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September 29, 2020

Legal Update

2021 Proxy and Annual Report Season: Time to Prepare

Preparations are key to a successful proxy and annual report season, and autumn is not too early to begin. While work on proxy statements, annual reports and annual meetings typically kicks into high gear in the winter, advance planning will make the process go more smoothly. This is especially true for the 2021 season, as companies evaluate the ramifications of COVID-19 that need to be discussed in various contexts in annual filings with the US Securities and Exchange Commission (SEC). Companies may also want to spend time this fall considering whether to expand proxy disclosures beyond what is required in order to address issues that are garnering increased attention, such as human capital, diversity and other environmental, social and governance (ESG) matters. This Legal Update provides an overview of key issues that companies should consider as they get ready for the 2021 proxy and annual report season (2021 Proxy Season), including:

Impact of COVID-19 on Proxy Statement Disclosures

The effects of the COVID-19 pandemic will be woven into many disclosures during the 2021 Proxy Season, including in topics addressed in various sections of the proxy statement.

Compensation Disclosures. Although the SEC's compensation disclosure rules have not changed for the 2021 Proxy Season, circumstances arising from the COVID-19 pandemic may trigger certain technical disclosure rules that companies may not typically encounter. For example, if a named executive officer has chosen to forgo any salary or bonus and instead receive equity or other non-cash compensation, the foregone amount is still reported in the salary or bonus column of the summary compensation table, with a footnote disclosure explaining the situation. In addition, any incremental grant date fair value of the equity award that was received in replacement would be reported in the stock award or option award column of the summary compensation table, as applicable, if higher than the amount of foregone cash compensation.

Companies must also ensure that decisions made with respect to named executive officer compensation are properly reflected in the proxy statement. For instance, changes to performance targets as a result of the pandemic need to be disclosed and companies need to consider whether any changes have shifted non-equity incentive plan compensation into discretionary bonuses, which requires different treatment in the summary compensation table. To the extent named executive officer salary has been reduced, voluntarily or otherwise, that reduction would be discussed in the compensation discussion and analysis (CD&A) section of the proxy statement. Although the CD&A only needs to discuss named executive officer compensation, some companies may want to expand the section to address workforce compensation generally in order to provide context for COVID-19 compensation-related decisions for named executive officers.

On September 21, 2020, the staff of the SEC's Division of Corporation Finance (Staff) issued compliance and disclosure interpretation (C&DI) 219.05[1] regarding whether benefits provided to executive officers because of the COVID-19 pandemic are perquisites or personal benefits for purposes of compensation disclosure and determination of the named executive officers. C&DI 219.05 explains that the two-step analysis previously articulated by the SEC continues to apply in the COVID-19 situation. Accordingly, an item is not a perquisite or personal benefit if it is integrally and directly related to the performance of the executive's duties. On the other hand, if an item that confers a direct or indirect benefit has a personal aspect, without regard to whether it may be provided for a business reason or for the company's convenience, it is a perquisite or personal benefit unless it is generally available on a non-discriminatory basis to all employees. C&DI 219.05 recognizes that the COVID-19 pandemic is a fact and circumstance that can be considered when assessing whether an item is integrally and directly related to the performance of an executive's duties. This C&DI notes that providing enhanced technology needed to make the executive's home the primary workplace upon imposition of local stay-at-home orders would generally not be a perquisite or personal benefit but indicates that new health-related or personal transportation benefits provided to address new risks arising because of COVID-19 may be perquisites or personal benefits even if the company provided these because of the pandemic, unless they are generally available to all employees.

Corporate Governance Disclosures. A key corporate governance disclosure in proxy statements relates to the board of directors' oversight of risk. Given the pandemic is global, it has posed significant risks for many companies. Item 407(h) of Regulation S-K expressly requires companies to "disclose the extent of the board's role in the risk oversight of the registrant, such as how the board administers its oversight function." Shareholders are likely to be particularly interested in how the board handled its oversight of the challenges posed by, and management's response to, the pandemic. Therefore, companies may want to consider expanding their risk oversight discussion to encompass the involvement of the board and its committees in overseeing the broad range of risks presented by the coronavirus.

Audit Committee Reports. Regulation S-K only requires a few specific disclosures in audit committee reports. However, many companies choose to voluntarily include additional disclosure as part of their audit committee reports. COVID-19 is another topic that companies may want to specifically address in their audit committee reports.

The Public Company Accounting Oversight Board (PCAOB) conducted conversations with audit committee chairs on the effects of COVID-19 on financial reporting and the audit and published a summary of those conversations (PCAOB Summary).[2] According to the PCAOB Summary, addressing the risks relating to the shift to a remote workforce was a prevalent theme raised by audit committee chairs, including whether additional time will be needed to conduct the audit remotely, the complexities remote working might have on the audit and the impact of remote working on internal control over financial reporting and cybersecurity risk. The PCAOB Summary also highlighted a number of points for audit committees to consider when communicating with auditors during COVID-19, including discussing if any audit procedures or disclosures may need to change as a result of COVID-19. The PCAOB Summary provides a helpful framework not only for questions that audit committees may want to consider in the COVID-19 environment but also for topics companies and their audit committees may want to consider expanding upon in their audit committee reports. Companies and their audit committees may find it useful to address how the audit committee handled the issues raised by the PCAOB Summary, in addition to any other expanded disclosures they choose to provide in their audit committee reports.

Letters to Shareholders. Many companies include a letter to shareholders from the company's chief executive officer, board chair or the full board of directors at the beginning of the proxy statement (or annual report) discussing major developments over the past year. To the extent that a company chooses to include such a letter, it is a natural place to include some description of COVID-19's impact on the company and the company's response to the effects of the global pandemic.

Human Capital. The COVID-19 pandemic has heightened interest in human capital matters, with investors seeking engagement on many topics, including protecting the health and safety of employees and customers, remote working issues, succession planning and the impact of these matters on business continuity. In addition, protests over racial and social injustice and other diversity matters have sparked conversations regarding explicit and implicit discrimination in the workplace. Even before the pandemic, human capital had been discussed within the ESG context, especially as issues such as board and workforce diversity and pay equity received greater attention. Now, as a result of the confluence of COVID-19 and social unrest layered on issues already part of the ESG dialogue, human capital is poised to play a magnified role in the 2021 Proxy Season.

Proxy statements already require diversity and pay ratio disclosure, as well as board oversight disclosure. Indeed, some companies have already received human capital-related shareholder proposals. But while several human capital issues are already discussed in proxy statements, there has been recent pressure to increase human capital disclosure, including an amendment to Regulation S-K to address human capital in the business description, as further discussed below. Some large institutional investors consider human capital management a priority for engagement. For example, BlackRock, Inc., which has made human capital management one of its priorities for its investor stewardship engagement, held 750 engagements discussing human capital-related topics with approximately 640 companies between July 1, 2019 and June 30, 2020, representing nearly three times more such engagements than during the prior year.[3] In addition, proxy advisory firm Institutional Shareholder Services (ISS) has commenced an initiative requesting companies to disclose the self-identified race and ethnicity characteristics of members of their board of directors.

As many companies now voluntarily include ESG disclosure in their proxy statement or otherwise, there may be a benefit to developing and enhancing human capital disclosure for the proxy statement, in addition to the disclosures added to their annual reports in response to the SEC's recent amendments to Regulation S-K business description requirements. This process has already begun. The EY Center for Board Matters reports that during the 2020 proxy season, 77 percent of Fortune 100 companies voluntarily highlighted human capital initiatives.[4] Examples of human capital proxy disclosures may include discussions of a company's human capital management policies generally. Other approaches separately target specific human capital issues, such as expanded board or workforce diversity or succession discussions, gender-based pay ratios, health and safety issues, employee training and development and the board's role in human capital management and human capital management risk oversight. In some cases, human capital management is identified in the proxy statement as one of the topics that has been a subject of shareholder engagement, and some institutional investors have indicated increased engagement with companies in this area. In addition, human capital management subjects have been highlighted in some board or CEO letters.

Companies considering new or expanded human capital management disclosure for their 2021 proxy statements should begin thinking about the desired focus and begin drafting the specific language and designing the presentation sufficiently in advance to allow time for review by various company personnel and outside advisors, as well as to coordinate with disclosure being added to their annual report. Another benefit to early consideration of expanded human capital disclosure for the proxy statement is that the exercise also serves as preparation for shareholder engagement on the topic and allows companies to be proactive in setting the tone for these conversations.

Virtual Meetings. Virtual shareholder meetings can take many forms. Some are hybrids, with in-person meetings supplemented by audio and/or video options. Other companies conduct fully virtual meetings, without an in-person component. While reliance on virtual annual meetings of shareholders has increased in the past few years, the COVID-19 pandemic exponentially increased usage during the 2020 proxy season as a matter of necessity.

The experience of the 2020 proxy season highlighted the benefits of virtual meetings. From the company perspective, the format may add efficiency to the flow of meetings. Investors, including proponents of shareholder proposals, may benefit from being able to attend more annual meetings, increasing opportunities to hear from, and engage with, management and directors. Eliminating travel saves expenses for both companies and investors as well as lowering the environmental impact of shareholder meetings. However, because the COVID-19 pandemic began to flare in the United States just as many companies were finalizing their 2020 proxy statements and annual meeting plans, the switch to virtual meetings occurred quickly. As a result, there may be administrative and technical issues that can be improved on. Companies considering virtual meetings for the 2021 Proxy Season, and their service providers, now have a wealth of experience to draw on and should now take the time to learn from lessons gleaned from their 2020 virtual meeting experiences.

Some investors and proxy advisory firms have been critical of virtual-only meeting formats. While the emergency health situation created by the global pandemic led to widespread acceptance of virtual-only meetings during the 2020 proxy season, opposition to virtual-only meetings could return for the 2021 Proxy Season, depending on the duration of the pandemic.

Companies considering conducting their next annual meeting of shareholders virtually should assess whether they want to also plan for an in-person option if health issues permit. They may need to make final decisions about the conduct of the meeting closer in time to their meeting dates and include appropriate disclosure in their proxy statements, but they should begin exploring and evaluating virtual annual meeting alternatives well in advance.

Companies planning to hold annual meetings virtually should also consider whether any revisions to proxy statement disclosure regarding virtual meeting practices would be appropriate to clarify procedures for shareholders to virtually attend and vote at meetings, even if they held a virtual meeting during 2020. Companies may want to explain in the proxy statement how they will handle technical glitches that may occur during the meeting and whether there will be telephonic or Internet-based help lines for shareholder support during the meetings. It can be useful to describe how question and answer sessions will be handled at the meeting, such as whether questions may (or must) be submitted in advance of the meeting or only during the meeting and whether proof of share ownership must be provided when submitting a question. Companies that schedule the question and answer session to occur after the voting is completed and the formal meeting is adjourned in order to minimize the impact of technical glitches on the proposals being voted upon should clearly disclose that fact.

Companies planning to conduct virtual meetings during the 2021 Proxy Season, especially companies that held virtual meetings for the first time during the COVID-19 pandemic, should reach out to their vendors early in order to get the dates and time slots they prefer and to allow time to address technical issues, particularly when multiple third-party systems are being used for the meeting. From an investor relations perspective, companies should be sure they have a way to track who submits questions so they have the ability to follow up for further engagement. Finally, companies conducting a virtual meeting should allow time for dry runs with the virtual systems.

Regulation FD applies in the virtual meeting context, including in situations where a technical difficulty occurs. Therefore, if it happens that some, but not all, participants at a virtual meeting are able to hear some or a portion of the proceedings, the company will need to assess whether information that was otherwise material and non-public was involved, in which case a press release or Form 8-K would be needed to comply with Regulation FD.

Companies considering virtual meetings should familiarize themselves with applicable laws and governance requirements, including applicable by-law or other governing documents, relating to convening, postponing, adjourning and reconvening shareholder meetings. To the extent companies relied on executive orders or temporary rules for the conduct of virtual meetings during 2020, they will need to determine whether there have been any changes to those orders and rules.

Other Proxy Statement Matters

ESG. There has been growing interest in ESG initiatives disclosure, particularly in recent years. The momentum for ESG disclosure has been boosted by various initiatives. A number of large institutional investors have published proxy voting and engagement guidelines addressing ESG issues. And, there are several third-party frameworks for ESG disclosure that have been growing in influence, such as the Sustainability Accounting Standards Board (SASB) and Task Force on Climate-Related Financial Disclosures (TCFD) frameworks. BlackRock and Vanguard have expressly endorsed SASB and TCFD in their own proxy voting guidelines. State Street has developed its own R-Factor score, to evaluate a company's ESG based on the SASB framework. In addition, there are a number of organizations separately rating companies based on their ESG, including Bloomberg, ISS, CDP and MSCI.

Social issues have dramatically grown in prominence during 2020. The impact of COVID-19 has highlighted issues such as employee health and safety and remote working issues. During the same time period, there has been increased focus on racial and social justice, raising awareness of issues such workforce diversity and discrimination and efforts that companies could be doing to address such societal problems. The combination of these developments has magnified human capital issues that are part of the "S" or social component of ESG. However, human capital has not eclipsed other ESG concerns, which are also expected to continue as prominent factors during the 2021 Proxy Season.

With increased ESG awareness among investors and other constituencies, as well as companies themselves, a growing number of companies have chosen to discuss sustainability initiatives and commitments in distinct sections of their proxy statements. The approach of adding voluntary 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 ESG disclosure for the proxy statement, companies should be cognizant of the securities laws and other legal ramifications of such disclosure. For example, from a liability perspective, it may be prudent to describe corporate ESG initiatives in aspirational terms rather than as commitments to achieve specific results. Companies may need to expand their disclosure controls and procedures, and possibly their internal control procedures, to take ESG disclosures into account. The team involved in drafting and approving ESG disclosure should develop a process to fact-check disclosures. Board oversight and review of ESG disclosure may help to confirm alignment with company initiatives. It is important that public companies draft ESG disclosure in a manner that is not susceptible to a characterization that it is inaccurate or misleading. Therefore, it may be useful for companies to include disclaimers in their ESG disclosures.

In May 2020, the SEC's Investment Advisory Committee (IAC) recommended that the SEC "begin in earnest an effort to update the reporting requirements of issuers to include material, decision-useful, ESG factors." The recommendation specified that investors need reliable, material ESG information for both investment and voting decisions and issuers should be the ones to directly provide such information. The recommendation asserted that requiring material ESG disclosure "will level the playing field between issuers" and "will facilitate the flow of capital to US Issuers of all sizes from investors with or without ESG-related investment mandates."[5] This recommendation was not unanimously adopted; four members of the committee dissented. In addition, some SEC Commissioners expressed the view that ESG encompasses quite different baskets of disclosure and that a general ESG disclosure mandate may not be as helpful as the current principles-based approach. The SEC is not obligated to implement the IAC ESG recommendation, which is advisory in nature, but the IAC is an influential body established by the SEC. As interest in ESG and related disclosures continues to evolve, it is worthwhile to monitor SEC actions in this area.

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 been no change in its employee population or compensation arrangements that would significantly change the pay ratio disclosure. The analysis of whether a new determination of the median employee is required is a company-specific matter, especially this year when furloughs, layoffs and pay reductions resulting from the COVID-19 pandemic have impacted employee population and compensation arrangements at many companies. Other events such as a significant acquisitions or dispositions could also trigger a need to identify a new median employee for pay ratio disclosure purposes. Companies should assess whether they will need to initiate the process for identifying their median employee this year as early as possible in their proxy season preparations.

Companies that need to identify their median employee in order to calculate their pay ratio 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 2020 compensation to be calculated and confirmed. If a company concludes that it is not necessary to identify a new median employee for its 2021 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 previously identified median employee 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 prior year's determination of the median employee. In any event, a company must disclose the date it selected to identify the median employee.

Although companies are not required to provide explanations for their pay ratios, voluntary additional disclosures are generally permitted. To the extent that a company believes its pay ratio changed in 2020 as a result of the global pandemic, or is otherwise anomalous, it may want to consider including language referencing that fact in order to provide context for the 2020 pay ratio.

Perks. The SEC continues to focus on disclosure of perquisites, including, for example, by instituting enforcement proceedings against a company in the spring of 2020 for failure to disclose all the perquisites and personal benefits paid to the company's chief executive officer that were required to be disclosed in its proxy statement. In addition to the disclosure violation, the SEC noted that the company failed to devise and maintain adequate internal accounting controls relating to such payments. This enforcement proceeding should serve as a reminder for companies to confirm that their disclosure controls and procedures and internal control over financial reporting are sufficiently robust to track, record and disclose as appropriate the various types of payments made to or on behalf of their named executives officers.

Say-on-Pay. During the 2020 proxy season, the say-on-pay proposal at most companies once again received majority approval. According to the Semler Brossy 2020 *Say On Pay & Proxy Results* report dated July 9, 2020, only 2.2 percent of the Russell 3000 had a failed say-on-pay vote. The average vote result was 90.6 percent in favor.[6] Note that the executive compensation that was voted upon during the 2020 proxy statement represented pre-COVID-19 decisions. It remains to be seen how investors and proxy advisory firms will evaluate compensation decisions made in response to the global pandemic.

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 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.

Shareholder Proposals.

No-Action Procedural Changes. The Staff no longer automatically provides formal no-action letters in response to requests pursuant to Rule 14a-8, which governs shareholder proposals submitted for inclusion in a company's proxy statement. When responding to a no-action request to exclude a shareholder proposal, the Staff still informs the proponent and the company of its position, but the response could be that the Staff concurs, disagrees or declines to state a view with respect to the company's asserted basis for exclusion. The Staff posts a chart on the SEC's website, indicating, among other details, the regulatory bases for exclusion of the proposal asserted by the company, the Staff's response to the company's request for exclusion and whether the Staff responded by letter. By reviewing the arguments for and against exclusion of a proposal, and checking the Staff response as shown on the chart available on the SEC website, companies and proponents can glean a sense of applicable Staff positions that will be useful in the upcoming proxy season.

The Staff has not articulated its process for deciding which no-action requests receive a formal no-action letter. Some of the formal no-action letters from the 2020 proxy season seem designed to emphasize, and further explain and publicize, points that Staff considers important, such as no-action letters addressing the helpfulness of board analyses to its consideration of no-action requests seeking to exclude proposals under Rule 14a-8(i)(7) or Rule 14a-8(i)(5). In addition, the Staff wrote no-action letters that expressed Staff policies of general applicability. For example, one Staff no-action letter clarified that a representative's failure to provide documentation meeting all of the guidelines of a staff legal bulletin does not provide a grounds for exclusion where there is no ambiguity about the actual proponent and its role with respect to the proposal or to explain that the Staff will decline to state a view regarding the exclusion of a proposal where there is litigation regarding that issue. Other no-action letters issued during the 2020 proxy season highlighted fact patterns that were determinative of Staff responses, such as whether a proposal transcends a particular company's ordinary business under Rule 14a-8(i)(7), whether aspects of a proposal constituted micromanagement under Rule 14a-8(i)(7) or whether company actions compared favorably to the guidelines of a proposal for the purpose of a substantial implementation exclusion under Rule 14a-8(i)(10).

Shareholder Proposals Receiving Majority Approval in 2020. While most shareholder proposals do not receive majority support, there were some shareholder proposals during the 2020 proxy season that achieved approval from a majority of the shares voting. In addition, there were some shareholder proposals that received significant minority support, which may prompt further engagement between those companies and their shareholders on the matters addressed by such proposals.

Of the minority of shareholder proposals that received majority approval during the 2020 proxy season, most involved governance matters. Among the governance proposals receiving majority support from shareholders at multiple companies were the elimination of supermajority voting requirements, the elimination of classified boards of directors and majority voting for the election of directors, with proposals for the elimination of classified boards often receiving particularly high levels of shareholder support. In addition, proposals to increase the ability of shareholders to act by written consent, to call special shareholder meetings and to require an independent board chairman, while only receiving majority votes in favor of the proposal in a relatively few number of cases where such proposals were voted upon, were numerous and frequently received support of over 30 percent in 2020.

Although with less frequency than governance proposals, there were also some social proposals, as well as a smaller number of environmental proposals, that achieved majority support, or significant minority support, at a number of companies in 2020. Proposals on social issues that garnered strong support included board and workforce diversity proposals and reports on political spending/lobbying, with a few of each receiving majority support and significant levels of minority support for those that did not pass. Proposals calling for reports on various environmental risks and strategies also passed at a number of companies, and received substantial support at many other companies, just missing majority support at a few additional companies and achieving 20-30 percent support at many others.

Possible Topics of Shareholder Proposals for 2021. Following a relatively strong showing of various ESG proposals during the 2020 proxy season compared to prior years, proposals on environmental, social or governance topics similar to those that gained significant support may be submitted during the 2021 Proxy Season. As a result of the COVID-19 pandemic, there may be proposals focusing on employee health and safety, as well as on human capital management generally. With racial and social justice issues attracting increased attention, companies may receive shareholder proposals targeting these issues, such as proposals highlighting employee diversity and equal opportunity. For example, in July 2020, the New York City Comptroller sent letters to the chief executive officers of 67 S&P 100 companies calling on them to match their statements affirming their commitments to racial equality and diversity and inclusion by publicly disclosing their annual EEO-1 Report data. These letters indicated that if the companies do not commit to making that disclosure they risk potential submission of shareholder proposals or opposition to the election of director nominees standing for re-election.[7]

Amendments to Rule 14a-8. On September 23, 2020, the SEC adopted amendments to Rule 14a-8[8] that:

- update the criteria, including the ownership requirements, that a shareholder must satisfy to be eligible to have a shareholder proposal included in a company's proxy statement;
- amend Rule 14a-8(c) to update the "one proposal" rule to clarify that a single person may not submit multiple proposals at the same shareholders' meeting, whether the person submits a proposal as a shareholder or as a representative of a shareholder; and
- amend Rule 14a-8(i)(12) to increase the levels of shareholder support a proposal must receive to be eligible for resubmission at the same company's future shareholder meetings.

In particular, Rule 14a-8(b) has been amended to:

- create a range of the amount of company voting securities required to be held in order to submit a proposal, which in some situations would increase the threshold amount of securities needed to be held in order to submit a proposal;
- potentially increase the amount of time those securities must be held;
- prohibit the aggregation of holdings to satisfy ownership thresholds;
- require a proponent to be available to meet with the company regarding the shareholder proposal; and

- require a proponent to provide specified information about any representative the proponent is using to submit a proposal or to act on the proponent's behalf.

Amended Rule 14a-8(i)(12) raised the required level of shareholder support that a proposal must receive in order to be eligible for resubmission at a company's future shareholders' meetings to 5 percent, 15 percent and 25 percent for matters previously voted on once, twice or three or more times, respectively, in the last five years.

While the amendments become effective 60 days after publication in the *Federal Register*, there is a transition period so that they will apply to proposals submitted for an annual or special meeting to be held on or after January 1, 2022. Accordingly, the amended shareholder proposal rules will not apply to the 2021 Proxy Season. The amendments also provide a transition period with respect to the ownership thresholds that will allow shareholders meeting specified conditions to rely on the current $2,000/one-year ownership threshold for proposals submitted for shareholders' meetings being held prior to January 1, 2023.

For more information, see our Legal Update
"SEC Amends Shareholder Proposal Rule," dated September 28, 2020.[9]

Proxy Voting Advice Amendments. On July 22, 2020, the SEC adopted amendments to its proxy solicitation rules designed to enhance the transparency, accuracy and completeness of the information that proxy advisors, such as Institutional Shareholder Services Inc. and Glass, Lewis & Co., provide to investors and others who vote on behalf of investors.[10]

The proxy voting advice amendments codify the SEC's position that voting advice produced by proxy advisors generally constitutes a solicitation under the proxy rules and make clear that the failure to disclose material information regarding proxy voting advice could cause such advice to be misleading, in violation of the proxy rules. These provisions of the amendments become effective on November 2, 2020.

The proxy voting advice amendments also add new conditions, contained in Rule 14a-2(b)(9), to the exemptions to the information and filing requirements of the proxy rules that proxy advisors have historically relied on. As a result, proxy advisors will have to:

- prominently disclose conflicts of interest to their clients in their proxy voting advice or in the electronic medium used to deliver that advice;
- establish procedures designed to allow all companies that are subject to their voting advice to be able to access that advice prior to or simultaneously with the release of that advice to clients; and
- provide a mechanism for their clients to be able to access any written company response to their voting advice on a timely basis before they vote.

Proxy advisors have until December 1, 2021, to comply with the Rule 14a-2(b)(9) conditions. Therefore, those conditions do not have to be implemented until the 2022 proxy season, which gives the market time to adapt to those new requirements governing the provision of proxy voting advice.

ISS sued the SEC in the US District Court for the District of Columbia in October 2019 over the SEC's position that proxy voting advice constitutes solicitation, but the parties agreed to hold this litigation in abeyance until the SEC adopted its final rules. On September 18, 2020, ISS filed an amended complaint and motion for summary judgement to encompass the final rules. Pursuant to the schedule established in a joint status report, the SEC has until October 30, 2020, to file its opposition to the ISS summary judgement motion and to file its own cross-motion for summary judgement. According to the joint status report, hearings on the cross-motions for summary judgment will be held in December 2020 or January 2021, with a decision to follow as soon as feasible thereafter.

For more information about the proxy voting advice amendments, see our Legal Update, "SEC Adopts Proxy Voting Advice Rule Amendments," dated July 29, 2020.[11]

Director and Officer Questionnaires. There have been 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.

COVID-19 Disclosures in Annual Reports

Disclosure Guidance. The Staff issued CF Disclosure Guidance: Topic No. 9 and CF Disclosure Guidance: Topic No. 9A providing guidance on disclosure considerations that companies should consider with respect to COVID-19-related disruptions.[12] In both sets of guidance, the Staff included a broad range of questions for companies to consider as they evaluate the impacts of COVID-19. Companies should review this guidance as they evaluate what impact the COVID-19 pandemic had on each of these annual report topics.

Risk Factors. There are many ways in which COVID-19 may pose risks that companies should consider as they prepare risk factors. Revenues may decline in some lines of business. Some companies may face liquidity challenges and credit may be less expensive or more expensive. To the extent that a company maintains an investment portfolio, it may be exposed to greater market volatility. Remote working might give rise to greater cybersecurity concerns. There could be increased litigation risk. Uncertainties with respect to the ultimate scope and duration of the pandemic may itself be a risk. The list of questions for assessing the impact of COVID-19 that the Staff provided in its guidance is a helpful starting place for such analysis, but companies need to reflect on how the pandemic has impacted their own particular company. It is possible that various segments of a company may be affected in different ways. For example, some segments might be having supply chain or distribution issues as a result of government shutdown orders while others may be more susceptible to a decline in discretionary spending arising from economic turbulence.

As the impact from COVID-19 has intensified and evolved, companies may become increasingly aware of additional ways in which the pandemic poses specific risks beyond what they may have previously disclosed. It would be useful for companies to begin drafting a comprehensive COVID-19 risk factor and continue to re-evaluate and update it as appropriate through the filing date.

Business. COVID-19 may have materially impacted various aspects of a company's business, such as its principal products produced and services rendered, sources and availability of raw materials, dependence on a single customer, backlog orders, competitive conditions, and number of employees. Therefore, companies preparing their annual reports on Form 10-K will need to consider whether additional or revised business disclosure is need to the extent that COVID-19 has materially changed, or is expected to materially change, its business. Among other things, companies potentially may need to develop new disclosure this year to explain an exit from a business line, the closure of a facility, sourcing difficulties and alternatives, or layoffs due to a business slowdown. Companies may also need to explain the relative impact of the COVID-19 pandemic on their various segments. Disclosure may also be required in the business section to the extent that previously announced acquisitions or organic growth initiatives were put on hold.

MD&A. Management's discussion and analysis (MD&A) must include information that a company "believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations." With COVID-19 impacting so many companies, often negatively, but in some cases providing opportunities, it is important for the MD&A to not only disclose COVID-19 as a known trend or uncertainty but also management's perspective on the type and extent of COVID-19's effect on the company, to the extent material. There are many possible questions for companies to assess for materiality in the COVID-19 context as they prepare their MD&A. For example, has the company experienced problems within its supply chain or distribution network and if so are such issues anticipated to be ongoing? How has COVID-19 affected liquidity? Has the company drawn down on bank facilities for any reason, including because it has not been able to finance in the capital markets? Is there a material risk that the company may not meet covenants in its credit or other agreements? Is the company able to service its debt and other obligations? Has the company needed to close any locations? Does the company operate any facilities where there has been a significant outbreak of COVID-19? Has there been any reduction in productivity as a result of a switch to a telecommuting workforce? Is the company party to contracts with force majeure provisions that have been, or may be triggered, by the COVID-19 pandemic, and if so, is there a material impact on the company's business? Is the company having a dispute with its insurance carrier regarding business continuity coverage?

Financial Statement Considerations. Companies should discuss with their accountants whether COVID-19 disclosure is needed as part of their financial statement footnotes, including a subsequent event footnote. Contingency disclosures should be carefully assessed, particularly from the perspective of whether a contingent COVID-19-related loss is remote, reasonably possible or probable. Companies will also need to make determinations from an accounting perspective as to whether COVID-19 has led to any impairment of various types of assets. Among other financial statement concerns to be considered with respect to COVID-19 in extreme cases are going concern issues.

Litigation. To the extent that companies are involved in litigation arising from COVID-19, whether as a plaintiff or a defendant, disclosure may be needed for the litigation section of the Form 10-K. For example, some companies may be suing their insurers for failure to cover damages under an insurance policy due to a loss of business income. Other companies may be facing suit by employees or customers who have allegedly contracted COVID-19 in the workplace or place of business.

Controls and Procedures. Form 10-K requires a company to disclose the conclusions of its principal executive officer and principal financial officer regarding the effectiveness of its disclosure controls and procedures as of the end of each quarterly period. In addition, Form 10-K generally requires a report of management on the company's internal control over financial reporting, with an attestation from the company's auditing firm. With the COVID-19 pandemic affecting so many aspects of business, and with many employees working remotely during 2020, these Form 10-K disclosures may be the subject of scrutiny this year.

In preparation for this upcoming Form 10-K disclosure, it is important for companies to continually monitor and evaluate their disclosure controls and procedures and internal control over reporting to make sure that they remain effective in the current environment, as well as to consider whether changes need to be made to ensure that they remain effective in gathering and reporting all required information. Companies may also want to consider making the potential impact of COVID-19 an express part of their applicable controls and procedures. In addition, because of the swiftly moving changes in the COVID-19 situation, it is especially important for companies to take into account all aspects of their business, including reaching out to areas that may not normally be part of their controls and procedures processes, to ascertain whether anything is happening that could require disclosure.

Other Annual Report Matters

Risk Factors. In addition to COVID-19, there are other trending topics that companies should also evaluate from a risk factor perspective.

Cybersecurity. Cybersecurity incidents and ransom demands have continued to plague businesses and therefore cybersecurity remains a significant risk factor that most companies need to address in their Form 10-Ks. COVID-19 may need to be discussed as part of the cybersecurity risk factor to the extent that operating through a remote workforce contributes to cybersecurity risk. But even outside the COVID-19 context, cybersecurity poses risks that companies should be identifying in their risk factor disclosures, tailored to describe how such risks affect their businesses. Cybersecurity threats continue to grow in sophistication and prevalence. Companies should carefully assess their current cybersecurity risk factor disclosures and related privacy concerns to determine whether additions or modifications are needed to reflect up-to-date conditions in this area.

In addition to discussing cybersecurity as a risk factor, companies should also 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. Updated cybersecurity discussions can also be helpful from shareholder and customer perceptions, to demonstrate that the company is aware of the potential impact of any cybersecurity risk.

LIBOR. Companies should assess their exposure to the transition away from LIBOR to determine whether they need to add, update or elaborate on any risk factor disclosure. The SEC staff is actively monitoring the extent to which the risks expected as a result of the discontinuation of LIBOR are being identified and addressed. In fact, the staff has given comments requesting the inclusion of a risk factor discussing how the expected discontinuation of LIBOR could affect a company's liquidity and results of operations. Companies should also determine not only whether they should disclose the potential impact of their 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.

Brexit. Companies that have been impacted, or that may be impacted, by the departure of the United Kingdom from the European Union and follow-up negotiations should review their past disclosures and consider whether they need to include Brexit as a risk factor and how they may need to revise past risk factor disclosure.

Intellectual Property and Technology Risks. On December 19, 2019, the Staff issued CF Disclosure Guidance Topic No. 8[13] (IP/Technology Guidance), which discussed disclosure obligations that companies should consider relating to intellectual property and technology risks associated with international business operations, particularly in jurisdictions that do not have levels of protection comparable to US protections for corporate proprietary information and assets. The IP/Technology

Guidance identified sources of international intellectual property and technology risk, including both direct intrusions by private parties and foreign actors and indirect risks that companies may face in order to conduct business or access markets in foreign jurisdictions. The IP/Technology Guidance suggested various questions that companies should consider to assess their risks and disclosure obligations relating to potential theft or compromise of technology and intellectual property arising from their international operations and how these risks may impact their business. The IP/Technology Guidance reminded companies that risks material to investment and voting decisions should be disclosed and that disclosure about such risks should be specifically tailored to a company's unique facts and circumstances. It also noted that where a company's technology, data or intellectual property is being or previously was materially compromised, stolen or otherwise illicitly accessed, hypothetical disclosure of potential risks is not sufficient to satisfy a company's reporting obligations.

For more information, see our Legal Update
"Ring in the New Year with SEC Year-End Guidance," dated January 9, 2020.[14]

Other Risk Factors. Risk factor disclosure must discuss the most significant factors that make an investment in a company speculative or risky. While there are topics, such as the ones noted above, that impact many companies or reflect current developments, each company needs to evaluate its own risk profile and tailor its risk factor disclosures accordingly. For example, some companies may need to describe risks related to climate change, trade and tariff matters, market volatility, social unrest, safety concerns, acquisition integration or intellectual property. In recent months, there has been significant focus by the SEC staff on disclosures related to conducting business in emerging markets. Companies domiciled in, or having substantial operations in, an emerging market should review and consider statements made by SEC Commissioners and SEC staff relating to potential areas of risk that companies should consider highlighting in this regard. There may be risks that are unique to an individual company. In addition, risks for a company may change from year to year. Therefore, while it may make sense to use the prior year's risk factor section as a starting place for drafting this year's disclosure, companies need to take a fresh look at their risk factor disclosures when preparing their upcoming Form 10-K, especially in light of the recent amendments to risk factor disclosure described below.

Critical Audit Matters. Audit reports for large accelerated filers already require disclosure of critical audit matters (CAMs) or a statement that the auditor determined that there were no CAMs. The CAM provisions will become effective for fiscal years ending on and after December 15, 2020, for all other companies to which the requirements apply. This means some companies will have CAM disclosure in their Form 10-Ks for the first time during the 2021 annual report and proxy season and those companies should be well into the preparation phase for this important upcoming requirement.

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 both:

- 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 be a CAM.

On December 30, 2019, the SEC's chairman, chief accountant and director of the Division of Corporation Finance issued a joint public statement on the role of audit committees in financial reporting, including key reminders regarding oversight responsibilities.[15] In it they encouraged audit committees to "engage in a substantive dialogue with the auditor regarding the audit and expected CAMs to understand the nature of each CAM, the auditor's basis for the determination of each CAM and how each CAM is expected to be described in the auditor's report."

The COVID-19 pandemic may have an impact on CAM disclosures this year. According to a report published by the Center for Audit Quality "the pandemic could increase the subjectivity and complexity of a specific audit area such that it meets the definition of a CAM, when it otherwise may not have prior to the pandemic." It also could result in the expansion of CAMs that were reported last year "to include new assumptions that were especially challenging or complex due to the pandemic and/or result in changes to the auditor's response to a previously identified CAM."[16]

MD&A Guidance. Discussing a company's financial condition through the eyes of its management in MD&A is a very important part of a company's disclosure. As discussed above, MD&A disclosure this year should include how COVID-19 has impacted the company and how the company has responded to the challenges of the impact. But COVID-19 is not the only factor that companies should be taking into account when preparing their MD&A for their upcoming Form 10-K filings. In particular, companies should once again review the MD&A guidance[17] (MD&A Guidance) that was issued in late January 2020 regarding key performance indicators and metrics used in the MD&A as they prepare for their upcoming Form 10-K filings.

The MD&A Guidance observed that some companies disclose non-financial and financial metrics when describing the performance or the status of their business, which may vary by company and industry and reflect external or macro-economic matters or a combination of external or internal information. According to the MD&A Guidance, each company that uses metrics in its MD&A "need[s] to include such further material information, if any, as may be necessary in order to make the presentation of the metric, in light of the circumstances under which it is presented, not misleading." Based on the facts and circumstances of a particular company, the MD&A Guidance indicated that such metrics must be accompanied by disclosure containing a clear definition of each metric and how it is calculated, a statement indicating the reasons why the metric provides useful information to investors and a statement indicating how management uses the metric in managing or monitoring the performance of the business. According to the MD&A Guidance, companies also should consider whether there are underlying estimates or assumptions for each metric or its calculation that need to be disclosed in order for the metric not to be materially misleading.

As a result of amendments to the MD&A that became effective in May 2019, companies are permitted to omit a discussion of the earliest of three years in a filing that includes financial statements covering three years to the extent that the discussion of that earlier year was already included in an SEC filing and such presentation identifies the location in the prior filing where the omitted disclosure may be found. On January 24, 2020, the Staff issued three new C&DIs to provide guidance in connection with that change.[18] These C&DIs clarify that a statement merely identifying the location in a prior filing where the omitted discussion can be found does not incorporate such disclosure into the filing; explain that a company may not omit the discussion of the earliest of the three years if it believes it "necessary to an understanding of its financial condition, changes in financial condition and results of operations;" and address the situation where a company files a Form 10-K in which the discussion of the earliest of the three years of financial statements is omitted from the MD&A and that Form 10-K thereupon becomes incorporated into a registration statement that is already effective.

For more information on the guidance discussed in this section, see our Legal Update, "SEC Issues MD&A Guidance," dated February 4, 2020.[19]

Amendments to Business, Risk Factor and Legal Proceedings Disclosures. On August 26, 2020, the SEC adopted amendments to Regulation S-K that are intended to modernize business, risk factor and legal proceedings disclosures.

In the area of business disclosure, the amendments reflect a move away from prescriptive, line-item disclosure requirements to principles-based disclosure requirements that rely on a company's management to evaluate the significance of information in the context of the company's overall business and financial circumstances in order to determine whether disclosure is necessary. The SEC has eliminated the prescribed five-year timeframe for disclosure, requiring companies to focus on information that is material to understanding the development of their business without regard to a specific timeframe.

Among the changes to the business description, the SEC added a provision requiring a description of human capital resources which would need to include, to the extent material to an understanding of a company's business, the number of persons employed by the company and any human capital measures or objectives that the company focuses on in managing the business, such as measures or objectives that address the development, attraction and retention of personnel.

With respect to risk factors, the amendments require a risk factor summary of not more than two pages if the risk factor discussion exceeds 15 pages. To focus disclosure on the risks to which reasonable investors attach importance in making investment decisions, the SEC changed the risk factor disclosure standard contained in Item 105 from the "most significant" risks to all "material" risks. The amendments also require companies to organize their risk factor disclosure under relevant headings. If a company chooses to disclose a risk that could apply to other companies or securities offerings without explaining why the identified risk is specifically relevant to investors in the company's securities, the amended rule requires such generic disclosure to be placed at the end of the risk factor section under the caption "General Risk Factors."

Under the amendments, the legal proceedings disclosure would be allowed to be provided by hyperlink or cross-reference to disclosure elsewhere in the document, such as in MD&A, risk factors and notes to the financial statements. The amendments to legal proceedings disclosure also raise the threshold for disclosure of environmental proceedings to which a governmental authority is a party from $100,000 to $300,000, with the flexibility for the company to select a different threshold if certain conditions are met.

A number of these changes are not applicable to foreign private issuers that prepare their annual reports on forms that do not specifically refer to Regulation S-K, such as Form 20-F, but may be applicable to registration statements on Forms F-1, F-3, and F-4. As a result, foreign private issuers should closely consider amendments.

For more information on these amendments, see our Legal Update "SEC Amends Business, Legal Proceedings and Risk Factor Disclosures," dated August 31, 2020.[20]

Amendments to Accelerated and Large Accelerated Filer Definitions. The SEC has amended the accelerated filer and large accelerated filer definitions in Rule 12b-2, excluding from those definitions a company that qualifies as a smaller reporting company (SRC) under the SRC revenue test (i.e., no revenues or annual revenues of less than $100 million in the most recent fiscal year for which audited financial statements are available), with business development companies being excluded in analogous circumstances. The amendments also increased the transition thresholds for accelerated and large accelerated filers becoming non-accelerated filers and for exiting large accelerated filer status, as well as adding a revenue test to the transition thresholds for exiting both accelerated and large accelerated filer status.

As a result of these amendments, certain low revenue companies are no longer subject to the auditor attestation requirements regarding internal control over financial reporting. In addition, these low-revenue companies do not need to comply with the shorter SEC reporting deadlines that apply to accelerated and large accelerated filers.

Because of the changes that removed certain low-revenue smaller reporting companies from the definition of accelerated filer, companies are now required to check a box on the cover pages of Forms 10-K, 20-F and 40-F to indicate whether an internal control over financial reporting auditor attestation is included in the filing.

For more information on these amendments, see our Legal Update "SEC Adopts Amendments to Accelerated and Large Accelerated Filer Definitions," dated March 25, 2020.[21]

Amendments to Business Acquisition and Disposition Disclosure. The SEC has amended certain financial statement disclosures with respect to business acquisitions and dispositions. Among other matters, these amendments revised the investment test and income test used in determining which business acquisition or disposition is considered significant, thereby necessitating the inclusion of target financial statements and updated the required contents and period coverage of the acquired business' financial statements. The amendments revised pro forma financial information requirements so that the adjustment criteria are broken out into three categories: "Transaction Accounting Adjustments," "Autonomous Entity Adjustments," and optional "Management's Adjustments."

For more information on these amendments, see our Legal Update "SEC Amends Business Acquisition and Disposition Disclosure Rules," dated May 28, 2020.[22]

Guaranteed or Collateralized Securities. The SEC has also simplified and streamlined the financial disclosures required for guaranteed or collateralized debt securities by amending Rule 3-10 and Rule 3-16 of Regulation S-X and relocating part of Rule 3-10 and all of Rule 3-16 to a new Article 13 in Regulation S-X. These amendments preserve a company's ability to omit separate subsidiary issuer and guarantor financial statements when certain conditions are met, with some modifications to the current conditions, and simplify the existing requirements relating to consolidating information.

For more information on these amendments, see our Legal Update "SEC Amends Financial Disclosure Requirements in Registered Debt Offerings involving Guaranteed or Collateralized Securities," dated March 23, 2020.[23]

Proposed MD&A Amendments. On January 30, 2020, the SEC proposed amendments to the MD&A rules and related disclosures to better clarify the objective of MD&A for both full fiscal years and interim periods. The proposed rules contemplated that the compliance date for the MD&A amendments would be 180 days after final rules, if any, are adopted, which suggests that calendar year companies would not be required to implement any such changes for their 2020 annual reports. However, companies should monitor the MD&A rulemaking carefully to be prepared for updated disclosure requirements.

For more information, see our Legal Update "SEC Proposes Significant Changes to MD&A and Related Disclosures," dated February 10, 2020.[24]

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Endnotes

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