a climate change and sustainability risk factor is something that a company should consider carefully.

Shareholder activism. Some companies now are including shareholder activism as a risk factor, either as part of a litany of matters that can impact the share price or as a separate risk factor describing how the company's business could be impacted as a result of actions by activist shareholders or others. For example, risk factors have stated that actions taken by activist shareholders could cause the company to incur substantial costs, including litigation, and could divert management attention and resources. Some have indicated that actions by activists could create uncertainty, making it more difficult to attract and retain employees, business partners and customers, and could result in the loss of business opportunities. Risk factors have mentioned that shareholder activism may hinder investment or other strategies and impact stock price.

Terrorism and armed conflict. Companies should consider whether they should add or expand risk factors addressing the potential impact of terrorism, armed conflict, possible use of nuclear weapons or other geopolitical issues in light of developments during the past year.

Non-GAAP Financial Measures

The Staff has continued to review compliance with the requirements for use of non-GAAP financial measures since issuing new and updated CDIs on the subject in May 2016. Many of the Staff's comments on SEC filings containing non-GAAP financial measures have been directed at the requirements for presenting the most directly comparable GAAP measure with equal or greater prominence and the company's justification for use of the non-GAAP measure outside of the context of pay-related proxy statement discussions as noted below. Companies should consider the most recent CDIs and Staff comments when preparing their annual reports and related earnings releases if they contain non-GAAP financial measures.

Regulation S-K and Staff interpretations provide limited special relief regarding non-GAAP financial measures used in pay-related proxy statement discussions with respect to target levels for performance. These interpretations afford additional relief as to the location of required GAAP reconciliation and other information when non-GAAP financial measures are disclosed in pay-related circumstances. However, companies sometimes include non-GAAP financial measures in their proxy statements in circumstances which do not relate directly to compensation, such as in a summary or a letter included in the proxy statement. Therefore, it is prudent for companies to consider carefully the limits of Staff's guidance on non-GAAP financial measures when preparing their proxy statements.

Audit Committee Disclosure

The technical requirements for the audit committee report for the proxy statement are quite modest. Item 407(d) of Regulation S-K only requires the audit committee report to state whether:

- The audit committee reviewed and discussed the audited financial statements with management;
- The audit committee discussed with the independent auditors the matters required to be discussed by Public Company Accounting Oversight Board (PCAOB) auditing standards;
- The audit committee has received the written disclosures and the letter from the independent accountant required by the PCAOB regarding the independent accountant's communications with the audit committee concerning independence and discussed the independent accountant's independence with the independent accountant; and
- Based on such review and discussions, the audit committee recommended to the board of directors that the audited financial statements be included in the company's annual report on Form 10-K.

In 2015, the SEC issued a concept release requesting comments on possible revisions to audit committee disclosures. The concept release focused on three main areas of disclosure:

- The audit committee's oversight of the auditor;
- The audit committee's process for appointing or retaining the auditor; and
- The audit committee's consideration of the qualifications of the audit firm and certain members of the engagement team.

The comment period for the audit committee disclosure concept release has expired, and the SEC has not issued any specific proposals in response to the issues raised by the concept release. However, in the interest of transparency, some companies have expanded their audit committee disclosures beyond the mandatory requirements.

In a recent analysis of 75 companies in the Fortune 100 list that filed proxy statements in each year from 2012 to 2017 (for annual meetings through August 15, 2017), Ernst & Young LLP (EY) found a continued increase in voluntary audit committee disclosures.[21] According to this study, in 2017, 87 percent of such Fortune 100 companies explicitly stated that the audit committee is responsible for the appointment, compensation and oversight of the external auditor, 84 percent stated that the audit committee considers non-audit fees/services when assessing auditor independence, 77 percent named the audit firm in the audit committee report, 75 percent stated that the audit committee was involved in the lead partner selection and 73 percent stated that the choice of external auditor is in the best interest of the company and its shareholders.

Expanding audit committee reports may be well received by institutional investors, some of which advocated for additional audit committee disclosures even before the SEC issued its concept release. As the 2018 proxy season approaches, those responsible for preparing the proxy statement may want to discuss with their audit committees and auditors whether they consider it appropriate to voluntarily expand audit committee disclosures at this time.

New Auditors' Report Requirements

The PCAOB has adopted a new standard for unqualified auditors' reports of financial statements.[22] On October 23, 2017, the SEC approved the PCAOB's changes to auditors' reports. Some commentators have expressed objections to certain of the new PCAOB provisions.

The PCAOB's changes would, among other things, require:

- Disclosure of critical audit matters, as well as communication to the audit committee, relating to accounts or disclosures that are material to the financial statements which involved especially challenging, subjective or complex auditor judgment;
- Disclosure of the year in which the auditor began serving consecutively as the company's auditor; and
- Improvements to the auditor's report to clarify the auditor's role and responsibilities, and make the auditor's report easier to read.

Subject to SEC approval, the provisions for the new audit report, other than those related to critical audit matters, are proposed to become effective for audits of fiscal years ending on or after December 15, 2017. Provisions related to critical audit matters are proposed to become effective for audits of fiscal years ending on or after June 30, 2019, for large accelerated filers and for fiscal years ending on or after December 15, 2020, for all other companies to which the requirements apply. Once the SEC approves the final standard, auditors may elect to comply with the new requirements early. Companies and audit committees should discuss the new audit committee report requirements with their auditors.

New Revenue Recognition Standard

The new revenue recognition standard, ASU No. 2014-09, goes into effect starting with fiscal years beginning after December 15, 2017. Calendar year companies will need to apply this new standard in their first quarterly report for 2018 rather than in their annual reports for 2017. However, companies that are required to apply the new standard should include robust transition disclosures in their annual reports to enable investors to understand the anticipated effects of the new standard. Companies affected by the new revenue standard should be discussing the anticipated effects of the new standard with their accountants and audit committees and preparing appropriate disclosure for their financial statement footnotes, management's discussion and analysis and/or other sections of their annual reports.[23]

Exhibit Hyperlinks

The SEC now generally requires the exhibits listed in the exhibit index of specified filings, including annual reports on Form 10-K or Form 20-F, to be hyperlinked. The hyperlink requirement covers both exhibits that are filed as part of a report and exhibits that are incorporated by reference to prior filings. The technical instructions for providing the required hyperlinks are contained in Chapter 5 of Volume II of the EDGAR Filer Manual. Note that Item 601(a)(2) of Regulation S-K and Item 102(d) of Regulation S-T require the exhibit index to appear before the required signatures in the registration statement or report.

Because an annual report on Form 10-K or Form 20-F generally has a substantially longer list of exhibits than other SEC registration statements and reports, it would be very useful for companies to identify the URLs for the exhibits that will be incorporated by reference into their annual reports well before the filing is due. Companies can start this process by gathering the exhibit indexes from last year's annual report and subsequent periodic and quarterly reports filed with the SEC and annotating them with the URLs. Appropriate company personnel should review the relevant EDGAR instructions and coordinate with their financial printers, EDGAR filing agents or software providers to understand what has to be done to ensure that their annual report exhibit indexes are prepared appropriately so that technical glitches do not interfere with the annual report filing when made.[24]

Form 10-K Developments

The SEC issued an interim final rule in 2016 amending Form 10-K to expressly allow, but not require, companies to include a summary of information required by that form. Item 16 of Form 10-K authorizes optional summary information that is presented fairly and accurately if there is a hyperlink to the material contained in the Form 10-K, including exhibits, disclosed in the summary. Many companies chose not to include such a summary in annual reports on Form 10-K for the year ended December 31, 2016, often referencing Item 16 in their Form 10-Ks, indicating "none" or similar words. If used, the summary may only refer to information that is included in the Form 10-K at the time it is filed. Companies do not need to update the summary for information required by Part III of Form 10-K that is incorporated by reference to a proxy or information statement filed after the Form 10-K, but in that case the summary must state that it does not include Part III information because that information will be incorporated from a later-filed proxy or information statement involving the election of the board of directors.

There have been some technical changes to the cover page of Form 10-K. In addition to the boxes indicating whether the registrant is a large accelerated file, an accelerated filer, a smaller reporting company or a non-accelerated filer, there also must be a box for an emerging growth company to check. In addition, the cover page must include a check box designed to indicate whether a registrant that is an emerging growth company has elected not to use the extended transition period for complying with any new or revised financial accounting.

Notes

1. For more information about this rule and its practical implications, *see* Mayer Brown's Legal Update "Understanding the SEC's Pay Ratio Disclosure Rule and its Implications," dated Aug. 20, 2015, *https://www.mayerbrown.com/files/Publication/a9183a67-efc1-4bcc-859a-f11c0a28e776/Presentation/PublicationAttachment/c3ae9779-28c6-4ee2-996a-efbd405d4952/150820-UPDATE-CS-EB.pdf*, Mayer Brown's Legal Update "SEC Provides Pay Ratio Disclosure Guidance," dated Oct. 25,

2016, Mayer Brown's Legal Update "Get Ready for Pay Ratio," dated Sept. 6, 2017, *https://www.mayerbrown.com/files/Publication/85ee0a7b-e1cd-4d83-8542-46dc2a17d5e4/Presentation/PublicationAttachment/9fe3af85-8c36-42a2-a60f-574c0839f23c/161025-UPDATE-CS.pdf*, and Mayer Brown's Legal Update "Pay Ratio Rule: SEC Provides Additional Interpretive Guidance," dated Sept. 28, 2017, *see https://www.mayerbrown.com/files/Publication/9fdf6781-ff29-4f85-877f-76148272bfa5/Presentation/PublicationAttachment/ce5ba2d6-b01a-49b3-ac17-806d3171553f/Get-Ready-for-Pay-Ratio.pdf*.

2. *See https://www.sec.gov/rules/interp/2017/33-10415.pdf*.
3. See *https://www.sec.gov/corpfin/announcement/guidance-calculation-pay-ratio-disclosure*.
4. *See https://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm*.
5. *See* Semler Brossy, "2017 Say on Pay Results," 9/13/2017, available at *http://www.semlerbrossy.com/wp-content/uploads/SBCG-2017-SOP-Report-09-13-2017.pdf*.
6. *See https://www.sec.gov/interps/legal/cfslb14i.htm*.
7. *See https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2017/steinercheveddenh&r072117-14a8.pdf*.
8. See *https://www.sec.gov/Archives/edgar/data/70145/000092189516006095/sc14n05867018_11102016.htm* for the Schedule 14N and *see https://www.sec.gov/Archives/edgar/data/70145/000080724916000490/nfg_10.htm* for the Schedule 13D/A.
9. *See http://www.proxymonitor.org/*.
10. *See https://www.ssga.com/investment-topics/environmental-social-governance/2017/Summary-of-Material-Changes-to-SSGAs-2017-Proxy-Voting-and-Engagement-Principles.pdf*.
11. *See* Baer, Justin, "State Street Votes Against 400 Companies Citing Gender Diversity," *Wall St. J.*, July 25, 2017, available at *https://www.wsj.com/articles/state-street-votes-against-400-companies-citing-gender-diversity-1501029490*.
12. *See https://www.issgovernance.com/file/policy/2017-2018-iss-policy-survey-results-report.pdf*.
13. *See https://about.vanguard.com/investment-stewardship/governance-letter-to-companies.pdf*.
14. *See http://comptroller.nyc.gov/newsroom/press-releases/comptroller-stringer-nyc-pension-funds-launch-national-boardroom-accountability-project-campaign-version-2-0/*.
15. *See https://comptroller.nyc.gov/newsroom/comptroller-stringer-virtual-only-meetings-deprive-shareowners-of-important-rights-stifle-criticism/*.
16. *See http://media.broadridge.com/documents/MKT-1956-17-VSM-Article4.pdf*.
17. *See https://east.virtualshareholdermeeting.com/vsm/home*.
18. *See https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2016/cheveddennaylor122816-14a8.pdf*.
19. *See https://comptroller.nyc.gov/newsroom/comptroller-stringer-virtual-only-meetings-deprive-shareowners-of-important-rights-stifle-criticism/*.
20. *See https://comptroller.nyc.gov/wp-content/uploads/documents/NYCRS-Corporate-Governance-Principles-and-Proxy-Voting-Guidelines_April-2016-Revised-April-2017.pdf*.
21. *See* EY Center for Board Matters, "Audit committee reporting to shareholders in 2017," available at *http://www.ey.com/Publication/vwLUAssets/ey-audit-committee-reporting-to-shareholders-in-2017/$FILE/ey-audit-committee-reporting-to-shareholders-in-2017.pdf*.
22. *See https://pcaobus.org/Rulemaking/Docket034/2017-001-auditors-report-final-rule.pdf*.
23. Companies transitioning to the new revenue recognition standard have a choice of two methods: the full retrospective method and the modified retrospective method. For a discussion of how the choice of method may affect registration statements of Form S-3, *see* Mayer Brown's Legal Update "Implications of New Revenue Recognition Standard on Certain Form S-3 Registration Statements," dated Sept. 20, 2017. *See https://www.mayerbrown.com/Implications-of-New-Revenue-Recognition-Standard-on-Certain-Form-S-3-Registration-Statements-09-20-2017/*.
24. For more information on the exhibit hyperlink requirement, *see* Mayer Brown's Legal Update "SEC Requires Hyperlinks for Exhibits in Company Filings," dated March 9, 2017, and Mayer Brown's Legal Update "Get Ready to Hyperlink SEC Exhibit Filings Beginning September 1," dated July 20, 2017. *See https://www.mayerbrown.com/files/Publication/5d8118bc-4fdf-4cbb-a455-fc811f904c7b/Presentation/PublicationAttachment/73cdf78f-8afa-4a16-9079-0587a582df84/170309-UPDATE-CS.pdf*.

SECURITIES ENFORCEMENT

The SEC's Unlawful and Dangerous Expansion of the Exchange Act

The SEC has applied the "internal controls" and "books and records" provisions to hiring interns and reinstituting an airline route. A careful review of statutory language and legislative history, however, demonstrates that the Commission has ventured far beyond the authority that Congress granted in these accounting provisions.

By Michael N. Levy and Amanda L. Fretto

In a series of recent settled enforcement actions with major U.S. companies involving the hiring of interns and the reinstatement of an airline route, the Securities and Exchange Commission (SEC) progressively has expanded what it believes to be the scope of Sections 13(b)(2)(A) and (B), commonly known as the "books and records" and "internal controls" provisions, of the Securities Exchange Act of 1934 (Exchange Act).[1] As discussed below, the plain meaning and congressional intent of these provisions addressing "internal *accounting* controls" and "books, records, and *accounts*" that fairly reflect "*transactions*" and the disposition of "*assets*" clearly establish that these recent resolutions reflect an expansion by the SEC of the Exchange Act well beyond any reasonable reading.[2] If allowed to persist, this expansion not only is unlawful, but it also hands the SEC the capacious authority to regulate by enforcement almost any aspect of the operations of any issuer. Congress did not grant that authority to the SEC when it passed these provisions,[3] and the SEC should not be allowed to seize that authority today.

Michael N. Levy *is a partner, and* **Amanda L. Fretto** *is an associate, at Paul Hastings LLP in Washington, DC. The views expressed in this article are those of the authors alone and do not reflect the views of any other individuals or entities.*

Background

In 1976, as concerns grew about the payment of bribes to foreign government officials to obtain business in those countries, members of Congress began to question the "double-bookkeeping" and "off-the-books accounts" that had facilitated those payments.[4] Likewise, the SEC itself published a report on May 12, 1976, that focused on how improper accounting in companies' books and records facilitated the making of improper payments and may have created material misstatements or omissions in companies' financial statements.[5] Throughout the development of what became the "internal accounting controls" and "books, records, and accounts" provisions added to the Exchange Act by the Foreign Corrupt Practices Act (FCPA), members of Congress, the SEC, and witnesses at hearings consistently spoke of the need to address corrupt *payments*. The focus was on the use of funds to pay bribes and how those bribes would be recorded (or disguised) in companies' *financial* records. There were no broad discussions, or even references, to the use of other potential benefits—such as providing internships or offering particular services—in an effort to gain influence. Although the FCPA's anti-bribery provision contains broad language covering the giving of "anything of value" to a foreign official,[6] neither the "internal accounting controls" provision nor the "books, records, and accounts" provision speaks with such flexible language. Both the plain meaning and legislative history of those two provisions make clear that they are dedicated exclusively to accounting concepts and do not apply broadly to all "internal controls" or all "records" used by companies in the course of running their businesses.

The "books, records, and accounts" provision, Section 13(b)(2)(A) of the Exchange Act, states that issuers shall:

> make and keep books, records, and *accounts*, which, in reasonable detail, accurately and fairly reflect the *transactions* and *dispositions of the assets* of the issuer.[7]

The text of the statute, therefore, limits the "books, records, and accounts" at issue to those books, records, and accounts that reflect the "*transactions*" and "dispositions of the *assets*" of the issuer. The provision requires accuracy only in the types of records one ordinarily would find in the financial records of a company—documents that record financial transactions, the generation of revenue, and payment of expenses—that ultimately roll up to the financial statements filed with the SEC and disclosed to investors. The provision uses the terms "accounts," "transactions," and "assets" for a reason; it is an *accounting* provision. It is not a provision that requires accuracy in all records anywhere in a company, whether or not they are related to the accounting concepts of "transactions" or the disposition of "assets."

Likewise, the text of the "internal accounting controls" provision is limited to *accounting* controls. In this regard, Section 13(b)(2)(B) of the Exchange Act states that issuers shall:

> devise and maintain a system of internal *accounting* controls sufficient to provide reasonable assurances that:
>
> (i) *transactions* are executed in accordance with management's general or specific authorization;
>
> (ii) *transactions* are recorded as necessary (I) to permit preparation of *financial statements* in conformity with *generally accepted accounting principles* or any other criteria applicable to such statements, and (II) to maintain accountability for *assets*;
>
> (iii) access to *assets* is permitted only in accordance with management's general or specific authorization; and
>
> (iv) the recorded accountability for *assets* is compared with the existing *assets* at reasonable intervals and appropriate action is taken with respect to any differences.[8]

The text of the statute makes clear that the provision governs only "internal *accounting* controls." The conclusion that, like the "books, records, and accounts" provision, this too is an accounting provision is further buttressed by the succeeding subsections that refer repeatedly to accounting concepts like recording "transactions" as necessary to prepare "financial statements" in conformity with "generally accepted accounting principles." Subsection (iv), for example, mandates that companies perform basic inventory accounting and reconciliation at reasonable intervals. Thus, Section 13(b)(2)(B) of the Exchange Act is limited on its face to "internal accounting controls," not, as often described, all "internal controls." The distinction is critical and reflects the unambiguous meaning of the term "internal accounting controls" as understood by members of Congress, the President, and the SEC itself at the time this legislation was passed.

The origins of the "internal accounting controls" and "books, records, and accounts" provisions are quite clear. As part of its 1976 Report on Questionable and Illegal Corporate Payments and Practices, the SEC proposed amendments to the Exchange Act that were "nearly identical to the [internal accounting controls and books, records, and accounts] provisions ultimately contained in the Act."[9] Explaining the source of its proposal, the SEC stated:

> Because the accounting profession has defined the objectives of a system of accounting control, the Commission has taken the definition of the objectives of such a system contained in our proposed legislation from the authoritative accounting literature. American Institute of Certified Public Accountants [("AICPA")], Statement on Auditing Standards No. 1 [(SAS 1)], 320.28 (1973).[10]

Subsequent statements by the SEC, in legislative reports, and at congressional hearings uniformly referred to SAS 1, and its Section 320.28 in particular, as the definitive source of the "internal accounting controls" provision.[11] The role of SAS 1, Section 320.28 as the "authoritative accounting literature" from which the language of the "internal accounting controls" provision of the Exchange Act was derived essentially verbatim is fundamental to understanding that statutory provision.

SAS 1, Section 320 expressly distinguished "accounting controls," as defined in Section 320.28, from "administrative controls," as defined in Section 320.27. "Accounting controls" are the organizational plan, procedures, and records for "the safeguarding of *assets* and the reliability of *financial records*" that are designed to achieve the same four elements as the "internal accounting controls" provision of the Exchange Act.[12] In contrast, "administrative controls" are the organizational plan, procedures, and records "that are concerned with the decision processes leading to management's authorization of transactions."[13] As the standard framed it, such "authorization is a management function directly associated with the responsibility for achieving the objectives of the organization."[14] To avoid any ambiguity, SAS 1, Section 320.49 expressly stated that "accounting control is within the scope of the study and evaluation of internal control contemplated by generally accepted auditing standards, while *administrative control is not*."[15] Thus, it is clear that Congress intended the "internal accounting controls" provision of the Exchange Act to cover accounting controls and *not* administrative controls.

SAS 1 repeatedly distinguished between accounting controls, which relate directly to an auditor's examination of a company's financial statements, and administrative controls, which relate only indirectly to a company's financial statements. Accounting controls must be audited as part of an examination of financial statements.[16] In contrast, "constructive suggestions to clients for improvement" in administrative or managerial controls are "incident to an audit engagement" and expressly "not covered by generally accepted auditing standards."[17] Administrative controls "are concerned mainly with operational efficiency and adherence to managerial policies and usually relate only indirectly to the financial records."[18] Indeed, in SAS 1, the AICPA expressly rejected a definition of accounting controls that broadly would have covered any "means of protection against something undesirable."[19] Such a broad definition of accounting controls would have applied,

> for example, [to] a management decision to sell a product at a price that proves to be unprofitable … to a decision to incur expenditures for equipment that proves to be unnecessary or inefficient, for materials that prove to be unsatisfactory in production, for merchandise that proves to be unsaleable, for research that proves to be unproductive, for advertising that proves to be ineffective, and to similar management decisions.[20]

One easily might add to that list hiring interns who are unqualified and offering products, services, or airline routes that are unprofitable.[21] SAS 1, Section 320—the express basis for the "internal *accounting* controls" provision of the Exchange Act—directly rejected such a broad definition.[22]

Likewise, the legislative history of the "books, records, and accounts" provision demonstrates that Congress, the President, and the SEC all intended that provision to apply to the books, records, and accounts "that are relevant to the preparation of financial statements," not to any and all records located anywhere in a company.[23] Nothing in the legislative history suggests otherwise. Both the "internal accounting controls" and "books, records, and accounts" provisions were consistently referred to at the time as "accounting" provisions.[24] Indeed, the provisions appeared in Section 102 of the Foreign Corrupt Practices Act of 1977, which was entitled "Accounting Standards."[25] Moreover, the legislative history reflects that, like the "internal accounting controls" provision, the "books, records, and accounts" provision was drafted from an accounting and auditing perspective and applies to the *financial* records of the company from which the company's external financial statements are derived.[26] Contemporaneous statements demonstrate the clear understanding by both Congress and the SEC that the provision requires an issuer's books, records, and accounts to "reflect *transactions* in conformity with accepted methods of recording *economic* events."[27]

In proposing the "books, records, and accounts" provision, the SEC called it "a prohibition against the falsification of corporate *accounting* records."[28] The goal was to ensure that corporate "funds" used to make questionable "payments" would be accurately recorded so that the financial statements "filed with the Commission and circulated to shareholders do not omit or misrepresent material facts."[29] Indeed, the Senate Committee on Banking, Housing and Urban Affairs stated that the requirement of Section 13(b)(2)(A) already was "implicit in the existing securities laws" but ought to be made explicit.[30]

The "books, records, and accounts" provision merely requires that companies do what they already were required to do.

In other words, the "books, records, and accounts" provision merely requires that companies do what they already were required to do: maintain financial records such that their publicly reported financial statements are not materially misstated. In discussing the proposed legislation, the SEC had the same perspective and objective for the "books, records, and accounts" standard: "Absent reliable underlying corporate records, the preparation of financial statements in accordance with generally accepted accounting principles would be extremely difficult."[31] Indeed, in one of the rare comments about the accounting provisions made during congressional debate, Senator John Tower, a member of the Senate Banking Committee, explicitly stated that the "books, records, and accounts" provision did not

> establish a new accounting standard. Its purpose is to require that books and records are kept so that financial statements prepared in accordance with generally accepted accounting principles can be derived from them.[32]

This legislative intent—to have the "books, records, and accounts" provision mandate the maintenance of those records needed to compile materially accurate financial statements—also is logically consistent with and complementary to the "internal accounting controls" provision of the Exchange Act passed in conjunction with it.[33] Financial records that are used for "external reporting," for example, are within the scope of internal accounting controls as described by SAS 1 and as set forth in Section 13(b)(2)(B) of the Exchange Act, but records that are used for "internal management" are not. SAS 1, Section 320.17 expressly discussed "the two separate purposes for which the financial records may be used[,] internal management and external reporting," while Section 320.19 stated that the definition of accounting control set forth in Section 320.28 clarified that accounting control extends only "to the reliability of financial records for *external reporting* purposes (see paragraph .17)."[34] Likewise, financial "books, records, and accounts" that are "kept so that financial statements prepared in accordance with generally accepted accounting principles can be derived from them" fall within the scope of Section 13(b)(2)(A) of the Exchange Act, but the vast majority of corporate documents do not.[35]

Analysis of Recent SEC Enforcement Actions

In a series of recent settled enforcement actions, however, the SEC has expanded its interpretation of these accounting provisions well beyond any reasonable reading of their plain meaning or congressional intent. As a result, the SEC has asserted for itself, without any judicial oversight, a vast authority to regulate through enforcement almost every aspect of every business listed as an issuer in the United States. This asserted power reflects a dangerous regulatory incursion by the SEC into aspects of American commerce in which it has neither expertise nor lawful authority.

This incursion began in August 2015 when the SEC and The Bank of New York Mellon agreed to the entry of a cease-and-desist order pursuant to Section 21C of the Exchange Act.[36] The SEC alleged that BNY Mellon provided internships to the sons and a nephew of two foreign officials in an effort to obtain or retain business from the sovereign wealth fund for which the officials worked. In addition to alleging a violation of the anti-bribery provision of the FCPA,[37] the SEC alleged a violation of the "internal accounting controls" provision of the Exchange Act for failing to "devise and maintain a system of internal accounting controls around its hiring practices."[38] The dearth of controls to which the SEC pointed in support of this allegation, however, had nothing to do with accounting. The SEC alleged that certain employees had "wide discretion" to make initial hiring decisions, human resources was not trained to "flag" potentially problematic hires, and the bank had "no mechanism to ensure that potential hiring violations were reviewed by anyone with a legal or compliance background."[39] "Legal or compliance" controls, however, are not "accounting controls," and "hiring violations" involve violations of precisely the type of "administrative controls" that do not fall within the meaning of "internal accounting controls" for purposes of the Exchange Act and SAS 1. The SEC did not charge BNY Mellon with violations of the "books, records, and accounts" provision of the Exchange Act, perhaps because none of the "hiring violations" impacted the books, records, or accounts that rolled up into the financial statements to ensure they would not be materially misstated. For the same reason, of course, these types of allegedly flawed hiring controls are not internal *accounting* controls.[40]

A year later, in November 2016, the Commission extended its misuse of the Exchange Act to encompass the "books, records, and accounts" provision. The SEC charged another bank with violating the anti-bribery, "internal accounting controls," and "books, records, and accounts" provisions of the Exchange Act in connection with the bank offering employment and internships through a "Client Referral Program" in its Asia-Pacific region to obtain or retain business.[41] The SEC contended that the bank had "failed to devise and maintain a system of internal accounting controls around its hiring practices sufficient to provide reasonable assurances that its employees were not bribing foreign officials" by offering employment or internships to their family members or others.[42] Simply calling something an accounting control, however, does not make it an accounting control for purposes of the statute. As described above with respect to BNY Mellon, the human resources, legal, and compliance processes described in the SEC's charges are administrative controls, not accounting controls. They impact financial records only indirectly and, on their face, involve human resources, legal, and compliance personnel and policies – not accountants and auditing.

The dearth of controls to which the SEC pointed had nothing to do with accounting.

Likewise, the "books and records" (the Commission simply omits references to the "accounts" portion of the provision) at issue were questionnaires developed to ensure compliance with internal company hiring policies.[43] Although those questionnaires may have had valuable legal and compliance objectives, they were not financial records and had nothing to do with the preparation of financial statements in accordance with generally accepted accounting principles. They were not books, records, or accounts that reflected "the transactions and dispositions of assets" within the plain meaning or legislative intent of Section 13(b)(2)(A) of the Exchange Act. If administrative controls failed and compliance questionnaires were inaccurate and that resulted in a violation of law over which the SEC has enforcement jurisdiction, then the SEC is well within its statutory authority to punish that resulting substantive violation. When the controls at issue, however, are not accounting controls and the documents are not "books, records, and accounts" involving transactions and the disposition of assets within the meaning of the Exchange Act, the SEC has no lawful basis to charge a company with violations of Sections 13(b)(2)(A) or (B) for failing to prevent that substantive violation.[44]

The most egregious disregard for the plain meaning and legislative intent of the "internal accounting controls" and "books, records, and accounts" provisions, however, came one month later, in December 2016, when the SEC reached a cease-and-desist agreement with United Continental Holdings.[45] The SEC alleged that United reinstituted a previously cancelled route from Newark, New Jersey, to Columbia, South Carolina, even though it was expected to be unprofitable, at the request of the Chairman of the Board of Governors of the Port Authority of New York and New Jersey, before which United had pending matters.[46] The Commission's reasoning attempting to justify "internal accounting controls" and "books, records, and accounts" violations was tortured.

Compliance and ethics approvals are not "books, records, and accounts."

In its Order, the Commission defined the internal decision by United's management to reinstitute the South Carolina route as "the Transaction."[47] Definitional legerdemain, however, does not magically convert into a "transaction" a decision about whether to offer for sale to the public a particular product or service, such as a particular airline route. Indeed, such a decision is precisely the type of management decision that is governed by administrative, not accounting, controls. As SAS 1 makes clear, "a management decision to sell a product at a price that proves to be unprofitable" or a "decision to incur expenditures … for merchandise that proves to be unsaleable" is governed by administrative controls and, accordingly, does not fall within the scope of SAS 1 or the "internal accounting controls" provision of the Exchange Act.[48] Likewise, the Commission's allegations that United violated its own compliance and ethics policies are inapposite.[49] Compliance and ethics policies may be very important, but they are not "internal *accounting* controls."

Remarkably, the SEC also alleged that United's failure to obtain the written approvals required by the company's compliance and ethics policies constituted a violation of the "books, records, and accounts" provision of the Exchange Act.[50] But the absence of a "transaction" dooms any such claim, and compliance and ethics approvals are not "books, records, and accounts" that have anything to do with auditing or a company's preparation of financial statements. As with its *ipse dixit* definition of "the Transaction," the SEC also attempted to justify the "books, records, and accounts" charge by asserting that United did not make and keep records that accurately and fairly reflected the "*use* of assets" in connection with the South Carolina route.[51] Section 13(b)(2)(A), however, does not address records relating to the "use" of assets. It addresses records relating to "transactions" and the "dispositions" of assets.[52] "Disposition" of an asset in this context means "the act of transferring or relinquishing of that property to another's care or possession."[53] Transactions and the dispositions of assets are about the types of sales or transfers that would impact the financial statements. They are not about how an asset is "used," which relates to management's administrative operation of the business. Put simply, compliance and ethics records or records of administrative decisions by management do not equate to books, records, and accounts that accurately and fairly reflect the transactions and dispositions of assets of the issuer and, as such, are outside the scope of the plain meaning and legislative intent of Section 13(b)(2)(A).

The danger of this Order is further laid bare when one considers that the United matter had nothing to do with—and the "internal accounting controls" and "books, records, and accounts" provisions of the Exchange Act apply without regard to—foreign bribery. The United matter was wholly domestic and, accordingly, no "anti-bribery" charges were, or could have been, brought by the SEC. Considered in this light, the United Order is an assertion by the Commission that violations of internal corporate ethics and compliance policies, internal management decisions about what products and services to offer, and written authorizations (or the lack thereof) to proceed with such decisions fall within the SEC's power to enforce the Exchange Act, even in the absence of foreign bribery, breakdowns in genuine *accounting* controls, or any errors or irregularities in the financial books, records, and accounts from which a company's financial statements are derived. This is frightening.

Conclusion

Through this line of cases, culminating (for now) in the United Order, the SEC has ignored the clear limitations on its authority set forth in the carefully chosen words and unambiguous legislative intent of the "internal accounting controls" and "books, records, and accounts" provisions. Without the limitations that Congress put in the statute, the SEC stands to become, in practice, an über regulator of virtually all aspects of all businesses listed on U.S. exchanges. Based on the United Order, the SEC could charge violations of Sections 13(b)(2)(A) and (B) any time an issuer violated its own internal ethics, compliance, or other policies (the internal controls) or failed to get the proper written authorizations (the books and records) for just about any management decision with which the SEC disagrees after the fact. As described previously, the AICPA expressly rejected a definition of accounting controls in SAS 1 that would have covered any "means of protection against something undesirable," and, in adopting the language of SAS 1 in Section 13(b)(2)(B), Congress rejected it as well.[54] Not only would such an expansion of the SEC's powers be unlawful, but it also would alter fundamentally the allocation of power within the Executive Branch. It would enable the SEC to become, in effect, a primary regulator for all publicly-traded companies. The SEC, however, does not have the industry expertise to serve such a role. Indeed, one would think that the appropriate body to regulate decisions by airlines about whether to offer certain routes would be the Department of Transportation, not the SEC.

Moreover, such a dramatic distortion of the SEC's enforcement power is not necessary to ensure compliance with the law. In addition to the ability of primary regulators (such as the Federal Reserve, the Department of Transportation, and many other bodies that have expertise and authority over the industries they regulate) to make and enforce rules governing the types of administrative management at issue in these three Orders, the Department of Justice retains the authority to enforce violations of our criminal laws. Indeed, the Department of Justice investigated and obtained a Non-Prosecution Agreement from United and a guilty plea from the former Chairman of the Port Authority for domestic bribery based on the company's establishment and operation of the South Carolina route.[55] There is no need, and no lawful authority, for the SEC to use Sections 13(b)(2)(A) and (B) to regulate this conduct.

In passing the Foreign Corrupt Practices Act, Congress did not authorize SEC enforcement actions for the failure of issuers to prevent wrongdoing writ large.[56] The "internal accounting controls" and "books, records, and accounts" provisions are carefully limited to matters relating to financial transactions, the sale or transfer of assets, and controls and records necessary to ensure that companies' financial statements are prepared in conformity with generally accepted accounting principles. They are not provisions that require issuers both to have and to comply fully with all of the legal, ethical, and compliance policies that govern the myriad of management judgments and administrative activities that occur every day in the life of a modern corporation. The SEC's assertion of such authority under the Exchange Act not only poses a threat to the appropriate allocation of authority within the regulatory state, but it also threatens to destroy any reasonable limits on the appropriate role of government in the business decisions of publicly traded companies.

Notes

1. In the Matter of The Bank of New York Mellon Corp., Exchange Act Release No. 34-75720, SEC File No. 3-16762, Order Instituting Cease-and-Desist Proceedings (Aug. 18, 2015) (BNY Order) (claiming violations of the anti-bribery and the "internal accounting controls" provisions for providing internships to relatives of foreign officials); In the Matter of JP Morgan Chase & Co., Exchange Act Release No. 34-79335, SEC File No. 3-17684, Order Instituting Cease-and-Desist Proceedings (Nov. 17, 2016) (JPM Order) (claiming violations of the anti-bribery, "books, records, and accounts," and "internal accounting controls" provisions for providing jobs and internships to relatives and friends of foreign officials); In the Matter of United Continental Holdings, Inc., Exchange Act Release No. 34-79454, SEC File No. 3-17705, Order Instituting Cease-and-Desist Proceedings (Dec. 2, 2016) (United Order) (claiming violations of the "books, records, and accounts" and "internal accounting controls" provisions in connection with reinstituting a flight route from Newark, New Jersey, to Columbia, South Carolina, for allegedly corrupt purposes).
2. 15 U.S.C. §§ 78m(b)(2)(A), (B) (emphasis added).
3. Congress passed these provisions in 1977 as part of the Foreign Corrupt Practices Act. Title I of Pub. L. No. 95-213, 91 Stat. 1494 (1977) (amending Section 13(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78m(b)). Subsequent amendments to the FCPA in 1988 and 1998 did not change the language of either Section 13(b)(2)(A), the "books, records, and accounts" provision, or Section 13(b)(2)(B), the "internal accounting controls" provision, of the Exchange Act. International Anti-Bribery and Fair Competition Act of 1998, Pub. L. No. 105-366, §§ 0001-0006, 112 Stat. 3302 (1998) (codified as amended in scattered sections of 15 U.S.C.) (making no changes to the FCPA's "accounting provisions"); Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, §§ 5001-5003, 102 Stat. 1107, 1415-25 (1988)) (codified as amended in scattered sections of 15 U.S.C.) (defining, in a new Section 13(b)(7), "reasonable detail" and "reasonable assurances" as used in Sections 13(b)(2)(A) or (B), but not altering the language of either of those provisions).
4. 122 Cong. Rec. S6515 (daily ed. May 5, 1976) (statement of Sen. Church); *see also* ABA Comm. on Corp. Law and Accounting, *A Guide to the New Section 13(b)(2) Accounting Requirements of the Securities Exchange Act of 1934 (Section 102 of the Foreign Corrupt Practices Act of 1977)*, 34 Bus. Law. 307, 328 (1978) ("1978 ABA Guide").
5. *See* SEC Rep. on Questionable and Illegal Corporate Payments and Practices, A-B (Comm. Print 1976), *reprinted in* Sec. Reg. & L. Rep. No. 353 (May 19, 1976) (submitted to the Senate Committee on Banking, Housing and Urban Affairs, 94th Cong.) (1976 SEC Report).
6. 15 U.S.C. § 78dd1(a). This article does not address whether providing internships to friends or relatives of foreign officials or deciding to offer particular goods or services for sale to the public constitutes the giving of "anything of value" to a foreign official for purposes of the Act's anti-bribery provision. Rather, this article focuses on the "internal accounting controls" and "books, records, and accounts" provisions of the Act because, as discussed *infra*, those two provisions are not tied statutorily solely to situations involving allegations of bribery of foreign officials and, accordingly, if misinterpreted or abused, could have a far broader, and more destructive, impact on the day-to-day business operations of issuers.
7. 15 U.S.C. § 78m(b)(2)(A) (emphasis added).
8. 15 U.S.C. § 78m(b)(2)(B) (emphasis added).
9. 1978 ABA Guide at 331. The only difference between the SEC's proposed amendment and the "books, records, and accounts" provision as passed was Congress's addition of the limiting phrase "in reasonable detail." *Compare* 1976 SEC Report at 63, *with* 15 U.S.C. § 78m(b)(2)(A); *see also* H.R. Rep. No. 95831, at 10 (1977) (Conf. Rep.) (Conference Report). The only differences between the SEC's proposed amendment and the "internal accounting controls" provision as passed was Congress's deletion of the superfluous word "adequate" modifying

"system" and insertion of the phrase "general or specific" in subsection (iii). *Compare* 1976 SEC Report at 63-64, *with* 15 U.S.C. § 78m(b)(2)(B); *see also* Conference Report at 10.

10. 1976 SEC Report at 59; *see also id.* at 65.
11. *See, e.g.*, Questionable or Illegal Corporate Payments and Practices, Exchange Act Release No. 3413185, 42 Fed. Reg. 4854, 4856 (Jan. 26, 1977) (reiterating that the legislation proposed by the SEC would require issuers to devise and maintain a system of internal accounting controls that meets "the objectives articulated by the American Institute of Certified Public Accountants in Statement on Auditing Standards No. 1, section 320.28 (1973)"); S. Comm. on Banking, Housing, and Urban Affairs, Foreign Corrupt Practices and Domestic and Foreign Investment Improved Disclosure Acts of 1977, S. Rep. No. 95114, at 8 (1977) (confirming that "the definition of the objectives contained in this subparagraph is taken from authoritative accounting literature" and citing SAS 1, Section 320.28); *Foreign Corrupt Practices and Domestic and Foreign Investment Disclosure: Hearings on S. 305 Before the S. Comm. on Banking, Housing, and Urban Affairs*, 95th Cong. 220 (1977) (statement of N. Wolfson, Professor of Law, U. Conn.) (testifying that "[t]he statutory language, however, is not the careless invention of Senatorial staffers but is taken word for word from the authoritative accounting literature" and citing SAS 1, Section 320.28); S. Comm. on Banking, Housing, and Urban Affairs, Corrupt Overseas Payments by U.S. Business Enterprises, S. Rep. No. 941031, at 11 (1976) (1976 Senate Report) (noting that "the definition of the objectives contained in this subparagraph is taken from the authoritative accounting literature").
12. SAS 1, § 320.28 (emphasis added).
13. SAS 1, § 320.27.
14. *Id*.
15. SAS 1, § 320.49 (emphasis added).
16. *See, e.g.*, SAS 1, § 320.02 (distinguishing between management advisory and consulting services to study, evaluate, and improve administrative controls and "those audit services required for compliance with the auditing standard for study and evaluation of internal control *incident to an examination of financial statements*") (emphasis added); SAS 1, § 320.06 (noting that "[t]he purpose of the auditor's study and evaluation of internal control" for purposes of this auditing standard "is to establish a basis for reliance thereon…in his examination of the financial statements").
17. SAS 1, § 320.08.
18. SAS 1, § 320.10.
19. *See* SAS 1, §§ 320.14, 320.19.
20. SAS 1, § 320.14.
21. *See, e.g.*, BNY Order (hiring interns); JPM Order (hiring interns); United Order (offering an airline route from Newark, New Jersey, to Columbia, South Carolina).
22. In 1988, SAS 1 was superseded in pertinent part by SAS 55, which was amended in 1995 by SAS 78 and again in 2001 by SAS 94. *See* Consideration of the Internal Control Structure in a Financial Statement Audit, Statement on Auditing Standards No. 55 (Am. Inst. of Certified Pub. Accountants 1988) (SAS 55); Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55, Statement on Auditing Standards No. 78 (Am. Inst. of Certified Pub. Accountants 1995) (SAS 78); The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit, Statement on Auditing Standards No. 94 (Am. Inst. of Certified Pub. Accountants 2001) (SAS 94). For public companies, the Public Company Accounting Oversight Board (PCAOB) in 2003 adopted this amended version of SAS 55 and then in 2010 superseded that standard and dispersed its elements into a number of new standards. *See* PCAOB Release No. 2003006, Establishment of Interim Professional Auditing Standards, at 2-6 (Apr. 18, 2003); PCAOB Release No. 2010004, Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards, at A912, A913, A914, A918, A931, A935, A108, A1036, A1037, A1041 (Aug. 5, 2010). These succeeding accounting standards confirm that what SAS 1 referred to as administrative controls fall outside the scope of an audit of accounting controls. Indeed, the standards consistently emphasize an audit's focus on financial statement accuracy and reiterate the distinction between administrative and accounting controls drawn by SAS 1. *See, e.g.*, SAS 55.7 ("An entity generally has internal control structure policies and procedures that are not relevant to an audit

and therefore need not be considered. For example, policies and procedures concerning the effectiveness, economy, and efficiency of certain management decision-making processes, such as the appropriate price to charge for its products, or whether to make expenditures for certain research and development or advertising activities, although important to the entity, do not ordinarily relate to a financial statement audit."); SAS 78.12 ("An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, controls concerning compliance with health and safety regulations or concerning the effectiveness and efficiency of certain management decision-making processes (such as the appropriate price to charge for its products, or whether to make expenditures for certain research and development or advertising activities), although important to the entity, ordinarily do not relate to a financial statement audit."); SAS 94.12 (same but adding: "Similarly, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as a commercial airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the financial statement audit and therefore need not be considered."). Of course, these subsequent accounting pronouncements, even though they uniformly are consistent with the distinction between administrative and accounting controls set forth in SAS 1, are irrelevant for purposes of statutory interpretation. Even as the AICPA moved the then-authoritative accounting language used virtually verbatim in Section 13(b)(2)(B) of the Exchange Act to an appendix in SAS 55 and then deleted it entirely in SAS 78, Congress never altered the statutory language of Section 13(b)(2)(B). Accordingly, it is the statutory language and legislative intent of the internal accounting controls language of the 1977 Act, rooted so firmly in SAS 1, rather than any subsequent changes in accounting literature, that govern.

23. 1978 ABA Guide at 313.
24. *See, e.g., id.* at 308 (describing both provisions as the "new accounting requirements of the 1977 Act"). The 1978 ABA Guide consistently refers to the two provisions as "accounting requirements," "the accounting provisions," "the accounting standards requirements of the Act," and "the new accounting mandates." *See, e.g., id*. at 308-09, 311-12, 325.
25. Foreign Corrupt Practices Act of 1977, title 1, Pub. L. 95213, 91 Stat. 1494 (1977).
26. *See* 1978 ABA Guide at 308 (referring to the "books, records, and accounts" provision as relating to the "maintenance of financial records"); *id*. at 309 ("Subsection (A) deals with the keeping of financial records; subsection (B) deals with internal accounting controls.").
27. 1976 Senate Report at 11 (emphasis added); *accord* Conference Report at 10 (stating that, when the Conference Committee accepted the House's amendment to add the phrase "in reasonable detail" to the "books, records, and accounts" provision, that amendment "makes clear that the issuer's records should reflect transactions in conformity with accepted methods of recording economic events and effectively prevent off-the-books slush funds and payments of bribes"); *Unlawful Corporate Payments Act of 1977: Hearings on H.R. 3815 and H.R. 1602 Before the Subcomm. on Consumer, Protection and Finance of the H. Comm. on Interstate and Foreign Commerce*, 95th Cong. 220 (1977) (statement of H. Williams, Chairman, SEC) (testifying that the "books, records, and accounts" provision "means that issuer records must reflect transactions in conformity with accepted methods of recording economic events").
28. 1976 SEC Report at 58 (emphasis added).
29. *Id*. at A-B; *see also id*. at 42 (noting that the "books, records, and accounts" provision "was directed to affirmative acts," such as the use of "substantial off-book funds" for questionable or illegal purposes, "that would distort the accounting records"); Questionable or Illegal Corporate Payments and Practices, 42 Fed. Reg. at 4855 (noting that the "Commission has found that improper and undisclosed expenditures of corporate assets are frequently accompanied by inaccurate maintenance, or outright falsification, of corporate accounting records").
30. 1976 Senate Report at 11.
31. Questionable or Illegal Corporate Payments and Practices, 42 Fed. Reg. at 4856.

32. 123 Cong. Rec. S38379, at 38602 (1977) (statement of Sen. John Tower), *https://www.gpo.gov/fdsys/pkg/GPO-CRECB-1977-pt30/pdf/GPO-CRECB-1977-pt30-1.pdf*.
33. Congress's amendments to the FCPA in 1988 and 1998 also demonstrated the legislature's consistent intent to limit the scope of the "books, records, and accounts" and "internal accounting controls" provisions. While the 1988 amendments expanded the scope of liability under the anti-bribery provision of the FCPA by removing the exclusion of ministerial or clerical government employees from the definition of "foreign official," Congress expressly limited liability under the accounting provisions by defining the terms "reasonable detail" and "reasonable assurances" "in order to clarify that the current standard does not connote an unrealistic degree of exactitude or precision." H.R. Rep. No. 10076, at 917 (1988); *see also id.* at 916 (stating the congressional finding that the accounting standards previously set forth in the 1977 Act were "excessive"). In 1998, Congress again expanded the scope of the anti-bribery provision by adding persons working for or on behalf of a "public international organization" to the definition of "foreign official" and adding "securing any improper advantage" to its enumerated prohibited purposes. S. Rep. No. 105277, at 2-3 (1998). At the same time, however, Congress declined to expand or amend in any way either accounting provision. By so doing, Congress powerfully confirmed the limited accounting and financial statement scope of the "books, records, and accounts" and "internal accounting controls" provisions, even while it expanded the scope of the anti-bribery provision.
34. SAS 1, §§ 320.17, 320.19 (emphasis added).
35. 123 Cong. Rec. S38379, at 38602; *see also* 1978 ABA Guide at 311 (identifying the objectives of the accounting provisions as ensuring that accurate "financial books and records" reflecting "transactions in conformity with accepted methods of recording economic events" are maintained in "such a manner as to permit the preparation of financial statements in conformity with generally accepted accounting principles"); *id.* at 313 (describing the standard for violating the "books, records, and accounts" provision as whether "at the time interim and annual financial statements are required to be prepared [the issuer] is unable to prepare from its books and records financial statements that are in all material respects in conformity with generally accepted accounting principles appropriate in the circumstances"); *id.* (describing the "books, records, and accounts" provision as requiring that "*accounting books of original entry, ledgers* and other *accounting data*," in addition to other "sufficient competent evidential matter" as defined by the AICPA, "be maintained *to the extent reasonably necessary to support the financial statements* and to permit the independent *auditors* to apply *generally accepted auditing procedures*") (emphasis added). False entries in internal company records that are not "reasonably necessary to support the financial statements and to permit the independent auditors to apply generally accepted auditing procedures" do not violate the "books, records, and accounts" provision of the Exchange Act.
36. *See* BNY Order.
37. As discussed earlier, *see supra* note 6, this article does not address the question of whether such internships constitute a "thing of value" for purposes of the anti-bribery provision of the FCPA.
38. BNY Order at 2.
39. *Id.* at 8.
40. Like the other resolutions discussed in this article, there were no allegations that any of the BNY Mellon internships were "no-show" jobs, in which someone was paid without actually having to show up to work. Those situations involve a more classic bribery scheme in which the job is merely a false accounting entry—just like a phony invoice—to cover up funneling cash payments for the benefit of the targeted official. Although the resolutions discussed herein are replete with allegations that some of the interns did not meet the "rigorous criteria" for being hired or were "less than exemplary" employees, *id.* at 6-7, the allegations do not come close to establishing such a direct bribery scheme. Indeed, some of the interns were unpaid. *See, e.g.*, *id.* at 7.
41. *See* JPM Order.
42. *Id.* at 3.
43. *See, e.g.*, *id.* at 3.
44. In contrast, earlier in 2016, in another matter involving efforts to obtain or retain business by offering

employment and internships to relatives of foreign officials, the SEC demonstrated precisely what types of internal accounting controls and books, records, and accounts do fall within the ambit of Sections 13(b)(2)(A) and (B). In that matter, the SEC alleged that Qualcomm had violated the anti-bribery provision of the Exchange Act by its offers of employment and internships but expressly did not allege that the failures of Qualcomm's internal controls or the inaccuracies in documents relating to this hiring violated the "internal accounting controls" or "books, records, and accounts" provisions. Rather, the Commission asserted violations of those provisions on the basis of allegedly inadequate accounting controls and inaccurate books, records, and accounts involving the much more traditional—and financial—problems of uncontrolled and falsely documented travel, gift, and entertainment expenditures for foreign officials. *See* In the Matter of Qualcomm Inc., Exchange Act Release No. 3477261, SEC File No. 317145, Order Instituting Cease-and-Desist Proceedings at 9 (Mar. 1, 2016) (charging an anti-bribery violation based on the employment and internship offers but "internal accounting controls" and "books, records, and accounts" violations based on "the provision of travel, gifts, and entertainment to foreign officials without prior pre-approval"); *id.* at 7 (citing only the provision of hospitality packages in the section of the Order relating to internal accounting controls); *id.* at 8 (citing only inaccurate booking of travel and hospitality events and deficient recording of expenditures on meals, gifts, and entertainment in the section of the Order relating to books, records, and accounts).

45. *See* United Order.
46. *See id.* at 2, 4.
47. *Id.* at 2.
48. SAS 1, § 320.14; *see also supra* at 4-5; SAS 1, § 320.19.
49. *See* United Order at 2.
50. *See id.* at 8.
51. *Id.* (emphasis added).
52. 15 U.S.C. § 78m(b)(2)(A).
53. *Disposition Definition*, USLegal.com, *https://definitions.uslegal.com/d/disposition/* (last visited July 20, 2017); *see also* Black's Law Dictionary (10th ed. 2014) (defining "disposition" as "[t]he act of transferring something to another's care or possession, esp. by deed or will; the relinquishing of property"); SEC Form 8K, SEC 873 (0417), Item 2.01 Instructions (requiring written disclosure of the disposition of assets where "[t]he term disposition includes every sale, disposition by lease, exchange, merger, consolidation, mortgage, assignment or hypothecation of assets, whether for the benefit of creditors or otherwise, abandonment, destruction, or other disposition"); *Nat'l Credit Union Admin. Bd. v. RBS Sec., Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 99,229 (D. Kan. July 12, 2016) (holding, in the absence of a statutory definition, that the term "disposed of" should be given its "ordinary meaning" of "transferred or relinquished…to another").
54. *See supra* at 5.
55. *See* United Continental Holdings, Inc. Non-Prosecution Agreement (Jul. 11, 2016), *https://www.justice.gov/usao-nj/file/875351/download* (imposing a $2.25 million penalty); *United States v. Samson*, No. 2:16cr00334 (D.N.J. 2016). *See also* In the Matter of J.P. Morgan Chase & Co., No. 1622BHC, Order to Cease and Desist, at 5 (Fed. Res. Bd. of Gov. Nov. 17, 2016) (Federal Reserve ordering cease and desist pursuant to Section 8 of the Federal Deposit Insurance Act, 12 U.S.C. §§ 1818(b)(1), (3) without relying on the Exchange Act). This further establishes that primary regulators are more than capable of regulating conduct in their industries without the need for the SEC to bring charges on the basis of unsupportable readings of the "internal accounting controls" and "books, records, and accounts" provisions.
56. Congress also did not provide such authority to the Department of Justice, for the same reasons articulated here. The Department of Justice, because it can turn to a far broader set of criminal statutes to prosecute corporate wrongdoing, generally has not found it necessary to push the scope of Sections 13(b)(2)(A) and (B) as expansively as the SEC has. *See, e.g.*, *Samson*, No. 2:16cr00334 (charging violation of 18 U.S.C. § 666(a)(1)(B) but not charging violations of 15 U.S.C. § 78m(b)(2)). Any effort by the Department of Justice to bring criminal charges under the "internal accounting controls" and "books, records, and accounts" provisions on the same basis as the SEC has in the three matters discussed in this article, of course, would be equally unjustifiable.

CORPORATE GOVERNANCE

SEC Staff Gives Company Boards Central Role in 14a-8 'Ordinary Business' and 'Economic Relevance' Exclusions

SEC Staff Legal Bulletin 141 sets out guidance on company requests to exclude shareholder proposals under the "ordinary business" and "economic relevance" exclusions in Rule 14a-8. It indicates an increased deference to companies, but requires greater board engagement.

By Richard Alsop, Stephen Giove, and Lona Nallengara

On November 1, 2017, the staff (Staff) of the Division of Corporation Finance of the Securities and Exchange Commission (SEC) issued Staff Legal Bulletin No. 14I (SLB 14I)[1] on shareholder proposals, which sets out a potentially meaningful repositioning of the role that the Staff has played in connection with its review of requests to exclude shareholder proposals under the "ordinary business" and "economic relevance" exclusions of Rules 14a-8(i)(7) and 14a-8(i)(5).

SLB 14I seeks to provide the Staff with the ability to rely on, and possibly defer to, a company's board of directors in connection with its assessment of no-action requests pursuant to these exclusions. In addition, SLB 14I also clarifies procedural requirements for shareholder proponents who submit proposals by proxy and "codifies" thinking it has expressed in recent no-action letter requests related to the use of images in shareholder proposals.

Background on "Ordinary Business"

Under Rule 14a-8(i)(7), a company is allowed to exclude a shareholder proposal that addresses "a matter relating to a company's ordinary business operations." When considering whether a shareholder proposal could be excluded under Rule 14a-8(i)(7), the Staff considers whether the proposal relates to a subject matter that is so fundamental to management's ability to run the company that it should not be subject to shareholder oversight. There is an exception to this exclusion—if a shareholder proposal relates to "significant social policy issues" that "transcend" a company's ordinary business operations, the Staff will not permit exclusion of the proposal.

Traditionally, the Staff has taken an active role in determining whether the subject matter of a proposal relates to a significant policy issue. While the Staff has not demarcated the boundaries of what is a significant policy issue (employing a "we know it when we see it" approach), past experience indicates that the Staff, in addition to the arguments presented by the company and the shareholder proponent, will independently consider a number of factors. These include the degree of public attention given to an issue, press and other media coverage, and recent legislative or regulatory activity. As a result, there is a well-developed body of specific issues that Staff considers to be significant policy issues, but these determinations have been developed on a case-by-case basis and then applied broadly.

Background on "Economic Relevance"

Under Rule 14a-8(i)(5), companies are permitted to exclude a shareholder proposal if the proposal relates to operations which account for less than 5 percent of a company's total assets, net earnings and

Richard Alsop, Stephen Giove, *and* **Lona Nallengara** *are partners at Shearman & Sterling LLP.* *The authors thank Shearman & Sterling associates Rupa Briggs and Daniel Yao for their contributions to this article.*

gross sales and is not otherwise significantly related to the company's business.

Despite the appeal of an objective, bright-line 5 percent test, this exclusion has been infrequently relied upon by companies because of the expansive view the Staff has taken under the "not otherwise significant" prong of the exclusion. If a company did any business related to the issue in question and the issue touched upon a matter of "broad social or ethical concern," the Staff has been inclined to deny exclusion of the proposal.

New Guidance under SLB 14I

With SLB 14I, the Staff has indicated that it wants to shift the determination of whether the subject of a proposal transcends the ordinary business operations of a company, in the case of the "ordinary business" exclusion, or is significantly related to a company's business, in the case of the "economic relevance" exclusion, to a company and, more specifically, to a company's board of directors.

The Staff has struggled with these determinations over the years and in SLB 14I it referred to these decisions as "difficult judgment calls." In SLB 14I, the Staff indicated that it believes a company's board of directors is "well situated to analyze, determine and explain whether a particular issue is sufficiently significant." Going forward, when a company relies on either Rule 14a-8(i)(7) or 14a-8(i)(5), the Staff will expect to see a discussion of "the specific processes employed by the board to ensure that its conclusions [as to whether the issue transcends its ordinary business operations or if it is significantly related to its business] are well-informed and well-reasoned."

For "economic relevance" exclusions, the Staff also indicated that the bar would be raised for proponents going forward. Proponents would need to demonstrate that a proposal was sufficiently related to a significant effect on a company's business and that the "mere possibility" of reputational or economic harm will not preclude no-action relief.

Notably, the Staff emphasized that there is a presumption that "substantive governance matters" will be significant to almost all companies, which likely forecloses the possibility of using the "economic relevance" exclusion for corporate governance proposals.

Implications

It will take at least one full proxy season to assess the significance of the Staff's repositioning on the "ordinary business" and "economic relevance" exclusions. As an initial observation, it appears that SLB 14I is a broad grant of deference to companies, recasting the role that the Staff played in determining the significance of any particular issue. How much the Staff will rely on the assessments made by a company's board of directors is something we will have to wait to see, but it does appear that the Staff wants to ease out of these complicated decisions for which it is not entirely equipped to make. It is also, perhaps, an admission by the Staff that a "one size fits all" approach may not be most appropriate given that companies considering proposals on the same social policy issue can be in widely different industries with widely different considerations. SLB 14I may mark a change in the way the no-action process has played out over the years. It could mean that certain topics, such as executive compensation or environmental issues, which, in the past, have been considered open-and-shut issues, could be reevaluated if a company can show the relative insignificance of such topic to its business operations. Additionally, proponents may no longer be able to defend against attempts at exclusion by shoehorning proposals into a topic that the Staff has deemed to be a significant policy issue for another company in the past.

What is certain, though, is that SLB 14I means direct engagement by the board of directors in the shareholder proposal process. Given the Staff's new focus on the assessment by a company's board of directors, specifically, the request for "a discussion of the specific processes employed by the board," we expect that companies looking to rely on these exclusions will need to show engagement by the board in the no-action letter process and explain what the board did and considered.

What Do Boards Need to Do?

This new dynamic will draw boards more directly into the shareholder proposal process. What the Staff expects to see from boards in terms of the process employed will become clear over time.

The following are steps that a board should consider in demonstrating that it has engaged in "specific processes" to evaluate the subject matter of a proposal.

Review past board work. Has the board considered the subject matter of the proposal before? If the board, in another context, has considered the policy issue or whether the issue in question is significantly related to the company's business, the board should be able to rely on that analysis. We would recommend, however, that the board, where appropriate, refresh the analysis with some of the steps identified below and, at the very least, address the topic as a board or a committee of the board in the context of the shareholder proposal.

Consider prior shareholder and stakeholder engagement. Have shareholders raised the subject matter of the proposal directly to the company? Are these issues on which institutional shareholders have expressed views? Have the issues in the shareholder proposal been raised by customers, employees or by the communities in which the company operates? If so, the board should consider and assess the importance of these perspectives as part of its analysis.

Consider legislative, regulatory developments. Has the subject matter of the proposal been part of any legislative or regulatory activity? The board should consider the implication of those actions.

Consider peer companies and industry activity. The board should understand if and/or how its peers have considered the issue and addressed the same shareholder proposal. The board also should have an understanding if there are developing trends or best practices both among leading companies and industry peers.

There are also some procedural implications that companies will need to consider if they seek to rely on these exclusions.

Less time, with more to do. Practically speaking, companies may have as little as 40 days between receiving a shareholder proposal and when they need to submit a no-action letter.[2] Companies should be prepared to have their boards meet if necessary during this period to consider responding to shareholder proposals under Rules 14a-8(i)(5) and (i)(7).

Does the whole board need to meet? It is unclear to what degree that the SEC will consider the analysis by a board committee to be sufficient in demonstrating that a board has undertaken "specific processes" in considering the issues underlying the shareholder proposal. Boards have wide latitude to delegate authority to committees and subcommittees, so we would expect that delegation to a properly constituted committee of a board would suffice.

Prior no-action letter precedent. It is unknown how much the Staff will rely on the prior history of Staff interpretations on a particular topic and the conclusions that the company's peers may have reached regarding the same issue. While we expect that the Staff will not consider itself beholden to its past decisions on any particular issue given the new guidance, it is also unlikely the Staff will wipe the slate clean. We expect that past precedent and peer practice will still play a role in the Staff's assessment of a particular issue.

How much should you say about "specific processes" employed by the board? We will learn over time what the Staff is expecting with respect to a discussion of the specific processes employed in assessing the issues presented in the shareholder proposal, but, for now, we would expect that any no-action request should include a discussion of the process the board employed to evaluate the issue, the factors it considered in making its determination and the determination itself. We do not believe that "specific processes" entails a description of the inner workings of a board itself, including the dates on which it met and the topics and decisions covered. A more general description of the board processes that demonstrates thorough consideration, along with conclusions drawn may be required so that the Staff can comfortably defer to the board's assessment. Companies should consider the level of detail included in a no-action request, as it will quickly become public disclosures of how the board operates.

Proponent Proxies

It is common for shareholder proponents, including certain individuals who have historically been very prolific in submitting proposals, to use "proxies" to submit proposals where such proponents do not directly own the shares. While Rule 14a-8 does not have formal procedures that lay out the steps necessary for proponents to submit "proposals by proxy," the Staff consistently has viewed such practice within the bounds of Rule 14a-8. SLB 14I clarifies, however, that the Staff may require proof that the shareholder of record has in fact delegated the appropriate authority to the proxy, in addition to any proof of ownership that may be required. The new documentation is required to: (1) identify the shareholder proponent and the person or entity selected as proxy; (2) identify the company to which the proposal is directed; (3) identify the annual or special meeting for which the proposal is submitted; (4) identify the specific proposal to be submitted; and (5) be signed and dated by the shareholder.

We expect that these new requirements will be quickly adapted to by shareholder proponents, although on the margins it may lead to exclusion of shareholder proposals where delegation is not considered to be sufficiently proven by the Staff. The new requirements seem to reflect a moderated response from the Staff to the growing frustration with the practice.[3]

Is a Picture Worth 500 Words?

SLB 14I also codifies into guidance recent decisions by the Staff relating to the use of images in shareholder proposals. Shareholder proposals are not prohibited from containing images; however, the images will be subject to compliance with the rest of Rule 14a-8, including, among other things, requirements that the images not be materially false or misleading, not impugn character, integrity or personal reputation, and not be irrelevant to the consideration of the subject matter of a proposal. In addition, should the image contain any text, such text will be counted toward Rule 14a-8's 500-word limit.

Conclusion

Much remains to be seen regarding how the Staff will implement SLB 14I in practice. While we expect that SLB 14I indicates an increased deference by the Staff to companies in determining the significance of a shareholder proposal to its business, we also expect that the Staff will consider perfunctory analyses by boards inadequate for exclusion under Rules 14a-8(i)(5) or (i)(7). To what extent the Staff will be willing to grant deference to a company's analysis and to what degree a company's board will need to demonstrate sufficient engagement with a shareholder proposal are questions that everybody—companies and shareholder proponents alike—will be eager to understand.

Finally, many of the shareholder proposals submitted to companies direct the company, and often times, the board of directors, to evaluate and consider if not prepare a report on a particular issue. While these proposals cover a wide array of topics, they overwhelmingly focus on issues that, for companies seeking to exclude the proposal, raise questions of whether the issue transcends the ordinary business of the company or if it is of economic relevance to it. Interestingly, the change in the Staff's position on Rules 14a-8(i)(5) and 14a-8(i)(7), is, to some degree, requiring boards to consider the very issues they were seeking not to have to address.

Notes

1. *See* Staff Legal Bulletin No. 14I (Nov. 1, 2017), available at *https://www.sec.gov/interps/legal/cfslb14i.htm*.
2. Under Rule 14a-8, there are two timing windows to consider: (1) a shareholder proponent's proposal must be submitted no later than 120 days prior to the first anniversary of the date of the company's last shareholder meeting and (2) the company's no-action letter must be submitted at least 80 days prior to the date the company files its proxy statement.
3. The Financial CHOICE Act of 2017, passed by the US House of Representatives on June 8, 2017, proposes to prohibit the submission of proposals by proxy completely.

IN THE COURTS

Ninth Circuit Trims PSLRA Safe Harbor's Protection

By Joseph E. Bringman

A recent decision of the U.S. Court of Appeals for the Ninth Circuit, *In re Quality Systems, Inc. Securities Litigation*,[1] cuts back on the protections afforded by the safe-harbor provision of the Private Securities Litigation Reform Act of 1995 (PSLRA) for public companies whose forward-looking statements are alleged to be false or misleading.

The PSLRA's safe harbor[2] is a codification of the common-law "bespeaks caution" doctrine. Subject to certain statutory exceptions—including for statements made in connection with an initial public offering or a tender offer—the safe harbor precludes civil liability based on forward-looking statements that turn out to be "wrong" in two instances. First, the safe harbor protects a statement if it is identified as forward-looking and is either immaterial or accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." Second, in the absence of meaningful cautionary language, the safe harbor still protects against liability if the maker lacked actual knowledge that the statement was false or misleading.

Pre-*Quality Systems* Application of PSLRA

"Mixed" statements containing both forward-looking and non-forward-looking components present the most difficult safe-harbor questions. In a "mixed" statement situation, arguably the inclusion of a forward-looking component makes the entire statement forward-looking. The Ninth Circuit sanctioned this approach in *Police Retirement System of St. Louis v. Intuitive Surgical, Inc.*,[3] holding that certain "mixed" statements, when examined as a whole, were forward-looking and therefore protected by the safe harbor. Other appellate courts have not gone this far, concluding that the safe harbor protects only the forward-looking portion of the mixed statement, leaving the speaker potentially liable for inaccuracies in the non-forward-looking portion.[4]

Joseph E. Bringman *is senior counsel at Perkins Coie LLP in Seattle, WA.*

Quality Systems Creates New Test

In *Quality Systems*, the Ninth Circuit essentially did an about-face, asserting that its decision in *Intuitive Surgical* had not addressed "the status of mixed statements under the PSLRA."[5] After holding that an allegedly false statement concerning the defendant company's "robust" pipeline was neither forward-looking—despite its inclusion in the same sentence as projections of revenue and earnings growth—nor inactionable as puffery, the court tacitly rejected the approaches taken in *Intuitive Surgical* and in the decisions of its sister circuits.

Focusing on the cautionary language requirement of the safe harbor's first prong, the court held that a materially false, non-forward-looking portion of a mixed statement almost always precludes application of the safe harbor to the forward-looking portion of the statement because "cautionary language must be understood in the light of the [accompanying] non-forward-looking statement."[6] In this situation, "virtually no cautionary language short of an outright admission that the non-forward-looking statements were materially false or misleading would have been adequate" to constitute the type of "meaningful" cautionary language required to qualify for safe-harbor protection.[7] In other words, in order for the safe harbor to protect the speaker from liability for the forward-looking portion of a mixed statement, the speaker would have to admit that it had violated the securities laws with respect to the non-forward-looking portion of the statement.

Having effectively gutted the protection provided by the safe harbor's first prong whenever a mixed statement includes an allegedly false non-forward-looking component, the court proceeded to do the same with the second prong based on a similar analysis:

> [Defendants'] forward-looking statements were premised on . . . non-forward-looking statements [that they knew to be untrue]. It necessarily follows that they also had actual knowledge that their forward-looking statements were false or misleading.[8]

The *Quality Systems* defendants filed a petition for rehearing *en banc*, primarily arguing that by establishing a new prerequisite for application of the safe harbor, not found in the language of the PSLRA, the court had largely eviscerated the protections afforded by the safe harbor, in contravention of Congress's intent to enhance market efficiency by encouraging greater disclosure of forward-looking information. The Ninth Circuit denied the petition.

Argument Not Considered by Ninth Circuit

Surprisingly, neither the defendants nor the amici who supported the defendants' petition for rehearing *en banc* argued that the allegedly false non-forward-looking statement in *Quality Systems*—that the company's product pipeline is robust—should itself be considered forward-looking, and therefore protected by the safe harbor, as "a statement of the assumptions underlying or relating to" the company's revenue and earnings projections.[9] Nor is there any indication in the decisions of either the Ninth Circuit or the district court[10] that this argument was presented at any time before the petition for rehearing *en banc*.

This approach, if accepted, would turn the entire "mixed statement" into a forward-looking statement subject to the safe harbor's protection. Indeed, the Ninth Circuit had appeared to endorse this approach in *Intuitive Surgical*.[11]

Implications

The Ninth Circuit may not have the last word. The *Quality Systems* decision appears to be an outlier, in conflict with decisions of other federal circuit courts of appeals and with the Ninth Circuit's own decision in *Intuitive Surgical*. Given this discord, as well as the apparent conflict between the Ninth Circuit's decision and the statutory language of the safe harbor, it would not be surprising if the defendants seek direction from the U.S. Supreme Court regarding the proper application of the PSLRA's safe harbor to mixed statements. Under the circumstances, the Supreme Court might find this case worthy of review.

But until then . . . . Unless and until the Supreme Court reverses *Quality Systems*, public companies seeking safe-harbor protections subject to the Ninth Circuit's interpretation would be well-advised to separate their forward-looking statements from any non-forward-looking, historical statements. At the very least, public companies should guard against including statements about projections or plans in the same sentence as historical information, and should not assume that optimistic descriptors like "robust" will be considered so vague as to be nonactionable puffery.

Notes

1. 865 F.3d 1130 (9th Cir. 2017).
2. 15 U.S.C. § 78u-5(c).
3. 759 F.3d 1051 (9th Cir. 2014).
4. *See, e.g.*, *In re Vivendi, S.A., Sec. Litig.*, 838 F.3d 223, 246-49 (2d Cir. 2016); *Spitzberg v. Hous. Am. Energy Corp.*, 758 F.3d 676, 691-92 (5th Cir. 2014); *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 705 (7th Cir. 2008).
5. 865 F.3d at 1141.
6. *Id.* at 1146.
7. *Id.* at 1148.
8. *Id.* at 1149.
9. 15 U.S.C. § 78u-5(i)(1)(A), (D).
10. 60 F. Supp. 3d 1095 (C.D. Cal. 2014).
11. 759 F.3d at 1059.

STATE CORNER

DFC Global: Delaware Supreme Court Emphasizes Role of the Market in Certain Appraisal Proceedings

By John Mark Zeberkiewicz and Robert B. Greco

The number of proceedings under Section 262 of the Delaware General Corporation Law (DGCL), in which stockholders who have not voted in favor of a merger and have otherwise perfected their right to seek a judicially determined assessment of the "fair value," in cash, of their shares,[1] has increased significantly over the past few years,[2] providing the courts with additional opportunities to explore the appropriate methods of assessing fair value. Although Section 262 of the DGCL expressly provides that the Court of Chancery, in assessing fair value, "shall take into account all relevant factors,"[3] a trend has emerged, principally in third-party transactions in which the target corporation was shopped, in which the Court has given significant (if not exclusive) weight to the deal price in appraising the shares subject to the proceeding.[4]

In *DFC Global Corp. v. Muirfield Value Partners, L.P.*,[5] the Delaware Supreme Court provided guidance on the use of deal price as a factor to be considered in assessing the fair value of shares in an appraisal proceeding. The Supreme Court reversed and remanded the Delaware Court of Chancery's ruling in *In re Appraisal of DFC Global Corp.*,[6] in which the lower court, in assessing fair value, relied on "a blend of three imperfect techniques," namely a discounted cash flow analysis, the respondent's comparable companies analysis, and the deal price. The Chancery Court gave each methodology equal weight and arrived at a price of $10.21 per share, which was far below the value of $17.90 per share that the petitioners' expert's discounted cash flow analysis would have yielded but still above the $9.50 per share merger consideration.[7]

On appeal, the Delaware Supreme Court stated that the respondent had made "convincing case-specific" arguments for reversing the Chancery Court's assessment of fair value—principally, that the lower court had found that the transaction was the result of a two-year market check in which financial and strategic buyers were invited to submit bids and that the target was acquired by a third-party buyer in an arm's-length transaction.[8] Although stating specifically that "there is no presumption in favor of the deal price" in an appraisal proceeding, the Supreme Court indicated that in circumstances similar to those at issue in *DFC*, deal price tends to represent the best evidence of fair value.[9] As the Chancery Court only provided one-third weight to deal price, the Supreme Court reversed and remanded its ruling.

Background

The respondent, DFC Global, was a publicly traded payday lending company with operations spanning multiple jurisdictions. Accordingly, DFC was subject to oversight from multiple regulatory authorities and frequently was unable to predict which existing and potential regulations would affect its business. Indeed, the Chancery Court found that, beginning in 2012, regulatory changes in the United Kingdom and in the United States created significant uncertainty with respect to DFC's market position and profitability.[10]

John Mark Zeberkiewicz *is a director, and* **Robert B. Greco** *is an associate, at Richards, Layton & Finger, P.A., in Wilmington, DE. The views expressed herein are those of the authors and are not necessarily the views of Richards, Layton & Finger or its clients.*

In the face of the increased regulatory uncertainty, high leverage, and questions regarding its management succession plan, DFC engaged a financial advisor to assist in a potential sales process. The process initially was focused on financial buyers, but was eventually expanded to include strategic buyers. Of the multiple potential bidders that were contacted, in late 2013, J.C. Flowers and Lone Star, the ultimate prevailing bidder, submitted indications of interest, at $13.50 and $12.16 per share, respectively.

Subsequently, DFC's board approved revised sets of projections, which lowered the company's forecast on several key metrics. As a result, and in light of other factors such as regulatory issues and a diminished market for acquisition financing, Lone Star reduced its offer. DFC ultimately accepted Lone Star's $9.50 per share offer.

The Chancery Court's Analysis

The Chancery Court reviewed in detail three metrics for arriving at fair value—discounted cash flow, comparable companies and deal price. Each method, according to the Court, suffered from a fundamental limitation attributable to the "tumultuous environment," stemming primarily from regulatory uncertainty, in which DFC was operating in the period preceding the sale.[11] The Chancery Court determined that the uncertainty affected DFC's projections, thus diminishing the reliability of the discounted cash flow analysis.[12] Similarly, the Chancery Court found that the regulatory uncertainty affected the multiples-based comparable companies analysis, a valuation methodology that relies in part on management's projected EBITDA.[13] Finally, as there was a potential that DFC was operating in a "trough" period, the Court determined that deal price was not necessarily indicative of fair value, despite the robust market check.[14]

Nevertheless, the Chancery Court found that each of the methodologies, although individually flawed, fell within a range of reasonableness and thus provided "meaningful insight" into DFC's value.[15] Given the various uncertainties, the Chancery Court determined that it would be appropriate to give each equal weight in arriving at the fair value of the shares subject to appraisal.[16]

The Delaware Supreme Court's Reversal

On appeal, DFC's central argument was that the Chancery Court erred by failing to give "presumptive and exclusive" weight to deal price.[17] DFC further argued that, in light of DFC's robust strategic review process, the lack of conflicts of interest, and other factors, the Chancery Court abused its discretion in assigning deal price only one-third of the weight. Moreover, DFC argued that the notion that the regulatory uncertainty prevented a valuation of DFC was not supported by the record.

The Supreme Court first addressed the issue that it concluded was raised on appeal but not at the lower court: the argument that deal price should be the presumptive indicator of fair value in an appraisal proceeding that follows a merger resulting from a third-party deal involving a market check. Although the Supreme Court was reluctant to consider the argument since it believed it was not properly presented to the lower court, it stated that, even if the issue were fairly presented, it was not persuaded to adopt the position. To this point, the Supreme Court echoed its prior ruling in *Golden Telecom, Inc. v. Global GT LP*,[18] in which the Court focused on the key language in Section 262 directing the Chancery Court to consider "all relevant factors" in assessing fair value to reject a similar argument.[19] Despite acknowledging that it had "little quibble with the economic argument that the price of a merger that results from a robust market check, against the back drop of a rich information base and a welcoming environment for potential buyers, is probative of the company's fair value," the Supreme Court saw "no license in the statute" for the creation of a presumption that it is either the exclusive, best, or primary evidence of fair value.[20]

But the Supreme Court's decision not to cabin the appraisal process did not

> in any way signal [its] ignorance to the economic reality that the sale value resulting from a robust market check will often be the most reliable evidence of fair value, and that second-guessing the value arrived upon by the collective views of many sophisticated parties with a real stake in the matter is hazardous.[21]

Rather, the Supreme Court recognized that, in assessing value, market prices tend to be considered superior to other valuation techniques because they constitute a distillation of the informed views of the market participants.[22] As the Supreme Court noted,

> corporate finance theory reflects a belief that if an asset—such as the value of a company as reflected in the trading value of its stock—can be subject to close examination and bidding by many humans with an incentive to estimate its future cash flows value, the resulting collective judgment as to value is likely to be highly informative and that, all estimators having equal access to information, the likelihood of outguessing the market over time and building a portfolio of stocks beating it is slight.[23]

In considering these economic principles in conjunction with Section 262's purpose, the Supreme Court explained that "fair price" is not the highest financeable price or the highest price a party would be willing to pay but is instead "the price at which a reasonable seller, under all circumstances, would regard as within a range of fair value; one that such a seller could reasonably accept."[24] In the Court's view, this was underscored by "real world evidence regarding public company M & A transactions" since "buyers in public company acquisitions are more likely to come out a loser than the seller."[25]

Applying this principle, the Supreme Court refuted each of the bases upon which the Chancery Court relied to diminish the role of deal price in determining fair value. In rejecting the argument that deal price was unreliable due to uncertainty surrounding DFC's future performance pending the outcome of regulatory actions, the Supreme Court observed that markets are apt at pricing this sort of regulatory risk.[26] The Supreme Court further found that the fact that Lone Star, a private equity firm, required a specific rate of return in connection with its acquisition of DFC did not render deal price unreliable since "all disciplined buyers, both strategic and financial, have internal rates of return that they expect in exchange for taking on the large risk of a merger."[27] "Especially untenable," in the Supreme Court's view, was the idea that deal price could not be reliable because lenders would not finance an acquisition by Lone Star at a higher price.[28] As creditors are paid before equity holders, their fear of repayment provided no reason to think that the equity was undervalued.[29]

Moreover, the Supreme Court held that the Chancery Court failed to sufficiently articulate its decision to give each of the three metrics it used one-third weight.[30] Although the Chancery Court has "considerable discretion" in determining how to calculate "fair value," the Supreme Court clarified that the Chancery Court must exercise this discretion "while also explaining, with reference to the economic facts before it and corporate finance principles, why it is according a certain weight to a certain indicator of value."[31]

In light of these findings, the Supreme Court reversed and remanded the case to the Chancery Court to reassess its fair value determination in light of the Supreme Court's decision.

Conclusion

Although the Supreme Court's decision in *DFC* declined to create a presumption in favor of deal price, the Supreme Court indicated that the discretion afforded to the Chancery Court in appraisal proceedings should be exercised in accordance with economic and corporate finance principles. In connection with third-party acquisitions of public companies following a thorough sales process, this may require a considerable weighting of deal price, particularly where comparable companies and discounted cash flow analyses may be unreliable.

Notes

1. 8 *Del. C.* § 262.
2. Charles R. Korsmo & Minor Myers, *Appraisal Arbitrage and the Future of Public Company M&A*, 92 Wash. U. L. Rev. 1551 (2015).
3. 8 *Del. C.* § 262(h).
4. *See, e.g.*, *In re Appraisal of PetSmart, Inc.*, 2017 WL 2303599 (Del. Ch. May 26, 2017); *Merion Capital LP v. BMC Software, Inc.*, 2015 WL 6164771 (Del. Ch. Oct. 21, 2015); *In re Appraisal of Ancestry.com, Inc.*, 2015 WL 399726 (Del. Ch. Jan. 30, 2015).
5. — A.3d —, 2017 WL 3261190 (Del. Aug. 21, 2017).
6. 2016 WL 3753123 (Del. Ch. July 8, 2017).
7. *Id.* at *1.
8. 2017 WL 3261190, at *1.
9. *Id.*
10. 2016 WL 3753123, at *21.
11. *Id.*
12. *Id.* at *22.
13. *Id.* at *23.
14. *Id.* at *22.
15. *Id.* at *23.
16. *Id.*
17. 2017 WL 3261190, at *12.
18. 11 A.3d 214 (Del. 2010).
19. 2017 WL 3261190, at *13–14.
20. *Id.* at *15.
21. *Id.*
22. *Id.* at *18.
23. *Id.*
24. *Id.*
25. *Id.* at *19.
26. *Id.* at *20.
27. *Id.* at *22.
28. *Id.* at *23.
29. *Id.*
30. *Id.* at *31.
31. *Id.*

CLIENT MEMOS

A summary of recent memoranda that law firms have provided to their clients and other interested persons concerning legal developments. Firms are invited to submit their memoranda to the editor. Persons wishing to obtain copies of the listed memoranda should contact the firms directly.

Andrews & Kurth LLP
Houston, TX (713-220-4200)

Pay Ratio Not Applicable to Certain Externally Managed Issuers (October 26, 2017)

A discussion of the non-applicability of the SEC's pay ratio disclosure rules to master limited partnerships and real estate limited partnerships that have no employees but, instead, are externally managed by a related entity pursuant to a service agreement.

Cadwalder, Wickersham & Taft LLP
New York, NY (212-504-6000)

Wild West No Longer: The SEC Brings Enforcement Action Against Two Initial Coin Offerings (October 12, 2017)

A discussion of the first SEC enforcement actions against two Initial Coin Offerings, which it alleges effectively operated as high-tech Ponzi schemes.

Davis Polk & Wardwell LLP
New York, NY (212-450-4000)

New Revenue Recognition Rules Could Cause a Speed Bump for Offerings in 2018 (October 2, 2017)

A discussion of special considerations for companies electing to use the full retrospective method in implementing the new revenue recognition rules (ASC 606 and IFRS 15) as they may find their ability to access the capital markets delayed until they have revised and reissued all required prior periods.

Deputy Attorney General Rod Rosenstein Delivers Address on Corporate Enforcement Policy (October 12, 2017)

A discussion of remarks by Deputy Attorney General Rod Rosenstein on corporate prosecution policies.

SEC Division of Enforcement Co-Directors on the Enforcement Division's Initiatives and Priorities (October 30, 2017)

A discussion of remarks by the SEC Enforcement Division Co-Directors, Stephanie Avakian and Steven Peiken, regarding the Division's new initiatives and enforcement priorities.

Dechert LLP
Philadelphia, PA (215-994-4000)

OCIE Publishes Risk Alert on Most Frequent Advertising Rule Compliance Issues Found during Examinations (October 2017)

A discussion of a risk alert issued by the SEC's Office of Compliance Inspections and Examinations highlighting advertising-related compliance issues "most frequently identified in deficiency letter sent to SEC-registered investment advisers" from a sample of examinations.

President Trump Signs Bill Directing SEC to Expand Safe Harbor for Certain Investment Fund Research Reports (October 2017)

A discussion of the Fair Access to Investment Research Act of 2017 signed into law by President Trump. It directs the SEC to amend Rule 139 under the Securities Act of 1933 to expand the rule's safe harbor to include certain investment fund research reports that are published or distributed by broker-dealers.

Dorsey & Whitney LLP
Minneapolis, MN (612-340-2600)

The New Supreme Court Term: Three Securities Cases (October 3, 2017)

A discussion of three securities cases on the docket for the new Supreme Court Term dealing with whistleblowers, federal and state jurisdiction of securities class actions and the scope of Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act).

Eversheds Sutherland LLP
Washington, D.C. (202-383-0100)

SEC and States Upping their Cyber Game (October 9, 2017)

A discussion of a new SEC enforcement initiative to address growing cyber-based threats and protect retail investors and the announcement by the North American Securities Administrators of over 1200 coordinated examinations finding cybersecurity-related deficiencies.

Fenwick & West LLP
Mountain View, CA (650-988-8500)

Results of 2017 Proxy Season in Silicon Valley (October 2017)

A report summarizing significant developments relating to shareholder voting at annual meetings in the 2017 proxy season among technology and life sciences companies included in the Silicon Valley 150 Index, and stockholder voting developments included in the S&P 100.

Gibson, Dunn & Crutcher LLP
Los Angeles, CA (213-329-7870)

SEC Proposes Amendments to Securities Regulations to Modernize and Streamline Disclosure (October 3, 2017)

A discussion of the SEC's proposal of amendments to modernize and simplify disclosure requirements for public companies, as well as investment advisers and investment companies pursuant to Congress' mandate under the Fixing America's Surface Transportation Act.

Goodwin Procter LLP
Boston, MA (617-570-1000)

Equity Compensation May Require HSR Filings for Executives of REITS or Other Companies (October 5, 2017)

A discussion of how the Hart-Scott-Rodino Antitrust Improvement Act applies to executives of REITs or other companies in the context of common equity compensation-related transactions.

Holland & Hart LLP
Denver, CO (303-295-8000)

Is Your D&O Insurance the Strongest? (October 26, 2017)

A discussion of a Tenth Circuit Court of Appeals decision, *MusclePharm Corp. v. Liberty Ins. Underwriters, Inc.*, affirming a finding that the company and its board of directors did not have coverage under their D&O policy for legal expenses incurred in responding to an informal SEC investigation. The memorandum notes that the policy contained a relatively restrictive definition of "claim" and that the company could have procured readily available coverage in the D&O insurance market.

Hunton & Williams LLP
Richmond, VA (804-788-8200)

Supreme Court Will Not Consider *Leidos* Case after Apparent Settlement (October 2017)

A discussion of a last minute settlement in *Leidos, Inc. v. Indiana Public Retirement System*, resulting in the U.S. Supreme Court not resolving a closely watched conflict among the lower courts as to whether shareholders can bring private actions for securities fraud premised on a corporation's failure to disclose information required by Item 303 of Regulation S-K.

Mayer Brown LLP
Chicago, IL (312-782-0600)

New SEC Guidance on Non-GAAP Financial Measures in Business Combination Communications (October 23, 2017)

A discussion of the SEC Division of Corporation Finance update to its compliance and disclosure interpretations on the use of non-GAAP financial measures in disclosures relating to business combination transactions.

Morrison & Foerster LLP
San Francisco, CA (415-268-7000)

Treasury Report, Part II: Regulation of the Capital Markets (October 10, 2017)

A discussion of a report issued by the U.S. Department of the Treasury titled "A Financial System that Creates Economic Opportunities, Capital Markets" that addresses various elements of the capital markets, from equity and debt markets, to the U.S. Treasury securities market, and to derivatives and securitizations. The Report recommends various measures, most of which would not require legislation, that would promote capital formation.

Non-GAAP Explained (October 30, 2017)

A report examining the regulations relating to the use of non-GAAP financial measures, commonly used non-GAAP financial measures, the SEC's guidance relating to the use of non-GAAP measures, comments issued by the SEC staff on this subject and what companies can do to revise their disclosures, earnings call and other communications.

Pepper Hamilton LLP
Philadelphia, PA (215-981-4000)

SEC Charges Former Private Equity Firm Partner with Defrauding Clients (October 27, 2017)

A discussion of a SEC enforcement action against a former senior manager at Apollo Management L.P. for defrauding his fund clients by improperly billing them for personal expenditures.

ReedSmith LLP
Pittsburgh, PA (412-288-3131)

SEC Investor Advisory Committee Considers Blockchain Technology and Securities Markets (October 17, 2017)

A discussion of a SEC Investor Advisory Committee meeting to consider, among other things, blockchain technology and the implications for securities markets.

Sidley Austin LLP
Chicago, IL (312-853-7000)

SEC Issues No-Action Letters to Address MiFID (October 30, 2017)

A discussion of three no-action letters issued by the SEC staff on October 26, 2017, intended to provide guidance to broker-dealers and investment advisers affected by the European Union Market's Financial Instruments Directive (MiFID) II requirements. Among other requirements, the directive compels EU investment managers to pay separately for trade execution and investment research—services that historically have been bundled in the U.S.

Wachtell, Lipton, Rosen & Katz
New York, NY (212-403-1000)

ISS Releases 2018 Draft Voting Policy Changes (October 26, 2017)

A discussion of Institutional Shareholder Services release of its draft voting policy changes for the 2018 proxy season as it relates to U.S. issuers, including: (1) director recommendations at companies with unratified "long-term poison pill;" (2) excessive non-employee director compensation; and (3) gender pay gap shareholder proposal.

Court Rejects Section 14(a) Damages Claim Alleging Inadequate Merger Proxy Disclosures regarding Regulatory Risk (October 31, 2017)

A discussion of a U.S. District Court for the District of Delaware decision, *Jaroslawicz v. M&T Bank Corp*. (Oct. 27, 2017), dismissing damages brought under Section 14(a) of the Exchange Act based on allegations that a merger proxy failed to disclose the risk that regulatory issues would delay the merger.

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