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Legal Update

2020 Proxy and Annual Report Season: Time to Get Ready—Already

As summer closes and autumn begins, it is time for public companies to begin planning for the 2020 proxy and annual report season. Advance preparations are key to producing proxy statements and annual reports that not only comply with disclosure requirements but also serve as tools for shareholder engagement. This Legal Update highlights the following issues of importance to the upcoming 2020 proxy and annual report season:

Proxy Statement Matters

HEDGING DISCLOSURE

On December 18, 2018, the US Securities and Exchange Commission (SEC) adopted a rule requiring companies to disclose their hedging policies and practices for employees, officers and directors. This rulemaking was mandated by Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The text of the hedging disclosure requirement is contained in paragraph (i) of Item 407 of Regulation S-K.

The 2020 proxy season will be the first proxy season in which most public companies will need to include the new hedging disclosure in their proxy statements. Smaller reporting companies and emerging growth companies will not need to comply until they file proxy or information statements for the election of directors during fiscal years beginning on or after July 1, 2020.

The hedging disclosure rule requires companies to disclose whether employees (including officers) or directors or their designees are permitted to purchase financial instruments or otherwise engage in transactions that hedge or offset, or that are designed to hedge or offset, any decrease in the market value of a company's equity securities granted to the employee or director as compensation or held directly or indirectly by the employee or director. If companies apply different policies for certain types of transactions, their disclosure would need to make clear what categories of transactions they permit and what categories they prohibit. The hedging disclosure rule only requires disclosure of practices and policies. It does not require disclosure of any hedging transactions that have occurred, although other existing disclosure requirements may reveal that company equity securities have been hedged.

The hedging disclosure requirement extends beyond the pre-existing requirement that the compensation discussion and analysis (CD&A) address hedging policies affecting the executive officers whose compensation is required to be disclosed in an annual meeting proxy statement to the extent material to a discussion of their compensation. The new requirement mandates disclosure of hedging policies with respect to all employees, officers and directors, whether or not material to their compensation. In addition, the hedging disclosure rule applies to all companies that are required to comply with the SEC's proxy rules. Therefore, this new rule impacts companies that are not required to provide CD&A disclosure, such as smaller reporting companies and emerging growth companies.

While the new rule does not require any company to have a hedging policy, a company without a hedging policy should reflect on how its shareholders will react when the company discloses that it does not have a hedging policy and consider whether it would be appropriate to adopt one in light of the upcoming requirement. This may also be an appropriate time for companies that have hedging policies to evaluate whether their existing policies should be amended.

For more information about the hedging disclosure rule, see our Legal Update "SEC Adopts Dodd-Frank Hedging Disclosure Rule," dated December 27, 2018.[1]

PAY RATIO DISCLOSURE

The 2020 proxy season will be the third year for mandatory pay ratio disclosure. The pay ratio rule, which requires disclosure of the ratio of the annual total compensation of a company's median employee to that of its chief executive officer, permits a company to identify its median employee only once every three years as long as the company reasonably believes there has not been a change in its employee population or compensation arrangements that would significantly change the pay ratio disclosure. Whether or not a company identified a new median employee for the 2019 proxy season, it should consider if it is appropriate to do so for the upcoming proxy season. The analysis of whether a new determination of the median employee is required is a company-specific matter. For example, in some situations, a significant acquisition or divestiture may affect workforce composition or compensation arrangements.

In any event, each company needs to review its employee composition and compensation practices in order to assess whether it is necessary to identify a new median employee for pay ratio disclosure purposes. Companies should perform this process sufficiently in advance of the date on which they will be filing their proxy statements in order to allow time for the median employee's compensation and the pay ratio for 2019 compensation to be calculated and confirmed. If a company concludes that it is not necessary to identify a new median employee for its 2020 proxy statement, it will need to disclose that it is using the same median employee in its pay ratio calculation and describe briefly the reason for its belief that there have not been any changes requiring a newly determined median employee.

If the rules do not require a new determination of the median employee, but the median employee identified for the 2019 proxy statement pay ratio disclosure has left the company or has had any compensation changes, the company may substitute another employee with substantially similar compensation as the median employee previously identified. In addition, the rules do not preclude a company from identifying a new median employee every year even if it would otherwise be able to rely on a previous year's determination of the median employee. In any event, a company must disclose the date it selected to identify the median employee.

For more information about the pay ratio disclosure rule, see our Legal Update "Understanding the SEC's Pay Ratio Disclosure Rule and Its Implications," dated August 20, 2015, [2] our Legal Update "SEC Provides Pay Ratio Disclosure Guidance," dated October 25, 2016, [3] our Legal Update "Get Ready for Pay Ratio," dated September 6, 2017,[4] and our Legal Update "Pay Ratio Rule: SEC Provides Additional Interpretive Guidance," dated September 28, 2017. [5]

BOARD DIVERSITY

Board diversity, especially with respect to women and minorities serving as directors, has grown to be a corporate governance issue attracting a great deal of attention. Many large institutional investors have adopted and publicized proxy voting policies under which they will vote against or withhold their votes from directors due to a lack of gender diversity. For example, BlackRock has publicly stated that it expects to see at least two women directors on every board, indicating that it may vote against nominating/governance committee members if it believes that a company has not accounted for diversity in its board composition.[6] State Street Global Advisors announced that it has enhanced its US board gender diversity voting guideline so that starting in 2020 it "will vote against the entire slate of board members on the nominating committee if a company does not have at least one woman on its board, and has not engaged in successful dialogue on State Street Global Advisors' board gender diversity program for three consecutive years."[7]

Proxy advisory firms also consider board diversity when they make voting recommendations to their clients. According to ISS's policy for meetings of companies in the Russell 3000 or S&P 1500 indices being held on or after February 1, 2019, ISS will generally recommend an against or withhold vote for the chair of the nominating committee and possibly other directors at companies when there are no women on the board. ISS will consider mitigating factors such as a commitment contained in the proxy statement to appoint at least one female to the board in the near term or the presence of a female on the board at the preceding annual meeting.[8] Glass Lewis's policy, which became effective in 2019, provides that it will generally recommend voting against the chair of the nominating committee of a board that has no female members and, depending on the circumstances, may extend that negative recommendation to all members of the nominating committee.[9]

In addition to proxy voting policies and recommendations, there have been other ways in which some investors have advocated for board diversity. New York City Comptroller Scott M. Stringer and the New York City Pension Funds have recommended that the skills, race and gender of board members be presented in a standardized board matrix in proxy statements. Other investors have also sought additional disclosure on board diversity, engaging companies on this topic. Disclosure of board diversity characteristics in proxy statements has been increasing, although not necessarily in a standardized matrix. According to EY Center for Board Matters (EY), 45 percent of the Fortune 100 explicitly disclosed the racial and ethnic diversity of the board of directors and 36 percent disclosed the level of overall diversity on the board, up from 23 percent and 13 percent, respectively, since 2016. EY also reports that "[t]hree-quarters of the Fortune 100 now use a skills matrix to highlight the diversity of relevant director qualifications in an easily readable format, up from 30% in 2016." [10]

With the increased focus on board diversity, more information is being gathered regarding directors' diversity characteristics. On February 6, 2019, the staff (Staff) of the SEC's Division of Corporation Finance issued two identical Regulation S-K compliance and disclosure interpretations (C&DIs), C&DI 116.11 and C&DI 133.13, addressing disclosure of a director's self-identified diversity characteristics.[11] According to these C&DIs, if a board or nominating committee has considered the self-identified diversity characteristics such as race, gender, ethnicity, religion, nationality, disability, sexual orientation, or cultural background of an individual in determining whether to recommend a person for board membership, and the individual has consented to the company's disclosure of those characteristics, the Staff expects the company's proxy statement will include, but not necessarily be limited to, identification of those characteristics and how they were considered. Similarly, in such a circumstance, the Staff expects the proxy statement's description of company diversity policies to discuss how the company considers the self-identified diversity attributes of nominees, as well as any other qualifications its diversity policy takes into account, such as diverse work experiences, military service, or socio-economic or demographic characteristics. For more information about these C&DIs, see our Legal Update "Disclosure of Board Self-Identified Diversity Characteristics," dated February 11, 2019.[12]

Some companies are taking additional steps to enhance their director searches to assure that they consider women and minorities as potential nominees. For example, the New York City Pension Funds indicated in its 2018 Shareowner Initiatives Postseason Report, issued in April 2019, that "[a]t least 24 companies publicly committed to include women and people of color in the candidate pool for every board search going forward, also known as the "Rooney Rule" of board governance."[13]

Some states have taken action with respect to board diversity. California law requires publicly-traded companies based in California to have at least one female (defined as an individual who self-identifies her gender as a woman) director by the end of 2019, with boards of five directors required to have at least two female directors and boards of six or more directors required to have at least three female directors by the end of 2021. The law authorizes the California Secretary of State to impose fines and penalties for violations.[14] Illinois has enacted legislation requiring publicly-held corporations with principal executive offices located in Illinois to report information about diversity in the annual reports they file with the Illinois Secretary of State as soon as practical, but no later than January 1, 2021. The Illinois statute does not set specific board diversity requirements but instead requires disclosure of the self-identified gender and minority person status (as defined in the statute) of directors, as well as information about policies and practices for considering and promoting demographic diversity, including with respect to executive officers. A number of other states are in various stages of consideration of board diversity legislation.

The push for gender diversity on boards of directors has been having an effect. This summer *The Wall Street Journal* reported that there are no longer any S&P 500 companies with all-male boards. The rate of change has been slower in the broader Russell 3000 Index, although the overall percentage of women on Russell 3000 boards has been increasing while the number of all-male Russell 3000 boards has been decreasing.[15] With respect to ethnic diversity, ISS reported that there has been a record number of members of ethnic minorities becoming directors, although that rate of change is considerably slower than the rate by which gender diversity has increased.[16]

TRENDING SHAREHOLDER PROPOSALS

Topics of shareholder proposals received during the 2019 proxy season may foreshadow subject matters for shareholder proposals during the 2020 proxy season. For example, during the last proxy season, multiple companies received shareholder proposals regarding independent board chairs, political spending and lobbying, supermajority voting or shareholder written consent. In addition, there were proposals on topics garnering attention in society in general, such as proposals relating to diversity, human rights, the opioid crisis and climate change. Any of these topics may resurface in shareholder proposals submitted for the 2020 proxy season. Individual companies may also find that issues raised by investors during shareholder engagement sessions may give rise to specific shareholder proposals.

While most shareholder proposals do not receive majority support, there were some shareholder proposals during the 2019 proxy season that received majority support in areas including diversity (board, executive and workplace diversity), opioid risk, human rights, political activities (spending and lobbying disclosure) and clawbacks.[17] And even shareholder proposals falling short of majority approval may also impact companies by pressuring them to take some action in order to be perceived as being responsive to investor concerns.

Companies should also be aware that some proponents of shareholder proposals now file voluntary notices of exempt solicitations pursuant to Rule 14a-6(g) and Rule 14a-103 under the Exchange Act with the SEC to urge shareholders to vote for their shareholder proposals, to vote against a management proposal or to encourage shareholders to vote in situations where a proposal otherwise may be in danger of failing. These notices allow proponents to respond to the company's statement of opposition in the proxy statement and to make additional arguments supporting the proposal, without being subject to any word limitation. Notices of exempt solicitation appear on the EDGAR page of the company, identified by a "PX14A6G" filing type, which means that persons who have set up general alerts for a company's SEC filings will be notified when such a filing is made by a proponent of a shareholder proposal. Companies do not need to respond to notices of exempt solicitation, but they likely will want to at least review them and be prepared to address their views with respect to the matter.

SHAREHOLDER PROPOSAL GUIDANCE

During the last two proxy seasons, the Staff issued two legal bulletins providing guidance on the shareholder proposal process. Companies receiving shareholder proposals for the 2020 proxy season should review these recent Staff positions when evaluating whether to seek no-action relief to exclude such proposals.

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.[18] SLB 14I addressed four topics:

- the scope and application of 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 five percent of a company's total assets, net earnings and gross sales;
- proposals submitted on behalf of a shareholder by a representative, sometimes referred to as proposal by proxy; and
- the impact of graphs and images on the 500-word limit in Rule 14a-8(d).

Following the 2018 proxy season, the Staff issued Staff Legal Bulletin No. 14J (SLB 14J) on October 23, 2018, to provide further guidance on shareholder proposals submitted pursuant to Rule 14a-8.[19] SLB 14J addressed three topics:

- board analyses provided in no-action requests that seek to rely on economic relevance pursuant to Rule 14a-8(i)(5) or ordinary business under Rule 14a-8(i)(7) as a basis to exclude shareholder proposals;
- the scope and application of the argument that micromanagement would be necessary to implement a proposal as a basis to exclude a proposal under Rule 14a-8(i)(7); and
- the scope and application of Rule 14a-8(i)(7) for proposals that touch upon senior executive and/or director compensation matters.

Both SLB 14I and SLB 14J discussed the inclusion of board analyses as part of the no-action request process for companies seeking to exclude shareholder proposals on the basis of economic relevance or ordinary business. SLB 14J identified the following six factors as examples of the types of considerations that may be appropriate for inclusion in the board analysis discussion of a no-action request:

- the extent to which the proposal relates to the company's core business activities;
- quantitative data, including financial statement impact, related to the matter that illustrate whether or not a matter is significant to the company;
- whether the company has already addressed the issue in some manner, including the differences between the proposal's specific request and the actions the company has already taken, and an analysis of whether the differences present a significant policy issue for the company;
- the extent of shareholder engagement on the issue and the level of shareholder interest expressed through that engagement;
- whether anyone other than the proponent has requested the type of action or information sought by the proposal; and
- whether the company's shareholders have previously voted on the matter and the board's views as to the related voting results.

SLB 14J specified that this list was not intended to be exclusive or exhaustive. In addition, it is not necessary for the board to address each one of these factors.

The Staff has not automatically granted no-action relief for exclusion of shareholder proposals where a board analysis was provided, either on economic relevance grounds under Rule 14a-8(i)(5) or on ordinary business grounds under Rule 14a-8(i)(7). And, there have been situations where the Staff has granted no-action relief where no board analysis was provided. SLB 14I and SLB 14J reflect the Staff's view that a board analysis has the potential to be useful, although not required, in the no-action process for shareholder proposals where economic relevance or ordinary business may provide a basis for a company to exclude a proposal from its proxy statement by sharing the insight a board of directors has regarding the details of the company's operations and the nature of its business.

Since the Staff enumerated in SLB 14J six factors that it deems appropriate for a board analysis to consider in support of exclusion of a shareholder proposal under Rule 14a-8(i)(5) or Rule 14a-8(i)(7) grounds, if companies plan to include a board analysis as part of their no-action requests, it makes sense for them to address as many of those factors as their particular circumstances support. However, the specific details discussed in a board analysis, as opposed to the existence of a board analysis, is what has the potential to influence whether the Staff finds an argument for exclusion on the basis of economic relevance or ordinary business persuasive.

While the Staff's guidance regarding board analyses is a significant feature of the recent staff legal bulletins, SLB 14I and SLB 14J also addressed other important topics that companies receiving shareholder proposals should take into account. For example, SLB 14J specified that proposals addressing senior executive and/or director compensation under Rule 14a-8(i)(7) could be excluded if a primary aspect of the targeted compensation is broadly available or applicable to a company's general workforce. SLB 14J expressly conditioned that exclusion on the company's demonstration "that the executives' or directors' eligibility to receive the compensation does not implicate significant compensation matters" and the Staff denied no-action requests during the 2019 proxy season if it was not satisfied that the company sufficiently made this demonstration. Therefore, it would be useful for companies seeking to exclude a senior executive and/or director compensation proposal involving aspects of compensation that also may be provided to the general workforce to explain in their no-action requests why the ability of senior executives and/or directors to receive the targeted compensation does not implicate significant compensation matters, rather than just arguing that these individuals receive compensation pursuant to the same plan, or of the same type, as the general workforce.

On September 6, 2019, the Staff announced a significant change to its process with respect to reviewing no-action requests submitted pursuant to Rule 14a-8.[20] Starting with the upcoming proxy season, the Staff will no longer automatically provide a written response of its views to all no-action requests. The Staff intends to issue a written response "where it believes doing so would provide value, such as more broadly applicable guidance about complying with Rule 14a-8." However, the Staff may respond orally to some of the requests.

When responding to a no-action request to exclude a shareholder proposal, the Staff will continue to inform the proponent and the company of its position, but the response may be that the Staff concurs, disagrees or declines to state a view with respect to the company's asserted basis for exclusion. According to the Staff's announcement, a Staff decision to decline to state a view on a particular request should not be interpreted as indicating that the company must include the proposal in its proxy statement. However, the company will need to decide whether it is comfortable excluding the shareholder proposal from its proxy statement without any direct guidance from the Staff or whether to take other steps, such as going to court, if it would like additional comfort before excluding the proposal from its proxy statement.

For more information on SLB 14I and SLB 14J, see our Legal Update "SEC Staff Issues Legal Bulletin on Shareholder Proposals," dated November 7, 2017,[21] and our Legal Update "SEC Staff Legal Bulletin No. 14J Provides Additional Shareholder Proposal Guidance," dated October 30, 2018.[22] For more information on the recent Staff announcement, see our Legal Update "SEC Announces Significant Changes to Shareholder Proposal Process," dated September 10, 2019.[23]

ENVIRONMENTAL AND SOCIAL DISCLOSURE

There has been growing interest in environmental and social (E&S) disclosure and, as a result, an increasing number of companies have chosen to discuss sustainability initiatives and commitments in distinct sections of their proxy statements, which are separate from responses to any E&S shareholder proposals that may be voted upon at meetings. Some large investors have published proxy voting and engagement guidelines addressing E&S issues. For example, BlackRock has indicated that it may vote against directors if it feels the company may not be dealing with E&S issues. State Street Global Advisors has affirmed its commitment to sustainable investing. In addition, there are a number of organizations separately rating companies based on their initiatives in the environmental, social and governance area, including Bloomberg, ISS, CDP and MSCI. There are also a number of voluntary disclosure frameworks in this area that have been developed by organizations including the Global Reporting Initiative, Principles for Responsible Investment and the Sustainability Accounting Standards Board Foundation.

With increased E&S awareness among investors and other constituencies, as well as companies themselves, the approach of adding voluntary E&S 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. To the extent that the practice of devoting a section of the proxy statement to a discussion of E&S matters gains traction, investors may see more companies providing E&S disclosure in the proxy statement or otherwise.

When preparing E&S disclosure for the proxy statement, companies should be cognizant of the securities law and other legal ramifications of such disclosure. For example, from a liability perspective, it may be prudent to describe corporate E&S initiatives in aspirational terms rather than as commitments to achieve specific results. The team involved in drafting and approving E&S disclosure should develop a process to fact-check the disclosure. Board oversight and review of E&S disclosures may help to confirm alignment with company initiatives. It is important that public companies draft E&S disclosure in a manner that is not susceptible to a characterization that it is false or misleading. Therefore, it may be useful for companies to include disclaimers in their E&S disclosures.

SAY-ON-PAY

By now, the say-on-pay vote is well integrated into the annual meeting process and drives a great deal of the proxy statement disclosure. The say-on-pay vote has also contributed to executive compensation as a topic of shareholder engagement. Compensation-related shareholder engagement has become a year-round process, especially since many investors are too busy during the proxy season to spend time talking to companies about their executive compensation programs.

During the 2019 proxy season, the say-on-pay proposal at most companies once again received majority approval. According to the Semler Brossy 2019 *Say On Pay & Proxy Results* report, through late June 2019, only 2.4 percent of the Russell 3000 had a failed say-on-pay vote. The average vote result was 90.8 percent in favor.[24]

According to the Semler Brossy report, when ISS recommended an "Against" vote on a say-on-pay proposal during the 2019 proxy season, shareholder support for the proposal was 31 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, 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 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.

OVERBOARDED DIRECTORS

An issue that some companies faced during the last proxy season and some companies may face during the upcoming proxy season arises when directors serve on the boards of multiple public companies or when a public company's chief executive officer serves on boards of companies other than the one he or she works for. Depending on the total number of public company boards that a director serves on, and whether or not the director is a chief executive officer of a public company, some investors may consider the director to be over-committed, or "overboarded." Some investors have adopted policies to vote against or withhold votes from directors they consider to be overboarded and proxy advisory firms Glass Lewis and ISS each have overboarding policies. According to ISS Analytics, during the 2019 proxy season overboarding criteria seemed to contribute to the highest level of significant director election opposition in the United States since 2011.[25]

The total number of public directorships that investors consider acceptable varies by investor, with some setting a cap of directorships at a total of six public boards, while others have adopted overboarding policies limiting the number of directorships to four or five. Overboarding policies may set a lower threshold for directors who also serve as executive officers. BlackRock reported that in 2019 it voted against 94 chief executive officers running for re-election to corporate boards outside their own.[26] Companies need to be aware that a nominee for director may receive reduced shareholder support if that individual serves on more public company boards than their investors find acceptable.

PROXY VOTING ADVICE GUIDANCE AND INVESTMENT ADVISER GUIDANCE

With the increased concentration of share ownership by institutional investors over the past several decades, the influence of proxy advisory firms has grown dramatically, all while the proxy regulatory process has become more complex. Emphasizing the importance of proxy voting, the SEC issued two separate sets of commission-level guidance on August 21, 2019. One release contains interpretation and guidance regarding the applicability of certain rules promulgated under Section 14 of the Exchange Act to proxy voting advice.[27] The other provides guidance on the proxy voting responsibilities of investment advisers under the Investment Advisers Act of 1940.[28] As guidance and interpretations of existing requirements (as opposed to amendments), both sets of proxy voting guidance apply to the 2020 proxy season.

For more information on the SEC's proxy voting guidance, see our Legal Update "SEC Issues Guidance on the Application of the Proxy Rules to Voting Advice," dated August 27, 2019,[29] and our Legal Update "SEC Publishes Guidance on the Proxy Voting Responsibilities of Investment Advisers," dated September 6, 2019.[30]

COMPENSATION LITIGATION AND COMPENSATION DISCLOSURE

Executive and director compensation decisions by companies should be made with care, especially by companies that anticipate resistance to any aspects of their compensation programs. Director compensation can potentially raise self-dealing issues, requiring the application of a heightened "entire fairness" standard rather than the business judgment rule in litigation, and there has been litigation in this area in recent years. To minimize potential litigation risk arising from director compensation, companies and boards should carefully review existing director compensation arrangements (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 "entire fairness" scrutiny, including by reviewing director compensation paid at comparable companies.

Executive compensation can also give rise to litigation. 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.

Companies should also pay close attention to how they present compensation disclosures in their proxy statements, including by emphasizing the corporate governance processes followed when making director and executive compensation decisions. Companies may also want to include additional narrative detail in their proxy statements describing the objectives and resulting design for determining director and executive compensation. When plans are submitted for shareholder approval, the proxy disclosure should be sufficiently clear to establish that the shareholder vote was obtained on a fully informed basis.

Finally, the SEC recently has focused on the adequacy of perquisite disclosure. Accordingly, it would be worthwhile for companies to confirm that they are properly characterizing and disclosing, if required, perquisites in their proxy statements. Companies should confirm that their disclosure controls and procedures are adequately identifying all perquisites being provided to their executive officers and directors.

DIRECTOR AND OFFICER QUESTIONNAIRES

There are no changes to SEC rules or New York Stock Exchange or Nasdaq listing standards in the past year suggesting a need for changing annual director and officer questionnaires at this time. However, to the extent that companies determine to include self-identified diversity characteristics in their proxy statement, they may want to develop questions for their questionnaires to elicit such 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 that information.

For example, the new Illinois diversity law requires that public corporations having their principal executive offices in Illinois report on diversity in the annual reports they submit to the Illinois Secretary of State no later than by the end of calendar year 2020. These Illinois-based public companies will need to disclose the self-identified gender of each director and the race and ethnicity of each director that self-identifies as a minority person (using statutorily defined categories). Additionally, it appears that the California Secretary of State is monitoring compliance with California's new gender diversity law by reviewing the Corporate Disclosure Statement filed annually by applicable companies, which requires disclosure of female directors. Companies impacted by these laws may find it useful to design a question responsive to such state disclosure requirements for inclusion in their annual director and officer questionnaires, particularly since the director and officer questionnaire being circulated for the 2020 proxy season may be the last questionnaire circulated to directors before state reports requiring diversity information become due.

Annual Report Matters

AMENDMENTS TO FORM 10-K DISCLOSURE REQUIREMENTS

There have been a number of amendments to SEC disclosure requirements that impact disclosure in annual reports on Form 10-K. For example, in August 2018, the SEC amended certain disclosure requirements that it determined to be redundant, duplicative, overlapping, outdated or superseded in light of other SEC disclosure requirements, US generally accepted accounting principles (US GAAP) or changes in the information environment. Because these amendments became effective in November 2018, companies should generally have experience with the applicability of those rule changes to Form 10-K disclosure. For additional information, see our Legal Update "Capital Markets Implications of Amendments to Simplify and Update SEC Disclosure Rules," dated August 29, 2018.[31]

More recently, on March 20, 2019, the SEC adopted amendments intended to modernize and simplify certain disclosure requirements of Regulation S-K and related rules and forms which became effective on May 2, 2019. While companies have been required to comply with certain of the amended rules for their quarterly reports on Form 10-Q, companies that have not filed annual reports on Form 10-K since the effective date of these amendments will be applying these revised disclosure requirements in the context of their annual reports for the first time this season. Key changes to disclosure requirements affecting the annual report on Form 10-K are described below. For additional information, see our Legal Update "SEC Adopts Rules to Modernize and Simplify Disclosure," dated March 27, 2019,[32] and our Legal Update "Follow-Up on Regulation S-K Modernization and Simplification," dated April 3, 2019.[33]

Given the number of changes to the disclosure requirements, companies should perform an updated form check when preparing their annual reports on Form 10-K this year.

Management Discussion and Analysis. The instructions to management's discussion and analysis of financial condition and results of operations (MD&A) set forth in Item 303(a) of Regulation S-K have been revised to provide that a registrant may use any presentation that, in its judgment, enhances a reader's understanding of the registrant's financial condition, changes in financial condition and results of operations, but do not suggest that any one mode of presentation, such as year-to-year comparison, is preferable to another.

The amendments to the Item 303(a) instructions eliminate the need to discuss the earliest year in certain circumstances if financial statements included in a filing cover three years. As amended, the discussion of the earliest year is not required in MD&A if discussion was already included in the registrant's prior filings on the SEC's EDGAR system, provided that the registrant identifies the location in the prior filing where the omitted discussion may be found.

The MD&A requirements no longer specify that five-year selected financial data need to be discussed when trend information is important, although trend information is required for a number of parts of MD&A, including liquidity and capital resources and results of operations.

Conforming changes to the MD&A requirements were made for foreign private issuers in the instructions to Item 5 (Operating and Financial Review and Prospects) of Form 20-F. However, because Form 40-F, which is used by Canadian issuers, is prepared in accordance with applicable Canadian requirements, there are no corresponding revisions to that form.

Property. Item 102 of Regulation S-K has been amended to require disclosure of principal physical properties *to the extent material* to the registrant. These disclosures may be provided on a collective basis, if appropriate. The amendments did not modify instructions to Item 102 that are specific to the oil and gas industry.

Exhibits. The amendments made several changes to the exhibit requirements set forth in Item 601 of Regulation S-K. Item 601(b)(4)(vi) of Regulation S-K, setting forth exhibit requirements for instruments defining the rights of security holders, now requires registrants to provide an additional exhibit to Form 10-K containing the description required by Item 202(a) through (d) and (f) of Regulation S-K for each class of securities that is registered under Section 12 of the Exchange Act. Drafting this new exhibit can begin well in advance of a company's usual Form 10-K preparation process. While descriptions of company securities from prior SEC filings can provide a useful starting place for this new exhibit, registrants will need to assess whether updates are needed, for example, to reflect changes to governance documents.

As further discussed below in "Inline XBRL," Item 601(b)(104) references a new exhibit with respect to cover page items that are now required to be tagged using Inline eXtensible Business Reporting Language (XBRL).

Item 601(b)(10) was amended to permit omission of confidential information from material contracts filed as exhibits without submitting a confidential treatment request (CTR) to the SEC if such information is both not material and would likely cause competitive harm if disclosed. A similar amendment was made to Item 601(b)(2) to allow redaction of immaterial provisions or terms in agreements relating to acquisitions, reorganizations, arrangements, liquidations or successions that would likely cause competitive harm if publicly disclosed.

In order to rely on the exhibit redaction provisions, registrants must limit the redacted information to no more than necessary to prevent competitive harm, mark the exhibit index to indicate that portions have been omitted, include a prominent statement on the first page of each redacted exhibit indicating that information in the marked sections of the exhibit has been omitted because it is both not material and would likely cause competitive harm to the company if publicly disclosed, and indicate with brackets where the information has been omitted from the filed version of the exhibit.

New paragraph (a)(5) of Item 601 of Regulation S-K allows registrants to omit entire schedules and similar attachments to exhibits unless they contain material information that is not otherwise disclosed in the exhibit or the disclosure document. A list briefly identifying the contents of omitted schedules must be contained in the exhibit. In addition, new paragraph (a)(6) of Item 601 of Regulation S-K allows registrants to omit personally identifiable information from exhibits without submitting a CTR.

Previously, Item 601(b)(10) of Regulation S-K required material contracts to be filed not only when the contract must be performed in whole or in part at or after the filing of the registration statement or report but also when the contract was entered into not more than two years before the filing. The amendments eliminated the two-year look-back for material contracts for all but newly reporting registrants.

The SEC made conforming changes to the exhibit requirements for foreign private issuers in Form 20-F, which continues a long-standing attempt to conform the exhibit requirements for Form 20-F with the exhibit requirements for registration statements filed by domestic issuers. However, the SEC did not make similar changes to Form 40-F.

Risk Factors. The requirements for risk factor disclosure were moved out of Item 503 of Regulation S-K into a new Item 105. The SEC eliminated the specific examples of risk factors from Regulation S-K to encourage registrants to focus on their own risk identification process.

Incorporation by Reference. Rule 12b-23(b) under the Exchange Act, which addresses incorporation by reference, has been amended to prohibit financial statements from incorporating by reference, or cross-referencing, information that is contained outside of the financial statements unless otherwise specifically permitted or required by the SEC's rules, US GAAP or International Financial Reporting Standards, whichever is applicable.

Form 10-K Cover Page. The cover page of Form 10-K must include the trading symbol for each class of the registrant's listed securities. In addition, the checkbox on the cover page of Form 10-K relating to late Section 16 filing disclosure has been deleted. As further discussed below in "Inline XBRL," once a company is required to use XBRL, information on the cover page of Form 10-K, as well as on the cover pages of Forms 10-Q, 8-K, 20-F and 40-F, is required to be tagged in Inline XBRL.

Heading for Section 16 Disclosure. The heading for disclosure of late Section 16 filings (i.e., Forms 3, 4 and 5) specified in Item 405 of Regulation S-K has been changed to "Delinquent Section 16(a) Reports" (instead of "Section 16(a) Beneficial Ownership Reporting Compliance"). An instruction encourages this caption to be excluded if there are no delinquencies to report. Because this disclosure typically appears in the proxy statement and is incorporated by reference into the Form 10-K, companies will need to address this change in their proxy statements.

Additional Hyperlinks. Registrants must now provide hyperlinks to information that is incorporated by reference if that information is available on EDGAR at the time the form is filed, whether or not the information is in a document filed as an exhibit.

CRITICAL AUDIT MATTERS

The audit report for large accelerated filers for audits of fiscal years ending on or after June 30, 2019 will need to disclose any critical audit matter (CAM) or state that the auditor determined that there were no CAMs. The CAM provisions will become effective for fiscal years ending on or after December 15, 2020, for all other companies to which the requirements apply.

Any matter arising from the audit of financial statements that was communicated or required to be communicated to the audit committee will be a CAM if it:

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

Determination of whether an accounting issue is a CAM involves a principles-based analysis. Examples of topics that constitute CAMs, depending on the facts and circumstances, could include:

- goodwill impairment;
- intangible asset impairment;
- business combinations;
- revenue recognition;
- income taxes;
- legal contingencies; and
- hard to value financial instruments.

While there is no specific number of CAMs that should be communicated in an auditor's report, CAM disclosure is likely to impact many companies and may involve more than one CAM. However, not every matter that the auditor discusses with the audit committee will necessarily rise to the level of a CAM.

Companies that will be subject to the CAM provisions for their 2019 audits should be well into the preparation phase for the important upcoming requirement. Companies that will not be subject to the CAM provisions until their 2020 audits may find it useful to conduct a dry run this year in preparation for when the CAM requirement will apply to them.

TRENDING ANNUAL REPORT TOPICS

There are a number of trending disclosure topics that can impact disclosures in various sections of the annual report. Many of these areas need to be addressed in the risk factor section, but discussion may also be appropriate in the business, MD&A and ligation sections, as well as in the notes to the financial statements. Depending on changing facts, companies may need to further review and update draft disclosures through the date of filing of the annual report.

Brexit. With the current October 31, 2019, deadline for the United Kingdom's exit from the European Union (Brexit) approaching, companies should be carefully reviewing and updating, or adding, Brexit disclosure to their annual reports as needed. To the extent significant, Brexit disclosure should describe how Brexit is expected to impact the company and its operations. If a "No-Deal" Brexit scenario occurs, or seems a real possibility at the time the annual report is filed, the disclosure should focus on how that result has affected, or is likely to affect, the company. For example, if a company has been relying on "passporting" to conduct its business, the company may need to discuss whether it expects to be materially impacted by the inability to passport following Brexit. Similarly, a company may need to mention in its Brexit disclosure that the imposition of tariffs after Brexit occurs could have a material adverse effect on its financial position or its results of operations. To the extent that Brexit is expected to have a material impact on a company's supply chain or employee base, that should also be described.

The importance of Brexit disclosure has been emphasized in remarks by SEC Chairman Jay Clayton and by William Hinman, director of the SEC's Division of Corporation Finance. Therefore, companies should assume that the Staff will be closely reviewing SEC filings to assess whether they adequately address the impact that Brexit will have on the company, both directly and indirectly through other businesses and individuals on whom the company relies.

LIBOR. Underscoring its concern regarding the transition away from LIBOR, the respective staff of the Division of Corporation Finance, the Division of Investment Management, the Division of Trading and Markets and the Office of the Chief Accountant issued a joint statement emphasizing the importance of companies determining their exposure to a transition from LIBOR.[34] This joint statement has a general section on managing the transition from LIBOR applicable to various constituencies, as well as specific guidance from each of the SEC divisions/offices participating in the joint statement. In the Division of Corporation Finance's section of the joint statement, the Staff offered companies the following guidance:

- The evaluation and mitigation of risks related to the expected discontinuation of LIBOR may span several reporting periods. Consider disclosing the status of company efforts to date and the significant matters yet to be addressed.
- When a company has identified a material exposure to LIBOR but does not yet know or cannot yet reasonably estimate the expected impact, consider disclosing that fact.
- Disclosures that allow investors to see this issue through the eyes of management are likely to be the most useful for investors. This may entail sharing information used by management and the board in assessing and monitoring how transitioning from LIBOR to an alternative reference rate may affect the company. This could include qualitative disclosures and, when material, quantitative disclosures, such as the notional value of contracts referencing LIBOR and extending past 2021.

The Staff noted that so far most LIBOR transition disclosure has been provided by companies in the real estate, banking and insurance industries and observed that "the larger the company, the more likely it is to disclose risks related to LIBOR's expected discontinuation." However, the Staff noted that for each contract held by a company providing disclosure, "there is a counterparty that may not yet be aware of the risks it faces or the actions needed to mitigate those risks." The Staff therefore encouraged "every company, if it has not already done so, to begin planning for this important transition."

The press release announcing the joint staff statement on LIBOR expressly indicated that SEC staff will be actively monitoring the extent to which the risks expected as a result of the discontinuation of LIBOR are being identified and addressed. Therefore, it is important for companies to consider whether they need to add, update or elaborate on their LIBOR disclosure. In that context, companies should determine not only whether they should be disclosing the transition away from LIBOR as a risk but also whether disclosure is appropriate in other sections of their annual reports, such as in the MD&A and/or the business section.

Cybersecurity. Cybersecurity incidents, including ransom demands, have continued to plague businesses. As a result, cybersecurity is generally recognized as a global concern. Companies should be sure that they are addressing this topic adequately in their annual reports on Form 10-K. In addition to discussing cybersecurity as a risk factor, companies should consider, based on facts and circumstances, whether they need to discuss cybersecurity more broadly in the context of their business and operations, legal proceedings, MD&A, financial statements, disclosure controls and procedures, and corporate governance. The Staff has been focusing on, and providing comments regarding, cybersecurity disclosure, which may lead to SEC enforcement action. Due to the significance of cybersecurity issues, the Staff monitors press reports on cybersecurity incidents and may raise questions about the sufficiency of cybersecurity disclosure in SEC reports on that basis. In addition to SEC concerns, updated cybersecurity disclosure can also be helpful, from shareholder and customer perceptions, to demonstrate that the company is aware of the significant impact of any cybersecurity risk.

On February 21, 2018, the SEC published interpretive guidance to assist public companies in preparing disclosures about cybersecurity risks and incidents. For more information on the SEC's cybersecurity guidance, see our Legal Update "SEC Issues Updated Guidance on Cybersecurity Disclosures," dated February 28, 2018.[35]

RISK FACTORS

Annually updating risk factors is a key component of preparing an annual report on Form 10-K or Form 20-F. This is not a one-size-fits-all exercise. Risk factors should be tailored for the specific issues affecting the company at the time of filing. While the prior year's risk factor presentation can be the starting place for analysis, companies should consider whether it is appropriate to disclose new risks, to supplement or revise previously disclosed risks or to delete any risks.

A few key areas in which new or revised risk factors may be needed are discussed above in "Trending Annual Report Topics." In addition, companies should consider privacy law-related risk factors, either in conjunction with a cybersecurity risk factor or as a free-standing risk factor. In this context, it may be appropriate to discuss the impact of the European Union's General Data Protection Regulation or the California Consumer Privacy Act if either constitutes a material compliance burden. In the trade area, companies should consider whether they need to update their risk factors to reflect developments relating to tariffs or sanctions as well as new import/export regulations. Companies that rely on foreign employees or consultants may need to discuss travel and immigration policies in their risk factors to the extent those policies make it more difficult and more expensive to hire the employees they need to conduct and grow their business. Sustainability and climate change is another area where companies may need to evaluate their risk disclosure. In light of increased mass shootings, some companies have been adding risk factors related to the potential impact of gun violence. Companies in the health or pharmaceutical industry may need to discuss the health crisis involving opioid abuse. Each company needs to identify the significant risks that are specific to it for the coming year and draft its risk factor disclosure on that basis.

On August 8, 2019, the SEC proposed amendments to Regulation S-K, including changes to risk factor disclosure requirements. Companies may want to take some of the SEC's proposals into account when reviewing and updating their risk factors this year. For example, if they are not already doing so, companies may want to group their risk factors into appropriately captioned sub-categories (such as "Operational Risks," "Financial Risks" and "Regulatory Risks"). Finally, companies might consider removing risk factors that generally apply to other companies or moving them to the end of the risk factor section. For a discussion of the proposed amendments, see our Legal Update "SEC Proposes to Modernize Business, Legal Proceedings and Risk Factor Disclosures," dated August 14, 2019.[36]

INLINE XBRL

In July 2018, the SEC amended its rules to require use of Inline XBRL format for the submission of financial statement information over a phased-in compliance period, although earlier compliance has been permitted. Inline XBRL allows filers to embed XBRL data directly into the document filed on EDGAR. Filers using Inline XBRL no longer need to tag a copy of the information in a separate XBRL exhibit or file a separate interactive data file on their websites. Instead, the Inline XBRL format makes the interactive data both human-readable and machine-readable as part of the main document.

Inline XBRL will be a feature of many annual reports for completed fiscal years that are filed during the upcoming annual report season because large accelerated filers that prepare their financial statements in accordance with US GAAP are required to use Inline XBRL for fiscal periods ending on or after June 15, 2019. Accelerated filers that prepare their financial statements in accordance with US GAAP must begin using Inline XBRL for fiscal periods ending on or after June 15, 2020, and all other filers must comply with respect to fiscal periods ending on or after July 12, 2021. If a company is a Form 10-Q filer, it is not subject to the Inline XBRL requirements with respect to Form 10-K or any other form until after it has been required to comply with the Inline XBRL in the first Form 10-Q for a fiscal period ending on or after its applicable compliance date. For more information about Inline XBRL, see our Legal Update "SEC Adopts Inline XBRL Rule," dated July 10, 2018.[37]

Once companies are required to use Inline XBRL, they will also need to tag certain data on the cover pages of Forms 10-K, 10-Q, 8-K, 20-F and 40-F, as applicable. With respect to current reports on Form 8-K, this adds an XBRL tagging requirement for cover page data, even if the Form 8-K does not contain any financial data.

The transition to Inline XBRL includes a change to the exhibit index. Instruction 1 to paragraphs (b)(101)(i) and (ii) of Item 601 of Regulation S-K, relating to interactive data files that are submitted using Inline XBRL, requires that the exhibit index include the word "Inline" within the title description for any XBRL-related exhibit. In addition, Exhibit 104 has been added to the exhibit requirements set forth in Item 601 of Regulation S-K for the Cover Page Interactive Data File.

On August 20, 2019, the Staff issued C&DIs addressing some technical issues relating to Inline XBRL, including changes to the exhibit index.[38] According to C&DI 101.01, the Cover Page Interactive Data File identified in the exhibit index as Exhibit 104 should cross-reference to the interactive data files submitted under Exhibit 101. With respect to the tagging of Form 8-K cover page data, C&DI 101.04 reiterates that Cover Page Interactive Data File should be identified in the exhibit index as Exhibit 104. However, if the only exhibit listed in a Form 8-K exhibit index would be the Exhibit 104 Cover Page Interactive Data File, C&DI 104 specifies that "the staff will not object if the registrant does not add an exhibit index to the Form 8-K solely for the purpose of identifying the Cover Page Interactive Data File as an exhibit under Item 9.01 of Form 8-K."

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Endnotes

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