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PROXY SEASON POINTERS

Updating Risk Factors: Key Developments and Drafting Considerations

By Maia Gez, Era Anagnosti, Colin Diamond, Scott Levi, Melinda Anderson, Amanda Maki, and Danielle Herrick

The Annual Report season will soon be upon us, and it is important to assess a company's risk factors at the outset and whether recent developments, including those relating to macroeconomic, geopolitical, and public health conditions, have had (or are expected to have) a material impact on a company's business, financial condition and results of operations.[1] Although each company will need to assess its own material risks and tailor its risk factor disclosure to its unique circumstances, this article provides a list of 10 key developments and then four important drafting considerations that all public companies should bear in mind as they update their risk factors.

Ten Key Developments to Consider when Updating Annual Report Risk Factor Disclosures

1. Market Conditions

Changes in global economic conditions, including volatile equity capital markets, may adversely affect a company's business, revenues, and earnings. Such conditions could impact a company's plans for growth and ability to access the capital markets to raise funds for general corporate purposes or as consideration for mergers and acquisitions. A company should assess any material risks related to these developments and whether they should be disclosed in its risk factors.

2. Inflation and Interest Rates

Companies should consider whether to disclose or update any risks related to inflation and rising interest rates, including their impact on revenues or earnings. These risks could include current and future increases in operating costs, such as fuel and energy, transportation and shipping, materials, and wages and labor costs, as well as a negative impact to revenue as a result of decreased consumer confidence and discretionary spending. Additionally, rising interest rates could impact a company through changes in financing availability, the cost of debt, and exchange rate fluctuations.[2]

3. Impact of COVID-19

As we enter the third year of the pandemic, it may still be too early to entirely eliminate COVID-19 specific risk factors, but companies may be able to significantly streamline their disclosures. Companies should take a fresh look at their existing COVID-19 risk factor disclosure and update it to account for the current risks they face, including eliminating or de-emphasizing risks that are no longer expected to be material.

For example, all companies face the risk of the emergence of new virus strains, availability of effective treatment, and potential regulatory and macroeconomic effects stemming from such impacts. However, outside of China, lockdowns, shelter-in-place restrictions, and vaccine mandates, prevalent during the initial stages of the pandemic, have been lifted for most companies. Companies should assess how the relevant risks impact their businesses and

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prospects in particular, rather than rely on hypothetical, generalized COVID-19 disclosure.

4. Environmental, ESG and Sustainability Issues

Issues such as climate change continue to receive significant attention from the Securities and Exchange Commission (SEC) and investors. On September 22, 2021, the SEC posted a sample comment letter to companies,[3] nearly six months (to the day) prior to issuing its proposed climate change disclosure rules that would require public companies to disclose extensive climate-related information in their SEC filings.[4]

The SEC's sample comment letter on climate change contained illustrative comments regarding companies' climate-related disclosure or the absence of such disclosure, including comments requesting information on the material effects of climate change-related transition risks.[5] Following this sample comment letter, our review of recent SEC comment letters between March 2021 and August 2022 found that the SEC issued 334 climate-change related comments to over 100 companies during this period, with over 50 of these comments (15 percent) related to risk factor disclosure.[6]

These SEC comments included requests to describe the material effects of transition risks,[7] material litigation risks related to climate change,[8] and a description of the consideration given to including information and risks disclosed in sustainability reports.[9] Moreover, our survey of the 2022 Form 10-Ks of 50 companies in the Fortune 100 found that 30 percent (or 15 companies) added entirely new risk factors devoted to climate-related impacts, and an additional 28 percent (or 14 companies) increased references to climate-related impacts in their existing risk factors.[10]

Risk factor disclosure related to environmental issues should be tailored to the company's specific circumstances and address a company's own material risks. Topics can include risks related to the impact of climate change on a company's business, such as risks of increased costs or reduced demand for products; physical risks related to severe weather events, sea level rise, and other natural conditions; climate change transition risks attributable to regulatory, technological, and market or pricing changes; risk of legal liability and defense costs; reputational risks, including those related to scrutiny from stakeholders on ESG issues or the risk of failing to meet announced goals and targets; and/or inadequate internal controls related to the disclosure of ESG data.

Companies should also consider whether any additional risks should be disclosed in light of the SEC's proposed climate change rules, including considering climate related risks over the short, medium, and long term, and impacts to their upstream and downstream operations.

5. Ukraine Conflict

As the conflict between Ukraine and Russia continues, companies should consider their potential additional disclosure obligations related to direct or indirect impacts that Russia's ongoing actions in Ukraine and the international response have or may have on their business and how it has changed since the conflict began. Notably, the SEC may require disclosures even by companies that have no operations in Russia, Ukraine, or Belarus.

On May 10, 2022, the SEC posted a sample letter to companies emphasizing companies' potential disclosure obligations related to direct or indirect impacts that Russia's actions in Ukraine and the international response have or may have on their business.[11] The SEC specifically noted that, to the extent material, companies should provide detailed disclosure regarding risks related to actual or potential disruptions in supply chains and new or heightened risks of potential cyberattacks by state actors or others. Our review of comment letters found that the SEC issued 117 Ukraine related comments to over 60 companies between March and September 2022.

These comments included requests to add risk factor disclosure about operations in Ukraine and material impacts related to the conflict,[12] requests to specifically disclose any increased risk of cyberattacks,[13] risks related to potential supply chain disruptions[14] and requests to disclose potential reputational risks related to the company's operations in Russia.[15] Additional disclosures that companies should consider include Russian sanctions; increases in commodity prices; impacts on the availability and cost of energy; vendor and supplier impacts; reputational impacts; and ongoing impacts on global economic condition.

6. Cybersecurity

As cybersecurity incidents, data misuse, and ransomware attacks continue to proliferate and become more sophisticated, the SEC Staff has been focusing on, and providing comments regarding, cybersecurity and privacy disclosures. The SEC issued guidance in 2018 that included considerations for evaluating cybersecurity risk factor disclosure,[16] and in March 2022, the SEC proposed mandatory cybersecurity disclosure rules related to material incidents, governance, and risk strategy.[17]

The SEC also issued guidance in December 2019 specifically calling on companies to assess risks related to the potential theft or compromise of their technology, data, or intellectual property (IP) in connection with their international operations and disclose them where material.[18] The SEC is expected to continue to be aggressive in reviewing public company disclosure of cybersecurity incidents, and in May 2022 the SEC nearly doubled the size of the unit responsible for monitoring companies' disclosures.[19]

In addition, the SEC has filed enforcement actions against public companies related to the timing and content of cybersecurity incident disclosures. These follow other high-profile enforcement actions for alleged inadequate or misleading disclosures,[20] all of which signal the SEC's continued focus on how public companies respond to and disclose material cybersecurity incidents and risks. Moreover, in 2021, the Ninth Circuit found that a major tech company's disclosure that cybersecurity risks "may" or "could" occur was misleading when the company was allegedly already aware of a cybersecurity breach.[21]

Most companies already include cybersecurity risk factor disclosure, but companies should consider updates to these disclosures, including whether there are any increased cyber-related risks due to pandemic-related technologies that they may have adopted to enable remote working or in connection with the ongoing conflict in Ukraine (see above).[22]

7. Supply Chain Disruptions

Shortages of supplies or shipping delays may need to be disclosed as a risk, particularly as these continue to be common due to the lingering impact of COVID-19 or the conflict in Ukraine, as well as a worldwide economic slowdown.

Companies should assess whether they have, or may experience in the future, supply chain disruptions that should be disclosed as a material risk. This includes any risks related to the ongoing global semiconductor chip shortage, which could impact software development, production, and manufacturing, among other things, depending on the company's industry.

8. Human Capital and Labor Issues

Material risks that companies may face with respect to human capital include risks related to the ability to attract and retain skilled employees, employee health and safety issues, increases in labor costs, and increased employee turnover. Although the job market has slowed and several Fortune 100 companies have begun to announce layoffs, shortages of qualified labor may need to be disclosed as a material risk for some companies, as these issues continue to be common due to COVID-19-related impacts as well as the fallout from "the Great Resignation."

In addition, a company's stock price volatility could negatively impact the value of employees' equity awards and a company's ability to retain key employees and executives. Companies should assess whether they have, or may experience in the future, issues related to labor shortages, increased labor costs, or employee retention that should be disclosed as a risk factor, including as a result of any ongoing personnel absences or issues with return-to-office transition plans.

9. Regulatory

Changes and potential changes in law, regulation, policy, and/or political leadership, including the regulatory agenda of the Biden administration, may necessitate modifications to risk factor disclosure for certain companies.

One such regulatory change that companies should consider is the Inflation Reduction Act (IRA), which includes several potentially impactful provisions, such as: (i) a 1 percent excise tax on corporate stock buybacks, which may affect corporate decisions with respect to capital markets and M&A transactions, among other items,[23] (ii) a corporate alternative minimum tax (applicable to companies with an average adjusted financial statement income over $1 billion for the past three years) equal to the excess of 15 percent of a corporation's adjusted financial statement income, and (3) energy related tax credits, which create tax incentives for green energy. Companies should consider whether the IRA creates any risks that warrant disclosure. Other examples include current and potential changes to immigration policies, minimum wage, tariffs, taxes, environmental policies, health care, and other political developments.

10. Risks Related to Doing Business with Companies in Regions Subject to Trade Sanctions

Companies should disclose any material risks related to business dealings with companies in regions subject to trade sanctions or prohibitions. For example, any companies receiving goods produced in the Xinjiang Uyghur Autonomous Region of China, or by certain identified entities, should disclose risks related to the fact that, for purposes of the Uyghur Forced Labor Prevention Act, which strengthens available measures to enforce an existing preventative measure in Section 307 of the Tariff Act of 1930, such goods are presumed to have been made with forced labor, and are therefore subject to an import prohibition in the United States. US Customs and Border Protection may therefore detain, exclude, or seize goods and assess monetary penalties, unless "clear and convincing evidence" shows that no forced labor, situated anywhere in the supply chain, produced any part of the goods (and importers comply with other requirements specified in published agency guidance).

Importantly, the statute contains no de minimis exception and there is no assurance that a company will be able to prove the absence of forced labor throughout the supply chain. Any potential supply chain or other impacts from these developments that are material for a company should be disclosed.

Four Important Drafting Considerations when Updating Annual Memo Risk Factor Disclosures

1. A Note on Hypotheticals

It is crucial for companies to review the hypothetical statements in their existing risk factor disclosures (for example, the statements that an event "could" or "may" occur rather than "has" or "did" occur in the past). The SEC has instituted enforcement actions and shareholders have filed claims under Section 10(b) of the Securities Exchange Act of 1934, as amended, alleging that statements in a company's risk factors were materially misleading because a company stated that an event only "may" or "could" occur, when the event was no longer hypothetical at the time of the disclosure. Accordingly, a company should carefully review its hypothetical risk factor language and clarify whether a potential disclosed risk has in fact occurred to some degree.[24]

2. A Note on Forward-Looking Statements

Beyond being legally required, well-drafted risk factors can protect a company from liability for its forward-looking statements and serve as a form of free liability insurance to protect a company when disclosing both projections as they relate to financial information and non-financial information, including ESG related goals and targets. In particular, companies should take into account financial models that support their projections and confirm that material risks related to these projections, including financial models, bases and assumptions that support them, are sufficiently disclosed.

Moreover, in the case of ESG net zero targets and other ESG related goals and transition plans, companies should consider whether their risk factor disclosure should include disclosure related to the potential challenges in meeting these goals and plans, including the inability to develop technologies to achieve them.

3. A Note on the Presentation of Risks

Although Item 105 of Regulation S-K does not require that risk factors be ordered in terms of which is most important or has the greatest potential impact, it is considered a good practice to do so.[25]

Item 105 does state that risks should be "organized logically," so companies should consider the order that makes the most sense for investors. In addition, companies are required to organize risk factors into groups of related risk factors under "relevant headings" and provide sub-captions for each risk factor.

Further, for any risk factors that apply generically to any registrant or offering, the company must either (i) tailor these risk factors to emphasize the specific relationship of the risk to the company, or (ii) disclose the generic risk factors at the end of the risk factor section under the caption "General Risk Factors." These requirements have been in effect since 2020, and companies should annually review their groupings and headings to confirm any updates or changes to their risk factor section's organization.[26]

4. A Note on Risk Factor Summaries

If a company's risk factor section exceeds 15 pages, it must include a series of concise, bulleted, or numbered statements that is no more than two pages summarizing the principal risk factors and place this summary at the "forepart" or at the beginning of the Form 10-K or Form 20-F. A number of companies have opted to combine this disclosure with their forward-looking statement legends in order to avoid repetition, and companies may consider this approach so long as the legend is titled to reflect its dual purposes (that is, "Cautionary Note Regarding Forward-Looking Statements and Risk Factor Summary").

Conclusion

Given the number of headwinds companies may face in this challenging economic and geopolitical environment, as well as new and evolving regulatory requirements, scrutiny, and enforcement activity, companies would benefit from getting a head start on updating their Annual Report's risk factors now. It is key for companies to disclose how they are specifically impacted by macro trends, rather than rely on generic disclosure. In addition, companies should not lose sight of updating their risk factors to account for the unique risks they face beyond these macro trends that could adversely impact their business, financial condition, and results of operations.

Notes

1. *See* Item 105 of Regulation S-K, available at *https://www.ecfr.gov/current/title-17/chapter-II/part-229/subpart-229.100/section-229.105*.
2. For more information, *see* our prior alert, "Inflation and increasing interest rates reshape US leveraged finance markets," at *https://www.whitecase.com/insight-our-thinking/us-levfin-2022-inflation-increasing-interest-rates*.
3. For more information, *see* our prior alert, "SEC Issues Sample Comment Letter as it Ramps Up Scrutiny of Climate Disclosures," at *https://www.whitecase.com/insight-alert/sec-issues-sample-comment-letter-it-ramps-scrutiny-climate-disclosures*.
4. For more information, *see* our prior alert, "SEC Proposes Long-Awaited Climate Change Disclosure Rules," at *https://www.whitecase.com/insight-alert/sec-proposes-long-awaited-climate-change-disclosure-rules*. On October 7, 2022, the SEC reopened the comment period for 11 rulemaking proposals, including the proposed climate change disclosure rules, with comments due by November 1, 2022.

5. Climate change transition risks relate to developments such as policy and regulatory changes that could impose operational and compliance burdens and market or pricing trends that may alter business opportunities, credit risks, and technological changes.
6. For example, "[i]t appears that you have identified your "electrification strategy" as a transition risk related to climate change. Tell us how you considered providing expanded disclosure regarding the factors that may affect your intention to bring additional electrification to your … portfolio (for example, the availability of necessary materials, the pace of technological changes, etc.) and the potential effect on your business, financial condition, and results of operations. In addition, describe other transition risks related to climate change you have considered, such as those related to your environmental policies, and how you considered addressing them in your Form 10-K."
7. For example, "Disclose the material effects of transition risks related to climate change that may affect your business, financial condition, and results of operations, such as policy and regulatory changes that could impose operational and compliance burdens, market trends that may alter business opportunities, credit risks, or technological changes."
8. For example, "Disclose any material litigation risks related to climate change and explain the potential impact to the company."
9. For example, "We note that you provided more expansive disclosure in your CSR report than you provided in your SEC filings. Please advise us what consideration you gave to providing the same type of climate-related disclosure in your SEC filings as you provided in your CSR report."
10. For more information, *see* our prior alert, "ESG Disclosure Trends in SEC Filings—Annual Survey 2022," at *https://www.whitecase.com/insight-alert/esg-disclosure-trends-sec-filings-0*.
11. For more information, *see* our prior alert, "SEC Issues Sample Comment Letter on Disclosure Obligations Related to Russia's Actions in Ukraine," at *https://www.whitecase.com/insight-alert/sec-issues-sample-comment-letter-disclosure-obligations-related-russias-actions*.
12. For example, "To the extent material, please disclose any known trends or uncertainties that have had or are reasonably likely to have a material impact on your liquidity, financial position, or results of operations arising from the conflict between Russia and Ukraine."
13. For example, "[t]o the extent material, disclose any new or heightened risk of potential cyberattacks by state actors or others since Russia's invasion of Ukraine."
14. For example, "[p]lease disclose whether and how your business segments, products, lines of service, projects, or operations are materially impacted by supply chain disruptions, especially in light of Russia's invasion of Ukraine. For example, discuss whether you have or expect to…be exposed to supply chain risk in light of Russia's invasion of Ukraine and/or related geopolitical tension."
15. For example, "[i]n future filings, please revise to address the following as it relates to your business in Russia and Ukraine: Disclose any material reputational risks that may negatively impact your business associated with your response to the Russian invasion of Ukraine, for example in connection with action or inaction arising from or relating to the conflict."
16. For more information, *see* our prior alert, "SEC Issues Interpretive Guidance on Public Company Cybersecurity Disclosures: Greater Engagement Required of Officers and Directors," at *https://www.whitecase.com/insight-alert/sec-issues-interpretive-guidance-public-company-cybersecurity-disclosures-greater*.
17. For more information, *see* our prior alert, "SEC Proposes Mandatory Cybersecurity Disclosure Rules," at *https://www.whitecase.com/insight-alert/sec-proposes-mandatory-cybersecurity-disclosure-rules*.
18. The SEC's guidance encourages companies to consider a range of questions when assessing these risks, including whether they are operating in foreign jurisdictions where the ability to enforce rights over IP is limited as a statutory or practical matter, and whether they have controls and procedures in place to adequately protect technology and IP. The Staff also emphasized that disclosure of material risks should be specifically tailored, and that where a company's technology, data, or IP is being (or previously was) materially compromised, hypothetical disclosure of potential risks is not sufficient to

satisfy the company's reporting obligations. Accordingly, companies should continue to consider this evolving area of risk and update disclosure on an ongoing basis to reflect current circumstances to the extent material. *See https://www.sec.gov/corpfin/risks-technology-intellectual-property-international-business-operations*.

19. *See* the SEC's press release, "SEC Nearly Doubles Size of Enforcement's Crypto Assets and Cyber Unit" at *https://www.sec.gov/news/press-release/2022-78*.
20. In August 2021, the SEC settled with an educational publishing and services company over its failure to adequately disclose a material cybersecurity breach and for making misleading statements in its SEC filings. Specifically the SEC found that: (i) several months after the breach, the company issued a Form 6-K that referenced a general risk of data breach/cybersecurity incident, but did not specifically reference the breach that had occurred; and (ii) the company's press statement referred only to "unauthorized access" and "expos[ure of] data" which "may [have] include[d]" birthdates and emails, even though the company knew that significant personal data had been downloaded, and made no mention of the volume of breached data nor of the other critical vulnerabilities in the system.

    In June 2021, the SEC settled with a real estate settlement services company for its alleged failure to adequately disclose a security vulnerability that could be used to compromise the company's computer systems. In May 2019, the company was notified of a software vulnerability that exposed personal and financial data, after which it issued a statement and furnished a Form 8-K, stating it had taken "immediate action" to terminate external access to the data. However, the executives responsible for the statement and Form 8-K were not informed that the company's information security personnel had been aware of the vulnerability since January 2019 or that the company had failed to timely remediate that vulnerability in accordance with its policies. According to the SEC, the January 2019 findings "would have been relevant to management's assessment of the company's disclosure response...and the magnitude of the resulting risk" and the company failed to maintain disclosure controls and procedures to ensure that management had all available relevant information prior to making its disclosures.

    With respect to cybersecurity, the SEC found that Yahoo's risk factor disclosures in its annual and quarterly reports were materially misleading in that they claimed the company only faced the "risk of potential future data breaches" that might expose the company to loss and liability "without disclosing that a massive data breach had in fact already occurred." The SEC's action is available at *https://www.sec.gov/litigation/admin/2018/33-10485.pdf*. For more information, *see* our prior alert, "SEC Fines Yahoo $35 Million for Failure to Timely Disclose a Cyber Breach," at *https://www.whitecase.com/publications/alert/sec-fines-yahoo-35-million-failure-timely-disclose-cyber-breach*.
21. For more information, *see* our alert, "Time to Revisit Risk Factors in Periodic Reports," at *https://www.whitecase.com/publications/alert/time-revisit-risk-factors-periodic-reports*.
22. A White & Case LLP survey of the disclosures made by Fortune 50 companies found that every company included at least one risk factor related to cybersecurity in its 2022 Form 10-K, and 42 of the 50 companies included detailed risk factors discussing the impact that a cybersecurity incident or data breach could have on the company's results of operations or financial condition.
23. For more information, *see* our prior alert, "New 1% Excise Tax on Stock Buybacks May Have Far-Reaching Consequences for Capital Markets, SPAC and M&A Transactions."
24. Disclosure may be required whether or not the degree of occurrence is material on its own. For more information, *see* our prior alerts, "Time to Revisit Risk Factors in Periodic Reports" (*https://www.whitecase.com/publications/alert/time-revisit-risk-factors-periodic-reports*) and "Key Considerations for the 2022 Annual Reporting and Proxy Season Part I: Form 10-K Considerations" (*https://www.whitecase.com/insight-alert/key-considerations-2022-annual-reporting-and-proxy-season-part-i-form-10-k*).
25. The Form 20-F also states that "companies are encouraged, but not required, to list the risk factors in the order of their priority to the company." *See* Part I, Item 3.D of Form 20-F. In addition, Item 105 applies to foreign private issuers to the extent their Form 20-F is incorporated by

reference into a registration statement, such as a Form F-1, F-3, or F-4.

26. For more information, *see* our prior alert "SEC Adopts Amendments to Modernize Disclosures and Adds Human Capital Resources as a Disclosure Topic: Key Action Items and Considerations for US Public Companies," at *https://www.whitecase.com/insight-alert/sec-adopts-amendments-modernize-disclosures-and-adds-human-capital-resources*.

Big Changes for Proxy Solicitors with Universal Proxy

By Michael R. Levin

Much about proxy contests will change, and already has started to change, with the universal proxy card (UPC). The UPC makes proxy solicitors more relevant than ever before. Here we explore exactly how that would work.

We expect activists to work with a proxy solicitor earlier, for valuable input in planning the director slate. Proxy solicitors also will work much harder with a company's shareholders, to help those shareholders with voting on individual directors and to follow-up with those shareholders even after they vote.

Alas, proxy solicitors frequently are an afterthought in a proxy contest. We've talked to many that rue how clients call them too late, long after they could help with critical decisions. It's a familiar story. An activist makes the expensive move to start a proxy contest. First call goes to the attorney, or maybe an investment banker or other advisor. Then, it asks the attorney or banker or consultant for the name of a proxy solicitor. The solicitor gets to work, collecting colored cards.

With UPC, activists should look to proxy solicitors for two roles: (1) planning the director slate, and (2) (of course) persuading shareholders to vote for that slate. A shrewd activist will involve a proxy solicitor early in planning. It also will push a proxy solicitor even harder than before to obtain votes, and importantly on persuading shareholders to change unfavorable votes.

Michael R. Levin *is founder and editor of The Activist Investor.*

Careful Planning

UPC transforms a proxy contest from binary to continuous voting. In continuous voting, the extent of shareholder support for an activist translates more directly into the number of Board of Director seats the activist can expect to win. An activist must assess that shareholder support early in its planning. It can then determine the size of the slate based on that expected support.

Naturally, no one knows that expected support better than a proxy solicitor. They talk to shareholders every day. They understand how published voting policies, proxy advisor positions, and sentiment about a company and an activist interact at one or another shareholder.

Solicitors also help comply with the 67 percent solicitation requirement in the new UPC rule. An activist might hit that level with a few hundred or few dozen shareholders. And, some companies have begun to demand proof of the solicitation. Thus, the solicitor can identify exactly which shareholders to solicit, track the solicitation, and compile the evidence.

Aggressive Solicitation

Before UPC, proxy solicitation involved persuading shareholders to vote the activist card. It's straightforward, even brutal work. Show how the activist thesis beats the company plan. Collect more of the right cards than the company.

UPC complicates shareholder voting, as shareholders compare individual candidates. Shareholders can support the entire activist slate or just a few nominees. An activist can and should target specific incumbents, to maximize the impact of their own nominees. Thus, the proxy solicitor painstakingly educates shareholders about these comparisons.

Sure, for disgruntled shareholders, a solicitor collects a proper card, voted only for the activist candidates. That remains ideal, like old times. For skeptical or wavering shareholders, a solicitor has a more involved conversion. It asks, "how much change do you want?" That takes more time and effort instead of a simple plea to "trust us and vote for our candidates."

Old-Fashioned Electioneering

UPC also provides a unique, unprecedented opportunity to actually "electioneer." Before UPC, a solicitor would monitor which shareholders already voted, and which ones to pester. Solicitation became a process of follow-up on the delinquent ones.

Now, an activist will collect many proxy cards with votes for both activist and company nominees. The solicitor will know, real-time, how shareholders vote, in addition to whether they vote. Importantly, they'll see which ones are skeptical or wavering and split votes between activist and company candidates. And, they'll see them at a time they can do something about it.

Crucially, UPC did not alter one important aspect of proxy voting: a shareholder can change its vote by submitting a later-dated card. Thus, a solicitor can try to persuade a shareholder that voted for company nominees to change those votes to activist ones.

This new opportunity helps explain some curious wording in early UPCs. In one current contest, both the company and activist admit shareholders might vote for the other side, and encourage shareholders to do so on their own cards. In that situation, we wrote:

> Why would each acknowledge that shareholders might vote for the other's nominees, and suggest they could do so using their own proxy card? We'd think they would do everything it could to discourage this.
>
> It appears each wants to receive as many proxy cards as it can. They can thus track which shareholders have already voted. If AIM receives proxy cards with votes for L&B nominees, and L&B for AIM nominees, then each can easily contact those shareholders, and attempt to persuade them to change their votes. Clever...

Perhaps this goes beyond monitoring which shareholders vote. Maybe each wants the opportunity to persuade shareholders to change votes. An activist can do that only if they have the proxy card.

Imagine an activist seeing how a shareholder voted, seeing the incumbents it supported, and contacting them to vote for activist nominees...

Going Beyond the Requirements: Why Your CD&A Should Address Strategy

By Bob Lamm

Once upon a time, I was contacted by a general counsel of a public company that had lost two or three consecutive say-on-pay votes. His board was getting a bit testy, and he reached out for some guidance. I looked over the company's most recent Compensation Discussion and Analysis (CD&A) section within the proxy statement and saw the usual statements to the effect that the company's compensation philosophy was based on the principle of paying for performance. However, there was little to support this statement, and notably absent was any linkage between the metrics used to measure performance and the company's strategy.

I brought this to the attention of the General Counsel and advised that this linkage needed to be made. In other words, if the company could demonstrate that its compensation metrics were linked to its strategy, and that the compensation program paid out when and only when the metrics are achieved, it would be possible to turn the vote around. I also pointed out that everyone says "we pay for performance," but that saying it doesn't make it so, and that very often the numbers suggest the opposite.

So, or so it seemed to me, the first thing we had to do was discuss the company's strategy. That's where things went really sour. "But we're not required to discuss strategy, "the General Counsel said, "and the analysts who follow us know what the strategy is."

For the record, telling me that a disclosure shouldn't be made because it is not required is the functional equivalent of showing a red flag to an enraged bull. Most companies understand this and give far more disclosure than is required. That's particularly true of the proxy statement, which is far more than a mere legal document; it's become a marketing and advocacy document, maybe the most important marketing and advocacy document a company puts out each year. Besides, I have yet to find a proxy statement that doesn't go beyond the rules in at least some areas, and this company was no exception. So, I won that point.

As for the analysts knowing your strategy, that may be true, but the analysts who follow your company generally have little or nothing to do with the people who determine how to vote your shares. The latter may not even know what your company does, much less the strategy behind it. Even many of your retail investors may not know what your company does. I'm not sure I won that point, but I didn't get any pushback, so we went to the next point. "Great! How would you describe your strategy?"

Which is when the conversation really became disturbing. "Well, he said, I guess our strategy is to be profitable." Remember, this was the general counsel of a public company. I honestly don't remember if the company had been profitable or not, but I nonetheless found his response… odd. "Well, that may be true, but that's a very general statement. Can you be a bit more specific." I won't bore you with the details of the balance of the conversation. We eventually hammered out some language, but it was a real struggle.

The moral of the story isn't whether the company's next say-on-pay vote passed or by how much. (I think it passed, but I don't recall the details.) Rather, it is that few, if any, institutional investors will accept the statement "we pay for performance" unless there is something to support it. They're skeptical (if not cynical) about executive compensation in general, and companies all too often act in a way that justifies that reaction.

Bob Lamm *is Chair of the Securities & Corporate Governance Practice of The Gunster Law Firm.*

Beyond that limited observation, failing to disclose something because it's not required doesn't make sense. For what it's worth, the Securities and Exchange Commission rules state, if not in so many words, that if there's something material that the rules don't explicitly require you to disclose, you still need to disclose it. But even if that were not the case, why wouldn't you disclose something, as long as it's accurate and put in the proper context, that would support your company's position?

Bringing the Dead Back to Life: Making Deadwood Disclosure Useful

By Bob Lamm

Spoiler alert—despite the title, this is not about zombies, vampires, or anything else of a spooky nature. Rather, it's how we can hopefully make some of the deadwood in our proxy statements meaningful.

I realize that the upcoming proxy season already poses a bunch of challenges; just thinking about the Securities and Exchange Commission's (SEC) over-the-top rules on pay versus performance alone could bring on a couple of migraines.

However, a recent article on SEC comment letters to some major companies reminded me that we also face challenges associated with long-standing, important disclosures that tend to be ignored once they've been drafted, no matter how much time has passed.[1]

For example, the SEC comments referred to in the article asked companies to do a better job explaining how their boards oversee risks:

- What is the timeframe over which you evaluate risks?
- Does the board use outside advisors to help them think about the unthinkable?
- How does the risk oversight process align with disclosure controls?

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Another area of comment related to board leadership:

- What exactly is the role of the board chair (or lead independent director)?
- Does he or she represent the board in communications with shareholders?
- Are there circumstances in which he/she could override the CEO on risk matters?
- Are there circumstances in which the board would separate (or combine) the positions of board chair and CEO?

And so on.

As noted, I view these as important disclosures. Sure, when the rules were changed a dozen or so years ago to require these disclosures, we thought they were pains in the neck (or other parts of our anatomy); we reviewed many companies' proxy statements to see how they handled the issues; we may have agonized a bit about what to say; and then we more or less forgot about the disclosure, other than the occasional tweak in subsequent years. You are free to disagree, but I think we owe it to our shareholders, if not to ourselves, to make these disclosures meaningful.

Now that I've gotten that off my chest, I want to focus on one particular set of disclosures that consistently disappoint me—specifically, the so-called director skill set disclosure called for by Item 401(e) of SEC Regulation S-K. For those of you who haven't committed all of Regulation S-K to memory, the requirement is as follows:

> [F]or each director or person nominated or chosen to become a director, briefly discuss the specific experience, qualifications, attributes or skills that led to the conclusion that the person should serve as a director.

Again, when this requirement was first instituted, many of us groaned. We looked at a bunch of so-called leading companies' proxy statements and debated pithy topics like whether we should provide this skill set disclosure in narrative, full-sentence form or the radical bullet-point approach. Really. And then, whatever we decided to do, we've tended to stick with it ever since.

At the time, I made the following two suggestions to my then employer:

1. For at least some directors—say, the board chair and the chairs of the board committees—do a little video clip in which each would explain what she/he contributed to the board. Embed a link to the video in the proxy statement; after all, if a picture is worth a thousand words, a video would be a multiple of that. This suggestion was greeted with groans: we'd have to draft scripts, fit video shoots into already complex schedules, etc. And it wouldn't be cheap. OK, I figured that would be a losing proposition.
2. A less technical approach would be to ask each director to draft a sentence or three that we could then edit and include in the proxy statement, all in the first person. I actually thought this was reasonable, but if the first suggestion elicited groans, this one was met with outright derision. I believe my (least) favorite response was "What? We can't ask our board members to do that!" To this day, it seems to me that when you're paying someone hundreds of thousands of dollars a year and putting your company in his/her charge, asking him/her to draft a sentence or three wasn't such a big deal.

And so it went, and so it goes. I still don't think either idea is bad, and I still see the same tired, old language in most proxy statements. In some cases, the language has been supplemented or replaced with graphics that range from harmless to incomprehensible, but no one seems to care (presumably including the SEC, which didn't raise the subject in that recent spate of comment letters).

That said, I'm really not wedded to either of these approaches or to any particular approach. What I do think was best expressed by one of my favorite people on the institutional investor side of the discussion, who once told me that *companies need to explain why each member of the board is better than having an empty seat at the board table.* It seems to me that that is a reasonable goal and one towards which we should all strive.

Note

1. *https://news.bloomberglaw.com/in-house-counsel/sec-presses-dell-amex-others-in-broad-sweep-for-proxy-details.*

Proxy Season Impact of Recent DGCL Amendments

By Kerry Burke, David Engvall, Matt Franker, David Martin, and Will Mastrianna

Several recent amendments to the Delaware General Corporation Law (DGCL) are of particular relevance for the 2023 proxy season. Notable DGCL amendments concern exculpation of officers, the availability of stockholder lists during stockholder meetings and notice of adjourned stockholder meetings.

Officer Exculpation Now Permitted

Section 102(b)(7) of the DGCL now permits Delaware corporations to eliminate or limit the personal liability of officers for claims alleging breach of the fiduciary duty of care. The DGCL has long permitted corporations, subject to certain exceptions, to adopt such exculpation provisions in their certificates of incorporation to shield directors from personal liability in connection with claims of breach of the fiduciary duty of care. Amended Section 102(b)(7) extends this benefit to officers, although, unlike for directors, does not permit exculpation of officers with respect to claims brought against them by or in the right of the corporation (that is, derivative actions).

Exculpation of directors, and now officers, is not required by the DGCL, and a corporation must affirmatively elect to include an exculpation provision in its certificate of incorporation. Board action and stockholder approval is required to adopt such a provision, either on a first-time basis or as an amendment to an existing exculpation provision. For this reason, public companies seeking to amend their certificates during the 2023 proxy season to provide for exculpation of officers will need to explain to stockholders why such action is in the best interests of the corporation.

Boards may want to emphasize that amended Section 102(b)(7) remedies the inconsistent treatment of officers and directors under Delaware law, despite both having similar fiduciary duties, and note that, unlike director exculpation, officer exculpation may not be provided in connection with claims brought against an officer by or in the right of the corporation. Boards might also note that several other states already permit corporations to eliminate or limit officer liability. In addition, boards should weigh the views of institutional investors and proxy advisory firms.

Institutional Shareholder Services (ISS)'s proposed policy updates for the 2023 proxy season generally would recommend a vote in favor of charter amendment proposals to implement officer exculpation (although ISS's 2023 voting guidelines are in proposed form at the time of writing and it is possible that the final guidelines may differ). In contrast, Glass Lewis has indicated that it generally will recommend a vote against such proposals, unless the board provides a compelling rationale and the provisions are "reasonable."

Stockholder Lists No Longer Required At Stockholder Meetings

Delaware corporations are no longer required to make a list of stockholders available for inspection at stockholder meetings. Section 219 of the DGCL previously required a stockholder list to be available during the entirety of meetings of stockholders.

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Stockholders physically attending a meeting were permitted to review a physical copy of the stockholder list, while for virtual meetings, corporations were required to allow stockholders to view the stockholder list through the virtual meeting platform and to provide stockholders with information on how to access the list in the meeting notice. Under amended Section 219, this is no longer required, but corporations still must provide stockholders with access to a stockholder list for a period of 10 days leading up to, but not including, the date of the meeting of stockholders.

Unless requirements in bylaws or other governing documents regarding access to the stockholder list during stockholder meetings are removed, companies with such requirements will still need to abide by them notwithstanding the amendments to Section 219. In light of such amendments, Delaware corporations with bylaw or other governance requirements referencing the availability of the stockholder list during stockholder meetings can take action to remove such references. Typically, an amendment to this provision of a corporation's bylaws would not require stockholder approval. Corresponding changes would also be needed, as applicable, to proxy statements, meeting scripts, meeting rules of conduct and board resolutions authorizing meetings.

Notice of Adjourned Stockholder Meetings

Section 222 of the DGCL has been amended to provide greater flexibility regarding the notice corporations must provide if there is an adjournment of a meeting, including an adjournment because of a technical failure of virtual meeting communication technology.

In the event a meeting is adjourned, no additional notice of the adjourned meeting needs to be sent to stockholders if the date, time, and place (including, as applicable, the means of virtual access) of the adjourned meeting is set forth in the original notice, is announced at the meeting or is displayed during that meeting on the virtual meeting platform. Corporations may alternatively satisfy their notice requirements by complying with the mail and electronic transmission requirements of Section 232 of the DGCL.

In light of the amendments to Section 222, Delaware corporations may wish to consider updating their bylaws or other governing documents to make reference to the additional means of providing notice of adjourned meetings. Corresponding changes may also be needed, as applicable, in proxy statement disclosures regarding such provisions.

The Next Wave in Board Diversity Disclosures?

By Allison Handy

As announced in a press release on November 15, 2022, the Russell 3000 Board Diversity Disclosure Initiative recently sent letters to Russell 3000 companies urging them to report the race, ethnicity, and gender of each individual director on their boards.[1]

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The press release acknowledges that 63 percent of companies disclose board diversity information on an aggregated basis, such as Nasdaq-listed companies that provide board diversity information in the Nasdaq board diversity matrix.

But the press release—and the letters sent to companies disclosing on an aggregated basis, as well as those letters sent to companies that have not disclosed any board diversity data—argues that the lack of individualized racial and ethnic information "creates unnecessary barriers to investment analysis and academic study."[2]

Companies receiving the letters are facing the questions of whether to respond and, if so, how. Here are three things to consider:

1. **The letters are framed as a request for disclosure, not as a proposal, demand, or new voting policy.** The letters refer to voting policies of organizations included in the initiative, such as versions of "vote against" policies for companies with no board diversity and/or no board diversity disclosures.They note that some member organizations are considering strengthening board diversity voting policies and expanding engagement on this topic. We are not aware of any announced voting policies that would penalize a company that reports board diversity information on an aggregate, rather than individual, basis. In light of this framing, many companies may decide that no direct response is needed at this time.
2. **The gap between the requested disclosure and the Nasdaq board diversity matrix is not clearly articulated.** It is worth noting that the Nasdaq matrix is intended to provide decision-useful diversity disclosures that are comparable across companies. The Nasdaq matrix requires disclosure of specified racial and ethnic characteristics, disaggregated by gender. The press release and letters from the initiative call for individualized disclosure, but do not explain why investors need individual, rather than aggregate, diversity data.Currently, large institutional investor and proxy advisor policies addressing board diversity disclosures generally accept either individual or aggregated diversity information. If a company does decide to engage with investors involved in this initiative, it might consider seeking clarity on why individualized disclosures are important.
3. **Some directors may have privacy concerns about individualized disclosures.** As acknowledged in Corp Fin's Regulation S-K CDIs 116.11 and 133.13, as well as Nasdaq's board diversity rules, companies need the consent of directors to disclose personal, self-identified diversity characteristics.

Not all directors are willing to have their diversity characteristics disclosed on an individualized basis, and companies may face more pushback on disclosure when disclosure is made on an individual, rather than aggregate, basis. Before committing to a new disclosure regime requested by investors, companies should consider these potential privacy concerns.

Notes

1. *https://illinoistreasurergovprod.blob.core.usgovcloudapi.net/twocms/media/doc/november2022_russell3000.pdf.*
2. These letters are at *https://illinoistreasurergovprod.blob.core.usgovcloudapi.net/twocms/media/doc/example%20letter%20to%20middle%20performers%20-%20dime%20community%20bancshares%20(11.14.2022).pdf* and *https://illinoistreasurergovprod.blob.core.usgovcloudapi.net/twocms/media/doc/example%20letter%20to%20bottom%20performers%20-%20arbor%20realty%20trust%20(11.14.2022).pdf.*

Glass Lewis Issues 2023 Voting Policies

By John C. Kennedy, Jean M. McLoughlin, Laura C. Turano, and Frances F. Mi

Proxy advisory firm Glass Lewis (GL) has updated its US voting policies applicable to shareholder meetings starting January 1, 2023. Below are the key changes, which relate to board diversity, board oversight of environmental and social (E&S) issues, board accountability for climate-related issues, executive director overboarding, board oversight of cyber risk, officer exculpation and long-term incentive grants, as well as various clarifying amendments.

We also discuss key changes to GL's ESG Initiatives policy guidelines, which relate to disclosure of shareholder proponents, racial equity audits and retirement benefits and severance. These updated policies, as well as GL policies for other jurisdictions including Canada, Continental Europe, and the United Kingdom, are available *https://www.glasslewis.com/voting-policies-upcoming/*.

US Voting Policy Changes

Board Diversity

Gender Diversity—As announced in 2022, GL will begin recommending against the chair of the nominating/governance committee (NGC) of a Russell 3000 company board that is not at least 30 percent gender diverse (inclusive of women and directors that identify as other than male or female). For non-Russell 3000 companies, GL's existing policy requiring one gender diverse director will continue to apply. GL may refrain from recommending against directors if boards provide a sufficient rationale or plan to address such lack of diversity, including a timeline to appoint gender diverse directors (generally by the next annual meeting).

Underrepresented Community Diversity—Beginning in 2023, GL generally will recommend against the NGC chair of a Russell 1000 company with no director from an underrepresented community (that is, Black, African American, North African, Middle Eastern, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, Alaskan Native, gay, lesbian, bisexual or transgender). GL will rely solely on self-identified information in company proxy statements for this purpose. As with gender diversity, GL may refrain from recommending against directors if boards provide a sufficient rationale or plan to address such lack of diversity, including a timeline to appoint directors from an underrepresented community (generally by the next annual meeting).

State Law Requirements—Some states have encouraged board diversity through legislation, and in 2022, GL announced a policy generally to recommend in line with applicable state laws mandating board composition requirements. Since then, Sections 301.3 and 301.4 of the California General Corporation Law (together, the California laws) mandating board gender and underrepresented community diversity, respectively, were deemed to violate the equal protection clause of the California state constitution. Pending appeal of the decision (which is ongoing), GL will refrain from recommending in accordance with the California laws until further notice, but will monitor the appeal and company compliance with these requirements.

Disclosure of Director Diversity and Skills—GL generally will recommend against the NGC chair at Russell 1000 companies that do not include proxy statement disclosure regarding (1) the board's percentage of racial/ethnic diversity; (2) whether the

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board's definition of diversity explicitly includes gender and/or race/ethnicity; (3) whether the board has adopted a policy requiring women and minorities to be included in the initial pool of candidates when selecting new director nominees (aka the Rooney Rule); and (4) board skills disclosure. Additionally, beginning in 2023, GL will recommend against the NGC chair at Russell 1000 companies that do not provide any disclosure of individual or aggregate racial/ethnic minority demographic information. Previously, GL had announced that these policies would apply to the S&P 500, not the Russell 1000.

Board Oversight of E&S Issues—GL generally will recommend against NGC chairs at Russell 1000 companies that do not provide explicit disclosure about the board's role in overseeing E&S issues, though boards should determine the best structure for this oversight, whether by specific directors, the entire board, a separate committee or one of the key existing committees. Beginning in 2023, GL will expand its tracking of board-level oversight of E&S issues to the Russell 3000 index. It will examine a company's proxy statement and governing documents (for example, committee charters) to determine if directors maintain a meaningful level of oversight and accountability for a company's material E&S risks.

Board Accountability for Climate-Related Issues—In both its 2023 US voting and ESG Initiatives guidelines, GL has included a new discussion on director accountability for climate-related issues. For companies whose own greenhouse gas (GHG) emissions represent a financially material risk, such as those identified by groups including Climate Action 100+, GL believes that clear and comprehensive disclosure regarding climate risks should be provided, including how they are being mitigated and overseen. These disclosures should be in line with the recommendations of the Task Force on Climate-related Financial Disclosures, and the boards of these companies should have explicit and clearly defined oversight responsibilities for climate-related issues. GL may recommend against the responsible directors in cases where these disclosures are absent or significantly lacking.

Executive Director Overboarding—GL has clarified that it generally will recommend against (1) a director who serves as an executive officer (other than executive chair) of any public company while serving on more than one external public company board, and (2) a director who serves as an executive chair of any public company while serving on more than two external public company boards. There is no change to the existing cap of no more than five public company boards for non-executive directors.

Board Oversight of Cyber Risk—GL has added a new discussion of its approach to board oversight of cyber risk, which it believes is a material issue for all companies and is critical for companies to evaluate and mitigate to the greatest extent possible. GL encourages companies to provide clear disclosure about the board's role in overseeing cybersecurity and on how companies are ensuring directors are fully versed on this topic. While GL generally will not make recommendations on the basis of cyber-related oversight or disclosure, it will closely evaluate such disclosure where cyber-attacks have caused significant harm to shareholders and may recommend against directors where it finds such disclosure to be insufficient.

Officer Exculpation—In 2022, the Delaware General Corporation Law was amended to authorize corporations to adopt charter provisions that eliminate or limit monetary liability of certain corporate officers for breach of the duty of care. GL will evaluate proposals to adopt such officer exculpation provisions on a case-by-case basis, and generally will recommend against such proposals unless a compelling rationale for the adoption is provided by the board and the provisions are reasonable.

Long-Term Incentive Grants—To align with market trends, GL has increased its threshold for the minimum percentage of the long-term incentive grant that should be performance-based from 33 percent to 50 percent and will note as a concern in its voting analysis any programs that fail to meet this threshold. As in past years, GL may refrain from a negative recommendation if there are no other significant issues with the program's design or operation, but may not if there is a negative trajectory in the allocation amount.

Clarifying Amendments

In addition to the above, GL has adopted the following clarifying amendments:

Board Responsiveness—GL has added guidance regarding the appropriate board response where 20 percent or more of shareholders vote contrary to management (in which case boards should demonstrate some initial level of responsiveness) versus where a majority or more of shareholders vote contrary to management (in which case boards must provide a more robust response to fully address shareholder concerns). In either case, shareholder engagement is warranted. GL also reiterates that they will examine the level of shareholder approval attributed to unaffiliated shareholders when determining whether board response is warranted at a company with unequal voting rights.

Mega-Grants and Other Compensation-Related—GL clarifies that it will recommend against the chair of the compensation committee when "mega-grants" have been made and the awards present concerns such as excessive quantum, lack of sufficient performance conditions and/or are excessively dilutive. GL also clarified its voting policies related to company responsiveness to say-on-pay votes, one-time awards, pay-for-performance, the exercise of compensation committee discretion on incentive payouts and clawback policies.

ESG Initiative Policy Changes

GL addresses the bulk of their policies related to shareholder and management proposal topics in a separate ESG Initiatives policy document. Among the key updates are the following:

Disclosure of Shareholder Proponents—For US companies, GL generally will recommend against the NGC chair if companies do not provide clear disclosure in their proxy statements of the identity of the proponent (or lead proponent if there are multiple proponents) of any shareholder proposal that may be going to a vote.

Racial Equity Audits—When analyzing proposals requesting that companies undertake racial equity or civil rights audits, GL will assess: (1) the nature of the company's operations; (2) the level of disclosure provided by the company and its peers on its internal and external stakeholder impacts and the steps it is taking to mitigate any attendant risks; and (3) any relevant controversies, fines or lawsuits. Based on these factors, GL generally will recommend in favor of well-crafted proposals requesting such an audit when it believes doing so could help the company identify and mitigate potentially significant risks.

Retirement Benefits and Severance—GL generally is supportive of proposals requesting that companies adopt a policy to require shareholder approval of severance benefits exceeding 2.99 times the amount of the executive's base salary and bonus. However, GL clarifies that it may recommend against these types of proposals if the company has already adopted a policy providing that they will seek shareholder approval for cash severance payments exceeding 2.99 times the amount of the executive's base salary and bonus.

RULE 10b5-1 PLANS

The Rise of Rule 10b5-1 Enforcement and How Companies Can Mitigate Risk of DOJ and SEC Actions

By Jina Choi, Edward A. Imperatore, and Brian Kidd

The US Department of Justice (DOJ) and Securities and Exchange Commission (SEC) have recently intensified their scrutiny of insider trading under Rule 10b5-1 trading plans. The emerging trend of enforcement investigations and actions in this area shows that regulators and prosecutors are keen to hold executives accountable for insider trading. Companies and executives should adopt best practices to mitigate the risk that trading pursuant to a Rule 10b5-1 plan could result in an insider trading investigation.

Key Takeaways

- The SEC and DOJ are increasingly using data analytics to identify and initiate investigations of suspicious trading under Rule 10b5-1 plans, which are intended to shield companies and executives from insider trading allegations by letting them schedule transactions in advance.
- Rule 10b5-1 plans, standing alone, cannot insulate corporate executives and employees from insider trading liability.
- Insiders cannot possess material nonpublic information (MNPI) when they put a Rule 10b5-1 plan in place; otherwise, the plan will not serve as an affirmative defense to an allegation of insider trading.
- The SEC has proposed amendments to the rules for Rule 10b5-1 plans, including a "cooling-off" period of at least 120 days between enacting the plan and when trading pursuant to the plan can begin.
- The SEC's view of information that constitutes MNPI may be expanding, and what is considered material will be assessed with hindsight.
- Companies should consider adopting the following for Rule 10b5-1 plans:
  i. ***Institute a Cooling-off Period.*** Companies and executives should consider a "cooling-off" period between enacting the plan and when trades begin under the plan. Although no such restriction is currently in place, the SEC has proposed a period of at least 120 days, which would span an entire quarter, meaning that no trading could occur under a Rule 10b5-1 plan adopted in a particular quarter until after that quarter's financial results are released. Adopting a cooling-off period designed to delay trading under a Rule 10b5-1 plan until after quarterly earnings are publicly announced can support an argument that the plan was created in good faith.
  ii. ***Ensure Robust Internal Controls***. Companies should ensure that they have robust internal controls that are consistent with SEC rules and enforcement developments. They should look closely at their insider trading policy, enforcement of trading windows for enactment of Rule 10b5-1 plans, and review modifications to Rule

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10b5-1 plans. Because the SEC has proposed heightened disclosure requirements for Rule 10b5-1 planned trades, companies may also want to prepare for possible disclosure of executive plans.

iii. ***No Overlapping Plans.*** The SEC's proposed rules prohibit "overlapping" Rule 10b5-1 trading plans. The SEC explained that, under the current rules, an insider can exploit Rule 10b5-1 plans by using them to establish multiple pre-existing hedged trading arrangements that temporally overlap and are timed to occur around dates on which the issuer is likely to disclose earnings or other material information. An insider may decide later which trades to execute and which to cancel under the plans after the insider becomes aware of MNPI but before the MNPI is made public. Under the proposed amendment, the affirmative defense would not be available for any trades by a trader who has established multiple overlapping trading arrangements for open market purchases or sales of the same class of securities. Companies should understand how directors and officers are using these plans and consider adopting a policy of prohibiting multiple overlapping plans.

What Are Rule 10b5-1 Plans?

Rule 10b5-1 plans are intended to provide companies and corporate insiders an affirmative defense to insider trading. Under such plans, insiders are permitted to buy or sell a predetermined number of shares at a predetermined time, but only while they do not possess MNPI. In theory, an executive is insulated from liability when the Rule 10b5-1 plan is enacted before the executive possesses MNPI and trading pursuant to the plan occurs after the executive obtains MNPI.

Since the SEC created rules for Rule 10b5-1 plans over two decades ago, companies have widely adopted such plans. On December 15, 2021, the SEC released proposed amendments and disclosure requirements pertaining to Rule 10b5-1 plans.[1] The proposed amendments would update the requirements for the affirmative defense, including imposing a cooling-off period before trading can commence under a plan, prohibiting overlapping trading plans, and limiting single-trade plans to one trading plan per 12-month period.

A New Enforcement Trend?

The SEC and DOJ are using data analytics to investigate unusual trading activity and potential abuses of Rule 10b5-1 plans. According to one news report, federal authorities are preparing to bring multiple cases.[2] In October, one company disclosed that it had received subpoenas from both the DOJ and SEC seeking materials concerning the trading activities of a former Chief Executive Officer in 2019 and 2020.

In September, the SEC announced a settled enforcement action against two executives of Chinabased mobile internet company Cheetah Mobile, Inc.[3] The SEC alleged that Cheetah's CEO had caused the company's misleading statements and failure to disclose a material negative revenue trend and that, after becoming aware of the trend, he and Cheetah's former President and Chief Technology Officer sold securities pursuant to an improperly established Rule 10b5-1 trading plan and avoided hundreds of thousands of dollars in losses.

The recent Cheetah enforcement action offers two lessons. First, the SEC has shown that trades made while executives had knowledge of nonpublic information will be scrutinized, even if the trades were placed pursuant to a Rule 10b5-1 plan. Second, the SEC's definition of what information constitutes MNPI may be expanding and evolving. While many insider trading cases relate to earnings announcements or potential mergers and acquisitions, in this case, the MNPI that the executives allegedly traded on was an undisclosed negative revenue trend.

The reports of the DOJ and SEC investigations using data analytics reveal proactive enforcement and increased scrutiny of trading pursuant to Rule 10b5-1 trading plans. The use of data analytics on Rule 10b5-1 plans to initiate investigations evokes a similar pattern of parallel civil and criminal actions brought by the DOJ and CFTC to prosecute "spoofing"—illegal trading practices used to manipulate the commodities market.

Conclusion

Federal investigations of insider trading under Rule 10b5-1 plans have recently intensified and will likely continue. Companies and executives should consider adopting best practices to avoid exposing themselves to risk. A Rule 10b5-1 trading plan, standing alone, cannot insulate an executive from liability for insider trading, and using a plan in ways regulators deem "abusive" may invite scrutiny.

Notes

1. *https://www.sec.gov/news/press-release/2021-256.*
2. *https://www.bloomberg.com/news/articles/2022-11-03/us-probes-insider-trading-in-prearranged-executive-stock-sales.*
3. *https://www.mofo.com/resources/insights/221003-sec-action-against-cheetah-mobile-execs.*

NON-GAAP FINANCIAL MEASURES

Triangulating to Clarity: Individually Tailored Accounting and Non-GAAP Financial Measures

By Michael H. Friedman

In 2016, the Division of Corporation Finance of the Securities and Exchange Commission (SEC) added a curiously-phrased "Question & Answer" to its Compliance & Disclosure Interpretations (C&DIs) for Non-GAAP Financial Measures:

> **Question:** A registrant presents a non-GAAP performance measure that is adjusted to accelerate revenue recognized ratably over time in accordance with GAAP as though it earned revenue when customers are billed. Can this measure be presented in documents filed or furnished with the Commission or provided elsewhere, such as on company websites?
>
> **Answer:** No. Non-GAAP measures that substitute individually tailored revenue recognition and measurement methods for those of GAAP could violate Rule 100(b) of Regulation G. Other measures that use individually tailored recognition and measurement methods for financial statement line items other than revenue may also violate Rule 100(b) of Regulation G.[1]

On its face, the Staff's answer is perplexing. The Staff's initial answer is a blunt and unqualified "no" but the bluntness quickly softens in the balance of the answer with the equivocal expressions "could violate" and "may also violate," each of which begs the question as to when such tailoring *will* violate. Adding to the perplexity: it's in the nature of *all* non-GAAP financial measures to adjust or exclude (that is, to tailor) one or more items from a GAAP financial measure.

A GAAP financial measure devoid of tailoring is, by definition, a GAAP financial measure. But since not all tailored, or non-GAAP, financial measures are deemed to involve proscribed individual tailoring, then what adjustments or exclusions to a GAAP financial measure convert the measure into a proscribed non-GAAP financial measure because it uses an individually tailored accounting method? One looks in vain for a definition.

One natural (and indeed useful) response to such perplexity would be to proceed inductively and catalogue instances highlighted by the Staff, in its comment letters, of problematic individually tailored recognition and measurement methods. With this catalogue in hand (updated from time to time for new Staff comment letters) one could run any given non-GAAP measure through a screen and thereby filter out non-compliant adjustments or exclusions.

Yet even if the catalogue were comprehensive, the formulaic screening process would not suffice, in and of itself, as a reliable and effective guide to presentations of financial measures in a manner that does not involve proscribed individual tailoring. The "catalogue and screen" methodology provides us with examples of problematic disclosures but sheds only a dim light on why any given disclosure is problematic and, more to the point, why the disclosure is problematic in a special way, that is, in a way that results in an individually tailored accounting method.

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As such, the "catalogue and screen" approach, although useful, does not position us to explain robustly why a given metric, in context and as presented, ought not to be proscribed as individually tailored accounting. What we want is a general principle or intelligible standard, abstracted from our catalogue of examples, that we can apply reliably across a wide range of factual scenarios to shape presentations of non-GAAP financial measures so they will not be construed as proscribed individually tailored accounting methods.

Here, let us pause on the word "individually" and consider whether "individually" carries more weight in our search for a general principle or intelligible standard than, at first glance, meets the eye. Might this adverb help us to discern a guiding principle or to formulate an intelligible standard that will allow us to identify and appropriately handle tailoring of GAAP financial measures in ways that avoid proscribed individual tailoring?

In this light, and as a prelude to the following discussion, consider how senses of the word "individual" resemble senses of "idiosyncratic" and "custom-designed" or similar modifiers that differentiate an individually tailored subject from formulations or presentations of a tailored subject in ways "comparable" to those used by other companies or in ways that may be considered to be "customary."

Also in this light, consider how these resonances of "individual" (as contrasted to, for example, "comparable" or "customary," which connote widespread usage) are amplified by the recognition that the SEC's underlying concern with "individual" tailoring is that such tailoring, unless accompanied by robust and nuanced explanation, may be misleading insofar as it suggests an idiosyncratic (or cherry-picked) view of a preferred method by which to evaluate the company's financial performance or position. And since it is the company itself that is publishing the metric, the company is, in effect, holding out, or endorsing, the metric as relevant to how investors should evaluate the company.

A useful way to approach the question as to what is (or is not) an individually tailored accounting principle for purposes of non-GAAP financial measure presentations is to set aside the view that such measures can be neatly catalogued or defined categorically and, instead, to view the label "individually tailored accounting principle" (or a common variant of the label) as a conclusion that the measure, *as presented*, is misleading or confusing in a special way.

In this light, application of the label is not so much an identification of a particular and problematic measure or method, but a critique of the way in which the measure or method is presented or disclosed. For example, if an exclusion from, or an adjustment to, a non-GAAP financial measure is handled inconsistently across periods, or inconsistently with other comparable items that are not also excluded or adjusted, then such inconsistency may be misleading or confusing. Absent the inconsistency, the deficiency may disappear.

Similarly, if an exclusion or adjustment is made that is neither used by management in the operations of the business nor sought by investors to assist them in their analyses, then the exclusion or adjustment may lack a legitimate purpose. But if the exclusion or adjustment is in fact used by management or investors, and disclosure of these use(s) and reason(s) is provided, then the grounds, so to speak, for applying the "individually tailored" label may disappear, or soften.

Indeed, if one surveys Staff comment letters and responses, one can discern that a leading indicator of an objectionable measure (that is, one that can be called an "individually tailored recognition or measurement method" or an "individually tailored accounting principle") is not the measure, in and of itself, but rather a flawed presentation of the measure.

As stated above, under this view, the labeling of a measure or method as "individually tailored" is not so much a statement as to the nature of the measure or method[2] but, rather, a criticism of the fairness of the presentation of the measure or method in light of the overall objectives of SEC regulation of non-GAAP financial measures.[3] What follows is additional detail in further explanation of the foregoing view.

GAAP as the Starting Point and "Not Misleading" as the Ending Point

GAAP financial statements and measures that derive, without adjustment or exclusion, from GAAP financial statements are the starting point. GAAP presentations, inclusive of explanatory footnotes that are part of the financial statements, are designed to provide a fair depiction of a company's financial performance and financial position and allow for informed judgments as to reasons for past performance, prospects for future performance and comparability of company performance with prior period performance as well comparability of company performance with performance of competitors, peers or other select industry participants.

For a variety of legitimate reasons, company management, investors and analysts commonly find it useful to assess supplemental measures of corporate performance or liquidity. In Section 401(b) of the Sarbanes-Oxley Act of 2002 (SOX), Congress directed the SEC to regulate non-GAAP financial measures (referred to in SOX as pro forma financial information) so that such information is not presented in a misleading way and, in furtherance of this imperative, is accompanied by a reconciliation with the GAAP counterpart.

Thereafter, in 2003, the SEC adopted Regulation G and amendments to Item 10 of Regulation S-K to regulate disclosures of non-GAAP financial measures and, in its adopting Release, the SEC stated: "The rules we adopt today reflect the letter and spirit of the Sarbanes-Oxley Act."[4]

In furtherance of the SEC regulations, the Staff has published CD&Is as to "dos and don'ts" for disclosures of non-GAAP financial measures and has issued multiple comment letters on specific disclosures. The unifying concern underlying the regulations, the CD&Is and the comment letters is with adjustments to GAAP numbers that are presented in a misleading way. The SEC's prescriptive rules are designed to work together to assure that disclosures of adjusted numbers are not misleading.

For example, a company that discloses a non-GAAP financial measure must present the most directly comparable GAAP measure with equal or greater prominence.[5] A company generally may not present adjustments inconsistently between periods. As the Staff has stated: "a non-GAAP measure that adjusts a particular charge or gain in the current period and for which other, similar charges or gains were not also adjusted in prior periods could violate . . . Regulation G unless the change between periods is disclosed and the reasons for it explained."[6]

Similarly, it may be misleading if an adjustment is made to a GAAP financial measure without also presenting the income tax effect on the adjustment. In the case of a non-GAAP performance measure, the company "should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability. In addition, adjustments to arrive at a non-GAAP measure should not be presented 'net of tax.' Rather, income taxes should be shown as a separate adjustment and clearly explained."[7]

Regarding the issue of individually tailored accounting, one of the most important disclosure points—indeed a point virtually inseparable from whether a given adjustment and presentation will result in a proscribed individually tailored recognition or measurement method—is found in the mandate in Item 10(e)(i)(C) of Regulation S-K, which requires that a precondition to including any non-GAAP financial measure in an SEC filing is a statement that discloses why the company's management "believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the registrant's financial condition and results of operations."[8]

Pause here, and note that if in fact a non-GAAP financial measure provides useful information to investors, then, except in unusual cases, the information is likely to assist investors in comparing the company to other (peer) companies or in assessing the company in light of metrics the investors view as important. It would be unlikely that a measure that in fact provides such useful information is "individual to" the company. In other words, if a company's disclosure of a non-GAAP financial measure is accompanied by a robust disclosure of the reasons why the disclosure is useful for investors, then the company will have greatly reduced the likelihood that the measure is idiosyncratic, or reflective of cherry-picking or, in the words of the CD&I, individually tailored.[9]

Moreover, if management believes that there is some specific event that calls for disclosure of a non-GAAP financial measure that is not a customary metric in the industry and if management is unable to articulate why investors would find the metric to convey useful information to investors, then the company will face a heavy burden of persuasion as to why the adjustment is being made and whether sufficient compensating disclosures have been made to overcome the presumption that such an adjustment is, on its face, misleading.[10]

Conclusion

The aim of this article has been to sketch out a framework to assist companies in their presentation of non-GAAP financial measures in a manner that reduces the likelihood that such measures will be labelled by the Staff as "individually tailored" methods or measures and to further assist companies in responding effectively to Staff comments that particular measures presented by a company are "individually tailored" and, therefore, objectionable.

Notes

1. Question 100.04 of the CD&Is.
2. Indeed, it would be hard (and, from a regulatory perspective, probably counterproductive) to provide a conceptually pure and complete (generic) definition of such a measure or method since, when we speak of any non-GAAP financial measure, we are necessarily speaking of a variation from a "generally accepted" baseline (that is, GAAP).
3. Of course, as a practical matter, one must look at specific adjustments (apart from the presentation of the adjustments) to understand the underlying sources of Staff concern. For example, if a company presents a metric that in substance accelerates revenue in advance of GAAP requirements linked to delivery of goods or services, then a registrant would face a heavy burden as to why its presentation was not inherently misleading even if the presentation included robust disclosure.
4. Release No. 33-8176 (effective March 28, 2003).
5. *See* 102.10 of the CD&Is.
6. *See* 100.02 of the CD&Is.
7. *See* 102.11 of the CD&Is.
8. Item 10(e)(1)(D) also provides for disclosure, to the extent material, of the additional purposes, if any, for which the company's management uses the non-GAAP financial measure.
9. Note that Regulation G, unlike Item 10(e), does not, by its terms, require disclosure as to why the company's management believes presentation of a non-GAAP financial measure provides useful information to investors. Consistent with the thesis of this article, however, the absence of such disclosure (apart from the general restriction in Regulation G on misleading statements and omissions) may increase the likelihood that a given presentation will be found to be an individually tailored accounting method, particularly if such absence is due to an inability of management to explain why the measure, as presented, provides useful information to investors.
10. The Staff has made clear that certain adjustments, such as adjustments that accelerate revenue recognition, or that smooth out expense recognitions, or that involve proportionate consolidation for equity investees, are unlikely to overcome an adverse comment linked to individual tailoring. The "catalogue and screen" approach is particularly valuable in this context because the precedent examples will alert companies and their advisors as to adjustments that are unlikely to overcome an adverse comment.

FORM 144

Form 144 Must Be Filed Electronically: Now What?

By Erin Gordon and Danielle Benderly

The Securities and Exchange Commission (SEC) recently published the updated version of its EDGAR Filer Manual that includes updates related to filing Forms 144 electronically on EDGAR, as required by the SEC's final rules adopted back in June. This means the clock on the six-month transition period from paper to electronic filings of Forms 144 is ticking—all Forms 144 must be filed electronically on EDGAR starting on April 13, 2023.

Now that the forms will be electronic, some have suggested brokers will stop making these filings on behalf of their customers, and that in-house counsel will end up having to make these filings on behalf of all the company's insiders. This likely sounds daunting for those that have never had to handle Forms 144 before.

If you're in this camp, you're probably wondering how to make these filings. You should be asking questions such as:

- Who outside of Section 16 filers (who already have filing codes) will need to make this filing?
- Should in-house counsel proactively reach out to all their insiders' brokers and get filing codes for everyone?
- Are there any other implications of Form 144 now being easily accessible on EDGAR that in-house counsel should be thinking about and explaining to insiders?

Here are five things you should be considering now to prepare:

1. **Have conversations with your "affiliates" (and be sure you know who they are).** As a quick refresher, Rule 144 of the Securities Act governs the conditions an affiliate of a reporting company must meet in order to sell company securities, one of which includes filing a notice on Form 144 in connection with any sale of company securities. More specifically, all of your company's affiliates must file Form 144 at the time they place a sell order with a broker, and they must be prepared to file Form 144 electronically on EDGAR when this e-filing becomes required.

Rule 144(a)(1) defines an "affiliate" as a person "that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with" the company. This mirrors the definition in Rule 405 of the Securities Act. For purposes of this definition Rule 405 defines "control" as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies" of the company. Whether an individual or entity is an affiliate of your company is a fact-specific question. However, the SEC Staff is on record as stating that there is a rebuttable presumption that every director, officer and 10 percent shareholder is an affiliate. And more generally, any person or entity who has the ability to influence management or the Board is likely an affiliate.

An affiliate's Form 144 filing requirement also applies to any sales of securities by (i) any relative or spouse who is living in the same household as the affiliate, (ii) certain trusts or estates of the affiliate or their spouse or other household member, and (iii) any entity in which the affiliate, or their spouse or other household member, is, individually or collectively, a beneficial owner of at least 10 percent of any class of such entity's equity securities. Sales by these related persons can be reported on Form 144

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filed by the affiliate but, depending on the specific facts and circumstances, may instead be reported on Form 144 filed by the related person.

You should plan to provide refresher training for your company's affiliates on Rule 144 compliance to ensure they understand how the Rule 144 requirements apply to their sales of company securities (and sales by their related persons as described above), especially given the new electronic filing mandate. Be sure to explain that all contemplated sale information included in a Form 144 that is filed on EDGAR will be available for the world to see immediately after filing.

2. **Obtain any necessary EDGAR filing codes.** Rule 144 may cover more than just your Section 16 officers and directors. While your Section 16 filers already should have EDGAR filing codes, they may prefer to have their related persons make their own Form 144 filings, instead of reporting such person's transactions as being made on behalf of the insider.

Because the SEC's turnaround time for obtaining EDGAR filing codes is at least two business days, you should be confirming whether each company affiliate, including members of the affiliate's household who may be making a separate Form 144 filing, has EDGAR filing codes in the near term.

If not, consider submitting a Form ID for each person who does not yet have EDGAR filing codes as soon as possible. Keep in mind that it is possible that some affiliates may have a CIK, but not the rest of their EDGAR filing codes, if the person has only ever made paper filings.

Also consider including an executed power of attorney with the Form ID that allows the company to make Form 144 filings on the filing person's behalf, as well as an attestation document authorizing electronic signatures on EDGAR filings. And make sure you keep a copy of all such documents, as well as your affiliates' EDGAR filing codes, in order to satisfy applicable document retention requirements.

3. **Consider discussing filing responsibilities with your affiliates' brokers.** Brokers have an incentive to ensure Forms 144 are filed, too—if the requirements under Rule 144 are not met, the broker could be deemed to be engaged in an unregistered distribution of securities and have liability as a statutory "underwriter."

This means that brokers may want to continue the long-standing practice of filing these forms themselves on behalf of their customers. If your company requires insiders to use a designated broker, you should reach out to that broker to discuss this issue.

If your company allows insiders to use their own brokers, you should get contact information for those brokers from your insiders, reach out to each of them about this issue and their planned processes moving forward, and maintain an open line of communication. And if you prefer to make these filings, make that preference known to the brokers.

4. **Familiarize yourself with the new fillable electronic form.** As promised in the final rules, the SEC has developed a fillable form to be used in filing the new electronic Form 144, a copy of which is included in the updated EDGAR Filer Manual. We expect the SEC to replace the existing pdf version of the Form 144 that is currently still posted on the rest of the SEC website before the deadline for mandatory EDGAR filing.

Take a look and make sure you are familiar with the information required by the updated Form 144. The SEC has stated this form can be filed in the same manner as you file Section 16 reports, so be sure you are familiar with that process too.

5. **Develop filing procedures for your company, your affiliates and their brokers.** Come up with a plan for how to handle Form 144 filings so they don't slip through the cracks:
   - Will you try to mandate that your insiders' brokers continue to make the Form 144 filings on behalf of your insiders?
   - Do you want to take on the responsibility for filing these forms to ensure they get filed on time and correctly?

- Consider whether your existing insider trading policy currently requires your insiders to pre-clear all transactions, and if not, whether you should recommend adding that feature as a way to help your insiders remember to provide you with advance notice of any contemplated sales so that you can prepare and timely file the Form 144.

Whatever your plan is, communicate it to all relevant parties so everyone is on the same page before this new requirement kicks in six months from now.

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