SEC Disclosure and Proxy Guidance and Proposals

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SEC Disclosure and Reporting Developments

Recently, the US Securities and Exchange Commission continued to move forward with a number of disclosure effectiveness and simplification initiatives, the details of which are available in our Disclosure Simplification Tracker.

Although many of these changes are administrative in nature, collectively they represent an ongoing shift toward principles-based disclosure. In the coming year, we expect that the practical limits of principles-based disclosure will be tested as the SEC moves to implement its August 2019 proposal for the simplification of the narrative description of the business and risk factor items, and attempts to tackle simplification of the MD&A section, which they have included on their Fall 2019 regulatory short-term agenda.

While we expect these changes will give wider latitude for companies to customize their disclosures, the impact may be less than expected because they will do little to address the underlying legal judgments about litigation and reputational risk management that have shaped the form of current disclosure practices.

SEC Disclosure Priorities

This year, we expect that the SEC will continue to be focused on the following areas:

— ***Earnings Management***. In fall 2019, the SEC instituted enforcement actions against Marvell Technology Group and Under Armour for pulling forward sales in order to meet quarterly revenue guidance. For companies that still provide quarterly guidance, directors should engage with management to determine whether earnings management is occurring and may wish to reconsider the practice of providing quarterly guidance altogether. For additional details, see our article in the *Harvard Law School Forum on Corporate Governance and Financial Regulation* and Auditing and Accounting: What's New in 2020 in this memo.

— ***Cybersecurity***. Disclosures should include material cybersecurity risks and incidents and should focus on specific cybersecurity risks and incidents involving harms to the company, including injury to the company's reputation, financial performance and customer and vendor relationships, as well as potential litigation or regulatory investigations. The SEC has reiterated its view that where a company has become aware of a material cybersecurity incident or risk, it will not be sufficient to merely disclose that such an incident "may" occur. For additional information about developments in this area, please see Cybersecurity: What Keeps Us Up at Night in this memo.

— ***Brexit***. Although the effects of the UK's pending exit from the European Union (Brexit) remain uncertain, a company's annual report and other relevant disclosures should describe management's views on the risks posed by Brexit, to the extent material, and any actions the company is taking to address those risks. Companies should avoid boilerplate disclosure merely stating that Brexit presents a risk with an uncertain outcome, but should instead write a disclosure that would "satisfy the curiosity of a thoughtful, deliberative board member considering the potential impact of Brexit on the company's business, operations, and strategic plans."[1] See View from the UK: Recent Development in Brexit and Corporate Governance in this memo.

— ***Non-GAAP Financial Measures***. The SEC remains focused on Non-GAAP disclosure, especially with respect to using "equal or greater prominence" when disclosing Non-GAAP financial measures. As a reminder, on December 26, 2018, the SEC issued a cease-and-desist order under Section 21C against ADT Inc. for providing Non-GAAP financial measures, such as adjusted EBITDA, adjusted net income and free cash flow before special items, without giving equal or greater prominence to the comparable GAAP measures.

— ***Sustainability***. Investors are increasingly interested in how companies address environmental, social and governance (ESG) matters. Yet, the SEC disclosure regime does not include—at least for now—specific rules calling for ESG disclosure, and SEC officials continue to encourage a materiality-based approach to such disclosure. For example, existing MD&A and risk factor requirements could require disclosure of ESG matters if the information is material and the failure to disclose makes other disclosures misleading. See Navigating the ESG Landscape in this memo.

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— ***LIBOR Transition***. The planned discontinuation of the London Interbank Offered Rate (LIBOR) will continue to raise significant challenges with risk identification, evaluation and mitigation efforts related to existing or new contracts for banks, insurance companies and other companies with significant LIBOR exposure. Companies with strong balance sheets and/or limited LIBOR-denominated debt may find that this issue is not material.

— ***Accounting Changes***.

- *Lease Accounting*. New standards on lease accounting under US GAAP (ASC 842) are now fully effective for SEC filers. ACS 842 generally requires a lessee to recognize a new lease asset (representing the right to use the leased item) and a new lease liability (representing the obligation to pay rentals). The new standard may have a dramatic impact on some balance sheets, income statements and financial ratios and performance

[1] Remarks by SEC Director of the Division of Corporate Finance, William Hinman, in a March 2019 speech at the 18th Annual Institute on Securities Regulation in Europe.

metrics that are used in covenants. The new standard may also trigger transition disclosure requirements applicable to accounting changes, which will generally be included in the notes to the financial statements. Companies should assess the impact of the transition to the applicable standard on other sections of Form 10-K.

- *CECL*. The Financial Accounting Standards Board's standard introducing the current expected credit losses (CECL) methodology is effective for SEC filers in fiscal years beginning after December 15, 2019. The new standard replaces the Allowance for Loan and Lease Losses standard, and focuses on estimating allowances for credit losses over the life of a company's loans. The impact of CECL is likely to be more significant to banks and other financial institutions than to other companies, but every company should assess and disclose any material impact that the new standard is expected to have on credit losses.

SEC Proxy Developments

In 2019, the Securities and Exchange Commission moved forward with Chairman Jay Clayton's ambitious review of the framework for shareholder voting at public companies with two rule proposals adopted by 3-2 votes along party lines. We expect aspects of the proposals will attract significant interest and opposition during the comment process as shareholder groups, asset managers and corporate governance watchdogs, as well as ISS and Glass Lewis, attempt to shape the course of Clayton's reforms.

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In August, the SEC announced interpretive guidance, and in November it proposed new rules (the "Proxy Advisor Rule Proposal") addressing the concerns of many public companies that the proxy advisory process is not as careful, reasonable and fair as it should be in light of the substantial influence of the proxy advisory firms. In a contemporaneous release, the SEC proposed changes to Rule 14a-8 that, in part, are intended to address the view of many public companies that the proxy process requires a disproportionate dedication of resources to proposals from the more prolific proponents (the "Shareholder-Proposal Rule Proposal").

Proxy Advisor Rule Proposal

The most significant benefits of the Proxy Advisor Rule Proposal for public companies are new rights to review and comment on proxy advisors' recommendations prior to their release as well as a requirement that proxy advisors, if so requested by the company, include a hyperlink to a company statement along with their own recommendations.[2] This would be a marked improvement to what can be a particularly frustrating area for public companies, which must rely on the goodwill of the proxy advisory firms to correct errors in their recommendations. If and when mistakes slip through, the options available to a company to correct them are often inadequate.

These changes are premised on the SEC's view, as expressed in the August guidance and in the November proposal, that proxy voting advice as it is currently provided by ISS and Glass Lewis constitutes a "proxy solicitation" under the Exchange Act and therefore subjects the proxy advisory firms to regulation. This position resulted in a swift legal challenge from ISS, which if successful could undermine the basis for the entire Proxy Advisor Rule Proposal.

[2] For additional details on this proposal, see our November Alert Memo here.

The ISS complaint gives a preliminary idea of the arguments ISS expects to make. It seeks to distinguish proxy advisory firms, which have no business interest in the shareholder vote other than to earn fee income from their advice, from others involved in the solicitation of proxies incident to another business interest that is not limited to providing advice; and it argues that only the second category should be regulated as proxy solicitation while the first should be regulated as investment advice. Whether that distinction limits the SEC's authority to regulate the proxy advisory firms will now be for the federal courts to determine.

The Proxy Advisor Rule Proposal would also codify the view that such recommendations are subject to the prohibition on making false or misleading statements under Rule 14a-9[3] and require proxy advisory firms to include specific disclosures on conflicts of interest that the advisory firm has with respect to the company.

Unsurprisingly, how to strike the right balance between the interests of companies and proxy advisors continues to be a hotly contested topic. The Proxy Advisor Rule Proposal sparked immediate dissent from corporate governance advocacy groups that worry such rules will pressure proxy advisory firms to take a more management-friendly approach in their reports and vote recommendations.[4]

Shareholder-Proposal Rule Proposal

By contrast, the Shareholder-Proposal Rule Proposal provides for a more modest change by raising or adding new procedural hurdles for submitting shareholder proposals. Most notably, the dollar threshold for the share ownership requirement to submit a proposal would be raised, limitations on resubmission of proposals would be increased, individuals would be limited to one proposal each (per company) and shareholder proponents would be required to participate in a minimum level of engagement with the company.[5]

These standards have not been revisited in more than 20 years, and a refresh to account for inflation and new developments in shareholder practices appears overdue. Despite the SEC's intention, in its current form we think the Shareholder-Proposal Rule Proposal is unlikely to reduce the number of proposals received by companies from the most prolific shareholder proponents, but will have the benefit of reducing the number of "zombie" proposals—proposals that are made every year but do not have a chance of passing.

Timing and Potential Roadblocks

In 2020 we will be keeping a close eye on the timing of both the Proxy Advisor Rule Proposal and the Shareholder-Proposal Rule Proposal (the "New Rule Proposals") and the related ISS litigation as they move forward. Comments to the New Rule Proposals are due by February 3, 2020, which will likely result in final rules being published in the spring of 2020. For early calendar year filers, the Shareholder-Proposal Rule Proposal would first impact the shareholder proposals they receive in the fall of 2020; however, the Proxy Advisor Rule Proposal provides for a one-year transition period and therefore would not go into effect until the spring of 2021, at which point early calendar year filers may be unable to avail themselves of the new rights offered until the 2022 proxy season.

Another wrinkle is that the New Rule Proposals were both issued in 3-2 votes, with Republican members Clayton, Peirce and Roisman forming the majority and Democratic Commissioners Jackson and Lee dissenting. Chairman Clayton's term expires in 2021, so the views of his successor could play a large role in how the rules are implemented. Likewise, if ISS prevails in its litigation against the SEC, the conceptual basis for the Proxy Advisor Rule Proposal would be removed—which would either severely dilute, or completely nullify, its impact.

[3] This also raises the interesting question of whether a company could successfully bring a claim against a proxy advisor based on the content of their recommendation. While there is case law finding that an investor has a private right of action against a company under Rule 14a-9, a claim by a company against a proxy advisory firm would be a step further—one it seems unlikely that companies will take for practical and reputational reasons in the ordinary course, although perhaps in a particularly contentious proxy battle or merger, a party might have a sufficient incentive for bringing such a claim.

[4] *See* Leading Investor Group Rebukes SEC for Proposed Rules That Undercut Critical Shareholder Rights, available here.

[5] For additional details on this proposal, see our November Alert Memo here.