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Legal Update

2024 U.S. Proxy and Annual Report Season: It's *Starting* Time!

Although it may seem early, it is already time to start preparing for the 2024 proxy and annual report season. Additional time may be required this year because of the substantial scope and pace of relevant changes in law and practice.

This Legal Update provides an overview of key issues companies should consider as they get ready for the 2024 proxy season. Its breadth and depth may warrant using it in two ways: first, to skim its entirety to gain a sense of the landscape, and second, to consult detailed content when addressing specific topics. Topics are organized in the following categories:

- Recent Proxy and Annual Report Developments
- Proxy Voting Matters
- Governance Matters
- Environmental and Social Matters
- Additional Annual Report and Proxy Statement Matters

Recent Proxy and Annual Report Developments

INSIDER TRADING DISCLOSURES

In December 2022, the U.S. Securities and Exchange Commission (the "SEC") amended rules relating to insider trading arrangements and related disclosures. The amendments added conditions to the availability of the affirmative defense to insider trading liability contained in Rule 10b5-1 under the Securities Exchange Act of 1934 (the "Exchange Act"). The amendments were designed to address concerns regarding alleged abuse of the rule by insiders to trade securities on the basis of material nonpublic information ("MNPI"). In addition, the amendments imposed new disclosure requirements regarding an issuer's insider trading policies and procedures and the adoption, modification, and termination of Rule 10b5-1 plans and similar trading arrangements by directors and officers, as well as new disclosure requirements for executive compensation for certain equity awards made close in time to the issuer's disclosure of MNPI.

Quarterly Disclosures. New Item 408(a) of Regulation S-K requires disclosure of whether during the company's most recently completed fiscal quarter (which would be the fourth quarter in the case of an annual report) any director or officer adopted, modified, or terminated a Rule 10b5-1 plan or a similar trading arrangement. For quarterly reports on Form 10-Q, this disclosure is to be provided in Part II, Item 5(c). For annual reports on Form 10-K, this disclosure is to be provided in Part II, Item 9(b). See "Share Buyback Disclosures – Narrative Disclosures" below for similar requirements applicable to a company's adoption or termination of a Rule 10b5-1 trading arrangement.

Disclosures must include the material terms of the plan or arrangement, such as the name and title of the director or officer, the adoption or termination date, the duration of the plan or arrangement, the aggregate number of securities to be sold or purchased pursuant to the plan or arrangement, and whether the arrangement is intended to satisfy the requirements for use of Rule 10b5-1's affirmative defense. However, the disclosure is not required to include the pricing terms of the trading arrangement. This disclosure may be provided in tabular or narrative form.

On August 25, 2023, two SEC compliance and disclosure interpretations ("C&DI") were issued related to these quarterly disclosures.[1] C&DI 133A.01 states that Item 408(a)(1) of Regulation S-K does not require disclosure of termination of a plan that ends due to expiration or completion of the plan in accordance with its terms, without any action by an individual. C&DI 133A.02 specifies that the Item 408(a) disclosure requirement applies to any Rule 10b5-1 plan or similar trading arrangement covering securities in which an officer or director has a direct or indirect pecuniary interest that is reportable under Section 16, where the officer or director has made the decision to adopt or terminate the plan or arrangement.

Because this quarterly disclosure was required in the first filing that covers the first full fiscal period beginning on or after April 1, 2023, companies, other than smaller reporting companies ("SRCs"), with a December 31 fiscal year-end were already required to include this disclosure in their quarterly reports on Form 10-Q and should continue to do so for the period ending September 30, 2023, as well as in their annual reports for the fiscal year ending December 31, 2023. Companies, other than SRCs, with a June 30 fiscal year-end must first provide this quarterly disclosure in their Form 10-K for the fiscal year ended June 30, 2023. SRCs have until their first full fiscal period beginning on or after October 1, 2023 to comply with the quarterly disclosures, so SRCs with a December 31 fiscal year-end must make their first quarterly disclosures in their annual report on Form 10-K for the fiscal year ending December 31, 2023, while SRCs with a June 30 fiscal year-end will make their first quarterly disclosures in their Form 10-Q for the quarter ending December 31, 2023. See C&DI 120.26.[2]

Annual Disclosures. There are also new annual disclosures relating to insider trading arrangements. New Item 402(x) of Regulation S-K requires narrative disclosure concerning the company's option grant policies and practices regarding the timing of option grants and the release of MNPI, including how the board determines when and whether to grant options, and, if so, how the board or compensation committee takes MNPI into account when determining the timing and terms of an award.

In addition, new Item 402(x) of Regulation S-K requires new tabular disclosures if, during the most recent fiscal year, the company made an award of stock options, stock appreciation rights or similar option-like instruments to any named executive officer during a period starting four business days before, and ending one business day after, the filing of a periodic report on Form 10-Q or Form 10-K or the filing or furnishing of a current report on Form 8-K that discloses MNPI (other than a Form 8-K disclosing a material new option award grant). If it has made such an award, it must disclose in tabular form:

- The identity of the named executive officer:

- The grant date;
- The number of securities underlying the award;
- The exercise price of the award;
- The grant date fair value of the award; and
- The percentage change in the closing market price of the underlying securities between the trading day before disclosure of the MNPI and the trading day after disclosure of the MNPI.

Finally, Item 408(b) of Regulation S-K and Item 16J of Form 20-F require public companies to disclose whether they have adopted insider trading policies and procedures for directors, officers and employees, and, in the case of Item 408(b), the company itself, reasonably designed to promote compliance with insider trading laws. Companies that have adopted insider trading policies and procedures will be required to file such policies and procedures as an exhibit to their annual report on Form 10-K or 20-F. For companies reporting on Form 10-K, this policy should be filed as Exhibit 19. If a company has not adopted such policies and procedures, it will be required to disclose why it has not done so.

A longer transition period applies to these new annual disclosures, including the requirement to file insider trading policies and procedures as exhibits to an annual report. According to C&DI 120.26, companies, including SRCs, with a December 31 fiscal year-end do not need to provide these annual disclosures until their Form 10-K or 20-F for the fiscal year ending December 31, 2024. Companies, other than SRCs, with a June 30 fiscal year-end, have until their Form 10-K or 20-F for the fiscal year ending June 30, 2024 to first provide the new annual disclosures. SRCs with a June 30 fiscal year-end have until their Form 10-K or 20-F for the fiscal year ending June 30, 2025 to provide their first annual disclosures.

With respect to proxy disclosure, C&DI 120.27 provides that companies other than SRCs need not include the new disclosures until their proxy or information statements relating to their first election of directors after completing their first full fiscal year beginning on or after April 1, 2023. SRCs have until their proxy or information statements relating to their first election of directors after completing their first full fiscal year beginning on or after October 1, 2023 to include the new disclosures. Companies, including SRCs, with a December 31 fiscal year-end need not provide this disclosure until their first election of directors after December 31, 2024.

Although a longer transition period applies to these disclosures, it would be worthwhile to review and update insider trading policies and procedures well in advance to reflect the amendments to Rule 10b5-1 and, otherwise, to consider whether any revisions would be appropriate or advisable.

XBRL. Companies must tag the narrative insider disclosures, as well as quantitative amounts within the disclosures, in Inline XBRL. For more information, see our Legal Update, "SEC Adopts Amendments to Rule 10b5-1's Affirmative Defense to Insider Trading Liabilities & Related Disclosures," dated December 19, 2022.[3]

SHARE BUYBACK DISCLOSURES

In May 2023, the SEC adopted new disclosure requirements for purchases of an issuer's equity securities by or on behalf of the issuer or an affiliated purchaser, commonly referred to as "buybacks." These amendments require quantitative and qualitative disclosure of buybacks on a day-by-day basis and revise and expand the existing periodic disclosure requirements for buybacks. For issuers that file SEC reports on Forms 10-Q and 10-K, any purchase made by or on behalf of the issuer or any affiliated purchaser of shares or other units of any class of the issuer's equity securities registered under Section 12 of the Exchange Act must be disclosed quarterly, including on new Exhibit 26 for tabular disclosures. This quarterly disclosure requirement starts with the first filing that covers the first full fiscal quarter that begins on or after October 1, 2023. Calendar year-end companies must include the buyback disclosures for the fourth quarter of 2023 in their annual report on Form 10-K for the year ended December 31, 2023.

Foreign private issuers ("FPIs") that file SEC reports using FPI forms, other than Canadian companies preparing reports under the SEC's multijurisdictional disclosure system ("MJDS"), will need to disclose buybacks annually on new Form F-SR, beginning with the Form F-SR that covers the first full fiscal quarter that begins on or after April 1, 2024. The Form 20-F narrative disclosure that relates to the Form F-SR filings will be required starting in the first Form 20-F that is filed after the FPI's first Form F-SR has been filed. For FPIs with a calendar year-end: their first Form F-SR will be required with respect to the second quarter of 2024, which will be due on or before August 14, 2024, and the narrative disclosure will be required in the Form 20-F for the year ending December 31, 2024.

Registered closed-end investment management companies that are exchange traded must provide the buyback disclosures beginning with their Form N-CSR which covers the first six-month period beginning on or after January 1, 2024. For such companies with a calendar year-end, this means their first disclosures will be in the Form N-CSR for the semi-annual period ending June 30, 2024.

Tabular Disclosures. There is a required tabular format for the daily buyback disclosures providing the following information for each day shares were repurchased:

a. The date of the repurchase;

b. The class of securities purchased;

c. The total number of shares (or units) purchased, including all issuer repurchases whether or not made pursuant to publicly announced plans or programs;

d. The average price paid per share (or unit);

e. The total number of shares (or units) purchased as part of a publicly announced repurchase program;

f. The aggregate maximum number (or approximate dollar value) of shares (or units) that may yet be purchased under publicly announced repurchase programs;

g. The total number of shares (or units) purchased on the open market, which includes all shares (or units) repurchased by the issuer in open market transactions (excluding tender offers and put options);

h. The total number of shares (or units) purchased that are intended by the issuer to qualify for the Rule 10b-18 safe harbor; and

I. The total number of shares (or units) purchased pursuant to a plan intended to satisfy the affirmative defense conditions of Rule 10b5-1(c).

A footnote to the table must disclose the date of adoption or termination of any plan intended to satisfy the affirmative defense conditions of Rule 10b5-1(c) for the buybacks. In addition, a checkbox above the table must indicate whether directors or Section 16 reporting officers (or, in the case of FPIs, senior management) purchased or sold shares that are the subject of the issuer's share repurchase program within four business days before or after the announcement of such program or the announcement of an increase of an existing share repurchase plan or program.

Narrative Disclosures. Amended Item 703 requires narrative disclosures describing the objectives or rationales for the issuer's share repurchases, the process or criteria the issuer uses to determine the amount of repurchases and any policies and procedures relating to purchases and sales of the issuer's securities during a repurchase program by its officers and directors, including any restriction on such transactions. In addition, details are required regarding purchases other than through publicly announced programs, including the nature of the transactions, such as whether the purchases were made in open-market transactions, tender offers, in satisfaction of the issuer's obligations upon exercise of outstanding put options issued by the issuer, or other transactions). The details for publicly announced programs, include disclosure of announcement dates, dollar amounts approved, expiration dates, if any, programs that expired during the covered period and programs being terminated prior to expiration or under which the company does not intend to make further purchases.

In addition, Item 408(d) of Regulation S-K requires disclosure of whether, during the company's most recently completed fiscal quarter (which would be the fourth quarter in the case of an annual report), the company (as opposed to any director or officer) adopted or terminated a Rule 10b5-1 trading arrangement. Disclosure must include the material terms of the arrangement, including the adoption or termination date, the duration of the arrangement, and the aggregate number of securities to be sold or purchased pursuant to the arrangement. However, the disclosure is not required to include the pricing terms of the arrangement.

XBRL. Buyback disclosures must be made using Inline XBRL. Detail tagging is required for the quantitative amounts disclosed within the required tabular disclosures and block text tagging and detail tagging is required for narrative and quantitative information.

"Filed" Disclosures. These disclosures are considered "filed," meaning issuers will be subject to liability for misleading statements under Section 18 of the Exchange Act for these disclosures, and such information will be incorporated by reference into other filings under the Securities Act of 1933, which are subject to Securities Act Section 11 liability.

For more information, see our Legal Update, "SEC Adopts New Share Repurchase Disclosure Rules," dated May 8, 2023.[4]

CYBERSECURITY PROCESS DISCLOSURE

In July 2023, the SEC adopted final rules aimed at standardizing and enhancing disclosure relating to cybersecurity incidents and risk management processes. These rules require public companies to report (1) material cybersecurity incidents on new Form 8-K Item 1.05 or Form 6-K for FPIs (other than Canadian issuers using MJDS) and (2) cybersecurity risk management processes in a more standardized manner annually on Form 10-K in accordance with new Item 106 of Regulation S-K or Form 20-F for FPIs (other than Canadian issuers using MJDS). The annual risk management process disclosure is relevant for the 2024 proxy season because this disclosure requirement begins with annual reports for fiscal years ending on or after December 15, 2023. The cybersecurity incident reporting on Forms 8-K or 6-K commences December 18, 2023. SRCs will have an additional 180 days to comply, or until June 17, 2024.

Item 106 and the corresponding section of Form 20-F requires disclosures of (1) the company's processes, if any, for identifying and managing cybersecurity risks, (2) the board of directors' role in oversight of cybersecurity risks, and (3) management's role in managing cybersecurity-related risks and implementing the company's cybersecurity policies and procedures. Companies should consider disclosing:

- Whether and how their cybersecurity processes have been integrated into their overall risk management system or processes;
- Whether the company engages assessors, consultants, auditors, or other third parties in connection with any such processes; and
- Whether the company has processes to oversee and identify material risks from cybersecurity threats associated with its use of any third-party service provider.

In addition, companies must describe:

- The board of directors' oversight of risks from cybersecurity threats and, if applicable, identify any board committee or subcommittee responsible for the oversight of cybersecurity risk; and
- If applicable, the processes by which the board or the applicable committee is informed about cybersecurity risks.

Companies are <u>*not*</u> required to disclose the frequency of the board's discussions of cybersecurity risk, and whether and how the board considers cybersecurity risks as part of its business strategy, risk management and financial oversight. The SEC also added a materiality qualifier, requiring companies to describe management's role in assessing and managing the company's material risks from cybersecurity threats. Companies should address, as applicable, the following non-exclusive topics as part of a description of management's role in assessing and managing the registrant's material risk from cybersecurity threats:

- Whether and which management positions or committees are responsible for managing cybersecurity risk, and the relevant expertise of such persons;
- The processes by which such persons or committees are informed about and monitor the prevention, mitigation, detection and remediation of cybersecurity incidents; and
- Whether such persons or committees report on cybersecurity risk to the board of directors or a committee of the board of directors.

For additional information regarding cybersecurity disclosures, see our Legal Update, "SEC Adopts Final Rules on Public Company Cybersecurity Disclosures of Incidents and Processes," dated July 28, 2023.[5]

PAY VERSUS PERFORMANCE DISCLOSURE

During the 2023 proxy season, public companies needed to comply with the SEC's "pay versus performance" rule for the first time in proxy and information statements in which executive compensation information is required to be included pursuant to Item 402 of SEC Regulation S-K. This rule requires companies to disclose in a clear manner the relationship between executive compensation actually paid and the financial performance of the company.

Pay versus performance disclosure is governed by Item 402(v) of Regulation S-K, which requires:

- A new pay versus performance table;
- A clear description of the relationship between the compensation actually paid to the principal executive officer ("PEO") and to the average of the compensation actually paid to the other named executive officers ("Remaining NEOs") and the company's performance across each measure included in the pay versus performance table, which may be presented as a narrative, a graph or a combination of the two; and
- A tabular list of the most important financial performance measures that the company uses to link named executive officer compensation to company performance (other than SRCs).

The pay versus performance table must disclose the compensation paid to the PEO and the average compensation paid to the Remaining NEOs as compared to the following performance measures:

- Company total shareholder return ("TSR");
- Peer group TSR (other than SRCs);
- Net income; and
- A company-selected financial performance measure ("Company-Selected Measure") (other than SRCs).

The rule generally requires disclosure of five years of pay versus performance data. As a phase in, companies, other than SRCs, were allowed to provide the pay versus performance disclosure for three years, instead of five years, in the first filing in which they provide this disclosure, providing disclosure for an additional year in each of the two subsequent annual filings in which this disclosure is required. SRCs were allowed to provide the pay versus performance disclosure for two years, instead of three years, in the first filing in which they provide this disclosure, providing disclosure for an additional year in the next subsequent annual filing in which this disclosure is required. As a result, companies that disclosed three years (or two years, for SRCs) of pay versus performance disclosure in the 2023 proxy season will need to provide four years (or three years, for SRCs) of data for the 2024 proxy season.

Because the pay versus performance disclosure requirement was new last proxy season, it would be useful for companies to review their peers' disclosures to determine if there are any emerging market practices, for example, with respect to Company-Selected Measures, tabular lists, use of supplemental information, and descriptions of the relationship between pay and performance. Companies may also want to consider whether they want to update their compensation discussion and analysis to further emphasize their own view of pay for performance (which might be different from the prescriptive requirements of the pay versus performance requirements of the Item 402(v) requirement). Companies should also monitor SEC developments in this area such as comment letters, C&DIs and other guidance based on the SEC's experience with the first year of disclosures.

For additional information regarding pay versus performance disclosure, see our Legal Update, "SEC Adopts Pay Versus Performance Disclosure Rule," dated August 31, 2022.[6]

CLAWBACKS

The SEC adopted Rule 10D-1 in October 2022, directing national securities exchanges to establish listing standards that prohibit the listing of any security of a company that does not adopt and implement a written policy requiring the recovery, or "clawback," of certain incentive-based executive compensation. In keeping with the schedule required by the SEC, the NYSE and Nasdaq proposed clawback listing standards closely tracking Rule 10D-1 in February 2023, which they amended in June 2023 to provide for an October 2, 2023 effective date and a 60-day implementation period. Shortly thereafter those amendments were filed, the SEC approved the listing standards. As a result, listed companies have until Friday, December 1, 2023, to adopt and implement a compliant clawback policy. The NYSE and Nasdaq clawback listing standards are contained in Section 303A.14 of the NYSE Listed Company Manual and Rule 5608 of the Nasdaq Rulebook, respectively. The NYSE is requiring its listed companies to confirm via Listing Manager, no later than December 31, 2023, that they adopted a compliant clawback policy by December 1, 2023 (or that they are relying on an applicable exemption).

After listed companies have adopted their listing standards clawback policies, they will need to file them as exhibits to their annual reports on Form 10-K, Form 20-F or Form 40-F, as applicable. For companies reporting on Form 10-K, this policy should be filed as Exhibit 97. There are also two checkbox disclosures on the covers required on Form 10-K, 20-F, or 40-F relating to clawbacks, one asking whether any financial statements contained in the report reflect the correction of an error to previously issued financial statements and the other asking if any of those corrections are restatements that required a recovery analysis of incentive-based compensation.

In addition, the SEC has adopted new subsection (w) to Item 402 of Regulation S-K, which requires disclosure in proxy and information statements if during or after its last completed fiscal year a listed company either (1) was required to prepare an accounting restatement that required a clawback under the company's compliant clawback policy or (2) had an outstanding balance of unrecovered excess incentive-based compensation under such policy relating to a prior restatement.

For more information on Rule 10D-1 and the related listing standards, see our Legal Update, "Compensation Clawback Listing Standards Requirement: U.S. Securities and Exchange Commission adopts Final Rules," dated November 3, 2022,[7] and our Legal Update, "SEC Approves Dodd-Frank Clawback Listing Standards with October 2, 2023 Effective Date," dated June 13, 2023.[8]

EXECUTIVE OFFICER DETERMINATIONS

The 2024 proxy season may be a good time for public companies to re-evaluate which individuals should be treated as executive officers. While being an executive officer of a public company is prestigious, such status subjects individuals to short-swing liability under Section 16 of the Exchange Act and related reporting obligations, as well public disclosure of their compensation and employment agreements depending upon on their positions and their relative compensation within the company. The ramifications of being an executive officer have recently changed. Executive officers now face additional restrictions under Rule 10b5-1, including longer cooling off periods before they may trade under Rule 10b5-1 trading arrangements, as well as potential clawback of their incentive-based compensation in the event of a restatement on a no-fault basis.

As is the case for officers subject to Section 16, the new Rule 10b5-1 conditions and the clawback listing standards adopted pursuant to Rule 10D-1 require the executive officer group to include the president, principal financial officer and principal accounting officer. However, there are other individuals who may be deemed executive officers based on function, such as any vice president in charge of a principal business function and any other officer or individual who performs a policy-making function and, in some cases, executive officers of parent or subsidiary companies, which may require a company-specific facts and circumstances analysis. In light of the fact recent regulation has made status as an executive officer potentially more burdensome, companies may want to re-examine past determinations of the individuals treated as executive officers to assess if the current facts justify a smaller group of officers being designated as the executive officers of the company for SEC purposes.

Proxy Voting Matters

SHAREHOLDER PROPOSALS

Shareholder Proposals in the 2023 Proxy Season. In November 2021, the staff of the Division of Corporation Finance (the "Staff") of the SEC issued Staff Legal Bulletin No. 14L ("SLB 14L"),[9] rescinding Staff Legal Bulletins Nos. 14I, 14J and 14K. This action reversed positions the Staff had taken since 2017, with respect to the ordinary business grounds for excluding shareholder proposals from company proxy statements pursuant to Rule 14a-8(i)(7) and the economic relevance grounds for excluding shareholder proposals pursuant to Rule 14a-8(i)(5).

Specifically, SLB 14L announced that when evaluating whether a proposal may be excluded pursuant to Rule 14a-8(i)(7), the Staff "will no longer focus on determining the nexus between a policy issue and the company, but will instead focus on the social policy significance of the issue that is the subject of the shareholder proposal." SLB 14L also applied a "measured approach to evaluating companies' micromanagement arguments for exclusion pursuant to Rule 14a-8(i)(7), recognizing that proposals seeking detail or seeking to promote timeframes or methods do not per se constitute micromanagement."

In addition, SLB 14L specified that proposals raising issues of broad social or ethical concern related to the company's business may not be excluded under the economic relevance tests set forth in Rule 14a-8(i)(5), even if the relevant business falls below the "economic thresholds" specified by that ground for exclusion. SLB 14L has made it much more difficult for companies to exclude proposals under Rule 14a-8(i)(7) or Rule 14a-8(i)(5), particularly shareholder proposals addressing climate change or other environmental, social and governance ("ESG") issues. For additional information regarding SLB 14L, see our Legal Update, "SEC Staff Issues Legal Bulletin Announcing Shift in Shareholder Proposal Review Process Ahead of 2022 Proxy Season," dated November 8, 2021.[10]

SLB 14L had a significant impact on the shareholder proposal process, both in terms of proposals permitted to be excluded from proxy statements and number of shareholder proposals submitted. For example, during the 2021 proxy season, the Staff concurred with company no-action requests to exclude shareholder proposals 40 percent of the time, while during the 2022 proxy season, the Staff concurred with exclusion only 23 percent of the time. The number of shareholder proposals submitted to companies during the 2023 proxy season increased 18 percent over the 2021 proxy season totals, with proposals on social and environmental topics leading the increase in both proposals submitted and proposals voted upon.[11]

Shareholder proposals submitted to companies for inclusion in their 2023 proxy statements spanned a wide range of topics. For example, shareholder proposals addressed independent board chairs, climate change (including greenhouse gas emissions and fossil fuel financing), severance pay, special shareholder meetings, workplace matters (such as diversity, harassment and safety), lobbying, advance notice bylaws, racial equity audits, reproductive rights and freedom of association. In addition, there were anti-ESG shareholder proposals.

According to Morrow Sodali, there were fewer no-action requests during the 2023 proxy season than there were during the 2022 proxy season. Nevertheless, the rate at which the Staff concurred with requests to exclude shareholder proposals from proxy statement, as well as the number of proposals permitted to be excluded, increased during the 2023 proxy season compared to the 2022 proxy season.[12] The reduction in the number of no-action requests may reflect companies being more selective about submitting no-action requests in light of SLB 14L and the Staff's denial of many no-action requests during the 2022 proxy season. Companies receiving shareholder proposals may be devoting more attention instead to negotiations with proponents, shareholder engagement generally and development of actions and disclosures responsive to the subject of shareholder proposals.

In some cases, companies submitting Rule 14a-8 no-action requests were successful in excluding shareholder proposals even if they touched on ESG topics, for example, where the company was able to effectively articulate how a proposal seeks to micromanage the company or to establish that the proposal contained a technical defect. It remains worthwhile for companies to carefully analyze any shareholder proposals for the 2024 proxy season promptly upon receipt to preserve their options as to how to best respond, including whether a notice of defects is appropriate and whether submission of a no-action request to the Staff has potential to be effective.

Voting support for shareholder proposals has declined sharply in the past two proxy seasons, with average percentage of shares voting in favor of shareholder proposals falling from 36 percent in the 2021 proxy season to 24 percent in the 2023 proxy season, with the portion of proposals receiving majority support dropping from 19 percent to 5 percent in those years. The drop during this period was even more dramatic for social and environmental proposals, with the average favorable votes dropping from 37 percent to 20 percent, with majority approval for social and environmental proposals plummeting from 23 percent to 3 percent.[13] As ISS observed, the 2023 proxy season witnessed a drop in average shareholder support levels for environmental and social shareholder proposal resolutions, a low number of majority-supported resolutions and an uptick in "anti-ESG" proposals.[14]

According to Alliance Advisors, 28 shareholder proposals on topics addressing governance, environmental, social and compensation issues received majority support during first half of 2023, compared to 80 during 2022, and 94 during 2021.[15] Among the topics garnering shareholder approval in 2023 were proposals involving supermajority voting, special shareholder meetings, pay equity, lobbying, severance pay, workplace matters, fugitive methane and climate aligned lobbying. However, prescriptive climate change proposals, such as those relating to fossil fuels, did not receive majority approval during the first half of 2023. Although 80 independent chair proposals were voted on through June 2023, none attained majority approval.

Proposed Amendments to Rule 14a-8. In July 2022, the SEC proposed amendments to revise three of the substantive bases for exclusion of shareholder proposals under Rule 14a-8 of the Exchange Act that may make it even more difficult to exclude shareholder proposals from proxy statements. The proposal would amend the substantial implementation exclusion set forth in Rule 14a-8(i)(10) by specifying the "essential elements" of the proposal must have been substantially implemented. The proposal would also modify the duplication exclusion contained in Rule 14a-8(i)(11) by specifying that "substantially duplicates" means a proposal "addresses the same subject matter and seeks the same objective by the same means" as a previously submitted proposal. Consistent with the proposed standard for Rule 14a-8(i)(11), the proposal would revise the Rule 14a-8(i)(12) exclusion for resubmissions by changing the "addresses substantially" standard to "substantially duplicates," specifying that "substantially duplicates" means addressing the same subject matter and seeking the same objective by the same means as a proposal, or proposals, previously included in the company's proxy materials.

The proposing release provides examples of how the applications of the proposed rules would differ from the current application of Rule 14a-8. In addition, the proposing release also "reaffirmed" the standards of the ordinary business exclusion contained in Rule 14a-8(i)(7) relating to significant social policy issues and micromanagement. If the proposed amendments are adopted substantially as proposed, there may be an increase in shareholder proposals submitted for inclusion in proxy statements, with companies receiving multiple proposals on similar topics containing sufficiently different details so that the objective and means can be readily distinguished from each other. According to the SEC's Spring 2023 regulatory agenda ("SEC Regulatory Agenda"), the SEC is targeting October 2023 for amendments to Rule 14a-8. However, it is not clear as of the date of this Legal Update when the SEC intends to adopt the amendments to Rule 14a-8 and whether any such amendments will be in effect for the 2024proxy season. For additional information regarding the Rule 14a-8 proposal, see our Legal Update, "SEC Votes on Changes to Shareholder Proposal and Proxy Solicitation Rules," dated July 18, 2022.[16]

There have also been legislative initiatives in the shareholder proposal area. For example, H.R. 4640 was introduced in the Republican-controlled U.S. House of Representatives to authorize the exclusion of shareholder proposals from proxy or consent solicitation material if the subject matter of the shareholder proposal is environmental, social, or political. H.R.4657 would clarify that issuers may exclude a shareholder proposal pursuant to Rule 14a-8 without regard to whether it related to a significant social policy issue. H.R. 4655 would amend the Exchange Act to prohibit the SEC from compelling the inclusion or discussion of shareholder proposals in proxy or consent solicitation material. H.R. 4640 would authorize the exclusion of shareholder proposals from proxy or consent solicitation material if such proposals substantially implement, substantially duplicate, or are substantially similar to previously included proposals. While these measures may not have the bipartisan support necessary to become law, they reflect that shareholder proposals have increasingly become a political issue.

SAY-ON-PAY

As usually happens, the say-on-pay proposal at most companies received majority approval during the 2023 proxy season. According to Semler Brossy, only 2.1 percent of Russell 3000 companies and 2.3 percent of S&P 500 companies had a failed say-on-pay vote in the 2023 proxy season. Misalignment between the relation of pay and performance, problematic pay practices, rigor of performance goals, shareholder outreach and disclosures, non-performance based equity awards and special awards and particularly large grants were among the factors likely contributing to a failed say-on-pay vote. The average vote results were 80.9 percent approval for Russell 3000 companies and 88.6 percent approval for S&P 500 companies.[17]

An "against" recommendation from a proxy advisory firm does not always result in a failed say-on-pay vote, but it will likely cause shareholder support to decline, which may influence the ongoing level and tone of shareholder engagement on compensation matters and director nominees in the coming year, as well as future votes on say-on-pay and director elections. 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. In order to use such newly prepared materials, companies must file them with the SEC as definitive additional soliciting material not later than the date first distributed or used to solicit shareholders.

UNIVERSAL PROXY

The universal proxy rules became effective for shareholder meetings held after August 31, 2022, providing for mandatory use of a universal proxy card for all proxy solicitations in connection with contested elections for directors that are not exempt under Rule 14a-2(b). Each party in a contested election distributes its own universal proxy card including the names of all nominees for director for whom proxies are solicited, either by the company or by dissident shareholders. This enables shareholders voting by proxy to pick and choose among the different slates of candidates, similar to the manner in which they would be able to vote for directors in person at a contested shareholders meeting.

Within each group on a universal proxy card, the nominees must be listed in alphabetical order by last name and must be presented in the same font type, style and size. The proxy card must prominently disclose the maximum number of nominees for which voting authority can be granted. It must also prominently disclose the treatment and effect of a proxy that is executed in a manner which grants authority to vote for fewer or more nominees than the number of directors being elected or which does not grant authority to vote with respect to any nominees.

A dissident that intends to solicit proxies for its own nominees in a contested election for directors must give the company notice of the names of its nominees at least 60 calendar days prior to the anniversary of the previous year's annual meeting date. This notice requirement is in addition to any advance notice requirements set forth in the company's governing documents, which frequently provide for earlier notice of director nominations by dissidents.

The dissident engaging in a contested director election must file its definitive proxy statement with the SEC by the later of 25 calendar days prior to the meeting date or five calendar days after the company files its definitive proxy statement. The dissident is required to solicit the holders of shares representing at least 67 percent of the voting power for the election of directors in order to trigger the universal proxy card requirements. The universal proxy rules require the company to disclose in its proxy statement how it intends to treat proxies granted in favor of a dissident's nominees if the dissident abandons its solicitation or if it fails to comply with the universal proxy rules.

For more information, see our Legal Update, "SEC Adopts Universal Proxy Rules," dated November 23, 2021.[18]

Governance Matters

BOARD DIVERSITY AND COMPOSITION

Nasdaq-listed companies are required to have, or explain why they do not have, at least two diverse directors, including (1) at least one director who self-identifies as female (regardless of gender designation at birth) and (2) at least one director who self-identifies as either an "Underrepresented Minority," as defined in Nasdaq Rule 5605(f), or as LGBTQ+ and to annually disclose directors' self-identified gender, race and ethnicity in a standardized board diversity matrix.[19] There are transition periods based on the company's listing tier and board size. For example, Nasdaq Global Select Market and Nasdaq Global Market companies must already have, or explain why they do not have, one diverse director by December 31, 2023, with this requirement increasing to two diverse directors by December 31, 2025. Nasdaq already requires board diversity matrix disclosure, either in a company's proxy statement or on a company's website. For more information, see our Legal Update, "SEC Approves Nasdaq Board Diversity Rule," dated August 10, 2021.[20] Additionally, some investors have advocated for board matrix disclosure more generally (rather than just for Nasdaq companies).

The SEC Regulatory Agenda targets April 2024 for proposed rule amendments to enhance company disclosures about the diversity of board members and nominees, but that timing means such board diversity amendments will not be in effect for the 2024 proxy season. However, there are other drivers of board diversity, such as voting policies established by proxy advisory firms, voting policies and engagement priorities of large institutional investors and public perception. In addition, a few states have adopted or considered board diversity legislation, in the form of mandates, disclosure or reporting requirements or non-binding resolutions, although California's two board diversity statutes have each been held to violate the California Constitution by the Superior Court of California. Litigation is also pending challenging the legality of Nasdaq Rule 5605(f). *National Center for Public Policy Research v. SEC* (oral argument in the Fifth Circuit Court of Appeals was held in August 2022).

There are board composition matters in addition to diversity that companies may want to take into consideration when recruiting director nominees. Nominating and governance committees may have areas of focus for board candidates specific to their companies. In addition, company, investor and other stakeholder recognition of the potential impact of climate change and cybersecurity may prompt recruiting nominees and training of directors in these areas.

BOARD LEADERSHIP STRUCTURE AND RISK OVERSIGHT

Last year, the Staff issued comments to a cross section of companies, seeking expanded proxy statement disclosures regarding board leadership structure, duties of lead directors and board oversight of risk, generally seeking expanded disclosure on these topics during the 2023 proxy season. The Staff undertook this disclosure review project because it believed disclosures required by Item 407(h) of Regulation S-K had become increasingly standardized and were not sufficiently tailored to how board leadership structure and risk oversight reflects the particular circumstances of a company and its unique challenges. It would be worthwhile for companies to review expanded board leadership structure and board risk oversight disclosures, and to consider the disclosures being made by their peer companies, to assess whether such descriptions suggest ways in which the company could provide more detailed insights on these topics.

In recent years, the SEC also has been focused on director independence issues. In preparing proxy statement disclosures, companies should consider any interlocking board of director relationships that may exist, as well as any other relationships that may impede independence.

CONTROLS AND PROCEDURES

Companies should regularly evaluate their controls and procedures for effectiveness, which is subject to quarterly certification by their respective chief executive officers and chief financial officers. Given recent SEC developments, as well as learning from SEC enforcement actions, it is important to be sure disclosure controls and procedures and internal control over financial reporting are adequate to cover new requirements. As examples:

- Companies need an appropriate disclosure control to determine whether any director or officer adopted or terminated any Rule 10b5-1 or other trading arrangement so companies can accurately fulfill their quarterly disclosure obligations.
- With respect to the new buyback disclosure requirements, companies should develop a process to gather and maintain buyback information to be presented in the required tabular daily buyback disclosure. Companies also need a process to assess the narrative buyback disclosure, keeping in mind that objectives and rationales may change from filing to filing based on circumstances impacting the period.
- There should be disclosure controls in place with respect to the checkbox for director and officer trades within four business days before or after the announcement of a share repurchase program or an increase to a share repurchase agreement.
- It may be appropriate for companies to consider the timing of stock-based compensation grants, particularly options and stock appreciation rights, in relation to the handling of MNPI.
- Companies should consider updating their disclosure controls and procedures to reflect both the new current reporting requirements for cyber incidents, including the potential need for amendments, and the annual disclosure requirements regarding cybersecurity risk management processes.

These suggestions represent just some of the types of new disclosure controls and procedures that may be appropriate to develop.

In addition to new requirements, companies should evaluate whether their disclosure controls and procedures and internal control over financial reporting need updating with respect to existing proxy and annual report requirements. The SEC continues to be focused on perquisite disclosures and has brought enforcement proceedings in this area over the last few years, including this year. As discussed further below, given the SEC's focus, including that of the Enforcement Division's Enforcement Task Force Focused on Climate and ESG Issues, on ESG-related disclosures, it would be prudent to ensure companies have appropriate disclosure controls and procedures in place related to all sustainability disclosures in order to vet these for accuracy. Also, as discussed further below, companies should assess their disclosure controls and procedures related to the use of non-GAAP financial measures and their use of key performance indicators ("KPIs"). For example, companies should focus on consistency (both in preparation and usage) calculation accuracy and evaluation of the source of data for their non-GAAP financial measures and KPIs. If a metric is customized, there should be a process to document its calculation so it can be performed consistently.

The SEC Chief Accountant has commented frequently on the importance of maintaining effective internal control over financial reporting. In a recent statement, the Chief Accountant noted the importance of the role of the audit committee and management in risk oversight and in remaining "alert to new or changing business risks to identify changes that could significantly impact [a company's] system of internal control," and "design[ing] and implement[ing] responses that support issuers' ability to appropriately disclose information in its periodic filings." The Chief Accountant identified a number of business risks, "such as a company's loss of financing, customer concentrations, or declining conditions affecting the company's industry, could affect issuers' ability to settle their obligations when due, and affect the risks of material misstatements in financial statements not being identified on a timely basis. Likewise, risks related to changes in technology could impact the effectiveness of controls around processing of transactions."[21]

Therefore, in connection with preparing their annual reports and proxy statements, companies should confirm their existing controls and procedures are sufficiently robust to identify and evaluate matters that may need to be disclosed.

DIRECTOR AND OFFICER QUESTIONNAIRES

Because companies now must disclose whether during their last fiscal quarter any director or Section 16 reporting officer adopted or terminated a Rule 10b5-1 plan or similar trading arrangement, they need a disclosure control and procedure to gather this information, including for their upcoming Form 10-K filings. While a company may already receive some of this information in connection with pre-clearance of trades in company securities or Form 4 filings, that information may not be complete. Therefore, companies may find it helpful to include a question in their annual director and officer questionnaires responsive to Item 408(a) of Regulation S-K with respect to fourth quarter trading arrangements. Subsequently, a company may extract this question and separately send it to the directors and officers prior to each quarterly report on Form 10-Q.

If companies include self-identified diversity characteristics in their proxy statements or on their websites, they may need to develop or expand questions for their director and officer questionnaires to elicit such information or otherwise develop a mechanism to gather this information. In addition, if companies need to provide diversity data on directors and officers for other purposes, such as a state law requirement, adding one or more questions to the director and officer questionnaire process may be the best vehicle for gathering such information. The questionnaires or other procedures should include obtaining the director's or nominee's consent to disclosure or should limit the collection of this information to the extent restricted by applicable data privacy law.

Companies might also want to consider adding or expanding questions about director expertise in areas such as cybersecurity, climate change or any other areas they might disclose as reasons why individuals are being nominated or renominated.

In light of universal proxy requirements, companies should review the consent language in their director and officer questionnaires to assess whether it is clear that the consent to be named as a nominee for director is sufficiently broad to cover not only the company's proxy statement but any proxy card of a dissident which triggered the universal proxy requirement.

OFFICER EXCULPATION

Section 102(b)(7) of the Delaware General Corporation Law ("DGCL") was amended in 2022 to permit Delaware corporations to exculpate certain senior officers from personal liability for monetary damages in connection with breaches of fiduciary duty of care, similar to what the DGCL has long provided with respect to directors. Existing Delaware corporations have to amend their certificate of incorporation to permit this officer exculpation, which amendment must be approved by directors and stockholders. Some public Delaware corporations submitted officer exculpation amendments for stockholder approval during the 2023 proxy season. Others, while interested in officer exculpation, decided to see how investors and proxy advisory firms reacted to company proposals to amend their certificates of incorporation to provide for officer exculpation.

During the 2023 proxy season, ISS announced it would evaluate officer exculpation proposals on a case by case basis and frequently supported such proposals. Glass Lewis, on the other hand, generally recommended voting against officer exculpation unless the board of directors provided a compelling rationale. Officer exculpation management proposals that were voted during the 2023 proxy season frequently received the requisite stockholder approval and some which failed were subject to supermajority voting requirements.

In light of voting recommendations and results in 2023, Delaware corporations waiting to see how the initial round of officer exculpation provisions fared may want to consider whether it would be beneficial to recommend that their stockholders approve an officer exculpation amendment to their certificates of incorporation. This involves drafting the amendment for discussion with their governance committees, and, ultimately, with their full boards. As part of the process, companies should develop the rationale for why officer exculpation is appropriate for their circumstances. Careful preparation can take time, so companies in this position should start the decision-making process soon to be in a position to move forward if they decide to add officer exculpation to the 2024 annual meetings' agendas.

Environmental and Social Matters

CLIMATE CHANGE

The SEC proposed extensive climate change disclosure rules in March 2022. According to the SEC Regulatory Agenda, the SEC is now targeting October 2023 for consideration of final rules, but as of the date of this Legal Update, final rules have not been adopted. It is therefore not clear what the scope of any final climate change disclosure rules will be or when they will be effective. For more detail on the SEC's climate change proposal, see our Legal Update, "SEC Proposes Climate Change Disclosure Rules Applicable to Public Companies," dated March 24, 2022.[22]

Even if no specific climate change disclosure rules are in effect for the 2024 proxy season, as the SEC explained in its 2010 "Commission Guidance Regarding Disclosure Related to Climate Change," [23] many existing SEC rules require climate change disclosure. In September 2021, the SEC's Division of Corporation Finance published a sample letter[24] containing comments to public companies regarding their climate change disclosures—or lack thereof—in SEC filings. The sample comments requesting analysis, as well as disclosure, to the extent material, could apply to many companies. Companies should pay close attention to this SEC guidance.

Increased focus on climate change among investors and other constituencies, as well as companies themselves, has prompted a growing number of companies to include sustainability initiatives in distinct sections of their proxy statements in addition to disclosures in annual reports. The approach of adding voluntary climate change and other ESG disclosure in the proxy statement may provide an opportunity for companies to control their message and provide a basis to direct shareholder engagement in this area. When preparing climate change disclosure for the proxy statement or annual report, companies should be cognizant of the securities laws and other legal ramifications of such disclosure. As alluded to above, misleading climate change disclosures can give rise to SEC or state enforcement proceedings and hefty monetary penalties. From a liability perspective, it may be prudent to describe corporate climate change initiatives in aspirational terms rather than as commitments to achieve specific results, unless the company is actively working towards reaching those goals within a designated time frame and is prepared for increased follow-up disclosure in subsequent years.

As noted above, companies may need to expand their disclosure controls and procedures, and possibly their internal control procedures, to take climate change disclosures into account. The team involved in drafting and approving climate change disclosure should develop a process to fact-check disclosures. Board oversight and review of climate change disclosure may help to confirm alignment with company initiatives. There should be consistency between a company's climate change disclosures in its SEC filings and the company's disclosures in any sustainability report it publishes and other climate change disclosures it makes on its website or in public statements. It is important that public companies draft climate change disclosure in a manner that is not susceptible to a characterization that it is inaccurate or misleading.

Companies also need to pay attention to potential climate change reporting requirements beyond the SEC' rules. The European Union ("EU") Corporate Sustainability Reporting Directive ("CSRD") and the associated European Sustainability Reporting Standards create detailed sustainability reporting requirements that will apply to a significant number of EU and non-EU companies and substantially increase the scope of their sustainability reporting. For further information on these sustainability reporting requirements, see our Legal Update, "The EU Corporate Sustainability Reporting Directive is upon us – what non-EU companies should know and do," dated September 2023.[25] There also may be applicable state law requirements to be considered. For example, the California legislature has approved a bill, which Governor Newsom has announced he intends to sign, requiring U.S.-based businesses with annual revenues exceeding $1 billion that do business in California to annually disclose the greenhouse gas emissions attributable to the business.[26]

HUMAN CAPITAL MANAGEMENT

Companies must discuss their human capital resources, including the number of employees, as well as any human capital measures or objectives that the company focuses on in managing its business in the business section of their annual reports on Form 10-K, to the extent material. This requirement, set forth in Item 101(c) of Regulation S-K, is principles-based, although it specifies the types of information that may be material to certain companies. For example, the regulation identifies measures or objectives addressing the development, attraction and retention of personnel as types of disclosures that may be appropriate to discuss, depending on the nature of a company's business and workforce.

There has been wide variation in how companies implemented the human capital management disclosure in their annual reports on Form 10-K, including with respect to the amount of detail given and the human capital measures discussed. Some companies also included human capital management disclosure in their proxy statements. Many investors now identify human capital management as an important topic of engagement.

Institutional investors have increasingly made human capital management disclosure and engagement a priority. In addition, shareholder proposal initiatives have requested companies to disclose workforce data by race/ethnicity and gender that they submitted to the US Equal Opportunity Commission on EEO-1 reports, and some companies have agreed to make such data public. And, because human capital management is important to employee relations, companies should consider the points of view of various employees when drafting human capital management discussions.

In light of these developments, many companies supplement their Form 10-K human capital management disclosure with additional proxy statement discussion. While the Form 10-K requirement is qualified by a materiality standard, voluntary proxy statement disclosure on human capital topics can be drafted in a way that communicates the information to interested shareholders without implying that it is important to how management runs the business. The proxy statement platform provides companies with the opportunity to focus their corporate messaging in a reader-friendly manner, often enhanced with graphics, on key human capital topics they chose to highlight, such as diversity, equity and inclusion, employee development and retention and workplace culture.

Human capital management continues to evolve as a disclosure topic. The SEC Regulatory Agenda indicates the SEC is now targeting October 2023 for proposed amendments to enhance human capital disclosures. Although it is unlikely any final amendment would be adopted in time to require compliance during the 2024 proxy season, companies should monitor that potential rulemaking to consider if it makes sense to voluntarily adopt any aspects of what is voluntarily in their next annual report or proxy statement.

Additional Annual Report and Proxy Statement Matters

RISK FACTORS

Risk factor disclosure is an important feature of an annual report. It must focus on the material factors that make an investment in a company speculative or risky, tailored to the specific reporting company. It is important to take a fresh look at risk factor disclosures each year to consider whether any risks need to be updated, whether any new risks should be added and whether it would be appropriate to delete any prior risk factors.

Companies should be particularly sensitive to situations where they previously described a risk in hypothetical terms and subsequently an actual event of that nature occurred. In these circumstances an update to the risk factors may be needed to avoid securities law liability for misleading risk factors. This has become an issue in the cybersecurity area, both for SEC and private litigation, where a prior risk factor discussed the potential of a data breach or ransomware attack and thereafter the company suffered a cyber incident, but it may also be a relevant consideration for risk factors on other topics.

Topics companies should consider when updating their annual report risk factors include inflation, and/or rising interest rates, tailored to the company's specific circumstances. For example, the Staff has issued a risk factor comment this year specifying that if inflationary pressures have materially impacted operations, the company should identify the types of inflationary pressure it is facing and how its business has been affected.

Companies should assess whether the Russian/Ukrainian war, related sanctions and escalations (potential or actual) should be discussed in their risk factors, even if they have not been previously. According to a recent sample comment letter issued by the Staff,[27] companies based in or with a majority of their operations in the People's Republic of China ("PRC") should disclose in their risk factors any material impact that intervention or control by the PRC government has or may have on their business or on the value of their securities. Whether or not a company is based in China, if policies or actions involving China pose a material risk to the company, that should be discussed in risk factors.

Given the ongoing focus on climate change, companies should consider whether they need to add or expand or otherwise update climate change risk factor disclosure. Cybersecurity and data privacy continue to be risks that many companies need to address in their annual reports. Some companies may have risks related to return to office mandates and hybrid work environment policies. Companies that develop or use generative or other artificial intelligence products ("AI") may consider including risk factors addressing potential issues in that area either on a stand-alone basis or as component of other risk factors. For example, a company's AI risks might include violation of existing and future laws regulating development and use of AI, lack of data science skills, limited access to training data, biased or inaccurate results, price pressure from competitors using lower-cost AI systems, or failure to secure IP rights. Companies that have been impacted by banking disruptions should reflect whether they have new and evolving material risks from either their direct exposure to operational or liquidity concerns or their indirect exposure through their vendors, suppliers, customers and lenders that should be addressed in a risk factor. Companies in the banking sector should reflect whether they have new and evolving material risks from regulatory proposals that may impose additional capital and other requirements on them that may impact their business and operations. For further information, see our Legal Update, "SEC Disclosure Considerations Following Banking Disruptions," dated March 27, 2023.[28]

Because risks for a company may change from year to year, and because material risks can arise from various aspects of a company's business, it is important from a disclosure control perspective that the full set of risk factors contained in an annual report be reviewed by the appropriate departments within the company to determine whether any new risks need to be added or any existing risk factor disclosure needs to be revised.

MANAGEMENT'S DISCUSSION AND ANALYSIS

As expressly stated in Regulation S-K, the objective of management's discussion and analysis ("MD&A") "is to provide material information relevant to an assessment of the financial condition and results of operations of the registrant," focusing "specifically on material events and uncertainties known to management that are reasonably likely to cause reported financial information not to be necessarily indicative of future operating results or of future financial condition," including "descriptions and amounts of matters that have had a material impact on reported operations, as well as matters that are reasonably likely based on management's assessment to have a material impact on future operations." Accordingly, MD&A disclosures are very company-specific.

To achieve the MD&A's objective, companies should approach the MD&A section of their annual reports on Form 10-K from a fresh perspective each year. While the MD&A discussion may need to update prior year strategies and discuss how results and financial condition changed from the prior period, it should also provide insight into the company's current operations and trends likely to materially affect the company. The MD&A is a key element of the Form 10-K and it should be thoughtfully drafted and carefully reviewed.

If inflation (and potential recession as a known uncertainty) has had, or is reasonably likely to have, a material impact on net sales or revenue, companies need to discuss these matters in the MD&A, even though there is no longer a prescribed disclosure item for inflation. For example, the Staff issued an MD&A comment this year to a company that included a risk factor identifying inflation as a potential adverse economic condition. The Staff requested that the company's MD&A identify the principal factors contributing to the inflation pressures the company experienced, clarify the resulting impact of inflation on the company, if material, and identify mitigating actions the company planned or had taken with respect to inflationary pressures. In another situation where inflationary factors such as price increases and wage increases were cited as factors impacting results, the Staff indicated that if such factors can be quantified as either a percentage change or total dollar impact, such quantification should be provided.

If cost or availability of credit impacts a company's results, financial position or liquidity, that should be addressed. Companies should focus on aspects of the MD&A that are the subject of frequent SEC comment, such as providing detail on quantification of period to period changes where there are multiple causes and around period to period variations. Companies should also assess their segment disclosures as well as their tax disclosures. In addition, companies may want to consider addressing topics that are of particular interest to investors in their MD&A, including ESG matters, such as climate change and human capital, even if pending rulemaking in those areas is not yet in effect.

NON-GAAP FINANCIAL MEASURES

Non-GAAP financial measures continue to be a focus of SEC attention. In December 2022, the Staff issued new and updated C&DIs on non-GAAP financial measures.[29] For example, C&DI 100.01, which addresses how presentation of a non-GAAP performance measure that excludes normal, recurring necessary cash operating expenses could be misleading, was updated to clarify that when evaluating what is a normal operating expense, the Staff considers the nature and effect of the non-GAAP adjustment and how it relates to the company's operations, revenue generating activities, business strategy, industry and regulatory environment. The Staff would view an operating expense that occurs repeatedly or occasionally, including at irregular intervals, as recurring.

Updated C&DI 100.04 provides additional non-exclusive examples of how non-GAAP measures could be misleading when they use adjustments that have the effect of changing the recognition and measurement principles required by GAAP. New C&DI 100.05 describes how non-GAAP measures can be misleading if not appropriately labeled and clearly described. As described in new C&DI 100.06, a non-GAAP measure may be misleading even if accompanied by disclosure about the nature and effect of each adjustment. C&DI 102.10(a) provides updated examples of non-GAAP measures that are more prominent than comparable GAAP measures. New C&DI 102.10(b) gives examples of disclosures that would cause the non-GAAP reconciliations to give undue prominence to a non-GAAP measure, and new C&DI 102.10(c) explains that an income statement which is comprised of non-GAAP measures and includes all or most of the line items and subtotals found in a GAAP income statement is considered a "non-GAAP income statement" which, by itself or as part of the required non-GAAP reconciliation, gives undue prominence to non-GAAP measures.

In addition to C&DIs, the Staff has issued comments on company disclosures containing non-GAAP financial measures. Also, the SEC has brought enforcement proceedings relating to the use of non-GAAP financial measures. Many of these enforcement proceedings also have cited that the companies lacked appropriate disclosure controls and procedures and internal accounting controls related to the non-GAAP financial measures. Accordingly, companies using non-GAAP financial measures should confirm that their presentations satisfy the parameters set forth in SEC guidance. The same observations can be made for KPIs. The Staff continues to issue comments related to the use of KPIs in company disclosures, as well as to raise questions concerning KPIs used in earnings presentations and investor presentations and how these compare to information presented by the company in its periodic filings.

XBRL

In September 2023, the Staff released a sample comment letter to companies regarding compliance with XBRL disclosures.[30] The illustrative comments provided in the sample letter, which do not represent an exhaustive list of potential comments, address the following topics:

- Compliance with Inline XBRL presentation requirements;
- Outstanding shares reported on the cover page and balance sheet that are tagged with materially different values (i.e., where one value is presented in a whole amount and the other value is presented in thousands);
- Inline XBRL tagging requirements for pay versus performance disclosures;
- Separate Inline XBRL tags for each required data point in pay versus performance relationship disclosure presentations under Regulation S-K Item 402(v)(5), even if combined in one graph, table or other format;
- Different XBRL elements used to tag the same reported line item on the income statement from period to period; and
- Using a custom tag instead of an XBRL element consistent with current U.S. GAAP in the income statement.

Companies should take the necessary steps when preparing the required XBRL data to ensure they are including all required information.

ITRA COMPLIANCE

The Iran Threat Reduction and Syria Human Rights Act of 2012 ("ITRA") continues to require Form 10-K and Form 10-Q disclosure if, during the period covered by the report, the company or any affiliate knowingly engaged in certain sanctionable activities, *regardless of whether those actions violate US law and without any materiality threshold*. If a company is required to report this activity in its annual or quarterly report, it must also separately file with the SEC, at the same time it files its annual or quarterly report, a notice that such disclosure is contained in the report. The ITRA disclosure requirement is statutory and is not referenced in the instructions for SEC annual or quarterly report forms.

Although ITRA disclosure requirements are typically framed in terms of Iran, some of the statutory provisions are broader, such as Section 13(r)(1)(d) of the Exchange Act that requires reporting if the issuer or an affiliate:

> (D) knowingly conducted any transaction or dealing with
>
> . . .
>
> (ii) any person the property and interests in property of which are blocked pursuant to Executive Order No. 13382 (70 Fed. Reg. 38567; relating to blocking of property of weapons of mass destruction proliferators and their supporters).

Entities and individuals in several jurisdictions, including but not limited to Russia and China, have been designated as subject to Executive Order No. 13382, including the Federal Security Service of the Russian Federation ("FSB"). Companies dealing with Russian or other entities or individuals sanctioned under EO 13382 should consider whether they need to make any modifications to their disclosure controls and procedures with respect to ITRA to assess whether such sanctioned party involvement gives rise to required disclosure and notice requirements.

For more information about the topics raised in this Legal Update, please contact any of the following authors.

Laura D. Richman
+1 312 701 7304
lrichman@mayerbrown.com

Jennifer J. Carlson
+1 801 907 2720 (Salt Lake City)
jennifer.carlson@mayerbrown.com

Lawrence Cunningham
+1 212 506 2203
lcunningham@mayerbrown.com

Anna T. Pinedo
+1 212 506 2275
apinedo@mayerbrown.com

David A. Schuette
+1 312 701 7363
dschuette@mayerbrown.com

Endnotes

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[13] Cunningham, *supra.*

[14] See ISS Insights, “In Focus: Shareholder Proposals in the 2023 U.S. Proxy Season, dated July 20, 2023, available at https://insights.issgovernance.com/posts/in-focus-shareholder-proposal-in-the-2023-us-proxy-season/

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