

Did You Remember These Developments for the 2020 SEC Reporting Season?

January 21, 2020

by Cam C. Hoang, Kimberley R. Anderson, and Anthony Epps

Preparations for annual reporting on Form 10-K and the 2020 proxy season have begun in earnest for many companies. We have summarized certain governance and disclosure developments that should be considered in the course of preparing these filings.

For additional background, please contact us for materials from our presentation, “Preparing for the 2020 SEC Reporting Season.”

Annual Report on Form 10-K

FAST Act Amendments

The SEC adopted amendments to modernize and simplify certain disclosure requirements in Regulation S-K, and to make annual reports on Form 10-K easier to understand and navigate.

- **Revised 10-K Cover Page:** Adds information on a company’s registered securities and stock exchanges, features Inline XBRL tagging, and deletes the Section 16 compliance checkbox.
- **Flexible Periods for MD&A:** While the Management’s Discussion and Analysis (MD&A) in the Form 10-K formerly covered a three-year period, companies may now discuss only two years of financial results, if the earliest year is included in prior filings and is not material to the current discussion. If the company elects to omit discussion of the earliest year, it must include a statement that identifies the location in the prior filing where the omitted discussion may be found.
- **Updated Headings:** Certain captions have been revised for brevity and clarity. “Information About Our Executive Officers” replaces “Executive Officers of the Registrant.” Additionally, in the proxy statement, “Delinquent Section 16(a) Reports” replaces “Section 16(a) Beneficial Ownership Reporting Compliance.” This latter section may be deleted if there were no late Section 16 reports during the fiscal year.
- **Streamlined Confidential Treatment Process:** Companies may now redact confidential information from material contracts without filing a confidential treatment request, so long as the information: (i) is not material and (ii) would likely cause

Related People

- Cam C. Hoang
- Kimberley R. Anderson
- Anthony Epps

Related Capabilities

- Corporate Governance & Compliance
- Capital Markets

competitive harm to the company if publicly disclosed.

- **New Exhibit for Description of Securities:** Companies must now file brief descriptions of their registered securities as an exhibit to Form 10-K. Going forward, a company may incorporate by reference and hyperlink a prior exhibit containing the required disclosure if the information is unchanged.
- **Fewer Material Contracts as Exhibits:** Previously, companies were required to file as exhibits all material contracts entered into within two years before filing. Now, companies other than “newly reporting registrants,” need only file as exhibits material contracts that are to be performed in whole or in part at or after filing.

A more complete summary of relevant changes may be found [here](#).

Risk Factors

In his remarks on [principles-based disclosure](#) in March 2019, William Hinman, Director of the Division of Corporation Finance, noted that risk factor disclosure should address the most significant things that make an investment in a company and its securities subject to uncertainties or risk. Concise and focused disclosure explaining how each risk affects the company is most useful for investors. Companies should take care not to bury the reader in generic boilerplate or laundry lists of risks that might apply to any company.

Not only should companies consider new and emerging risks, they should review the status of existing risks. Trending issues across industries include the disruptive impact of shifting trade policies in China and Europe, data privacy and compliance with the European Union’s General Data Protection Regulation and the California Consumer Privacy Act, the potential impact of climate change and natural disasters, uncertainty around government policies including on immigration, and transitions related to phasing out LIBOR. Drafters should keep the following tips in mind when discussing risk:

- Use descriptive captions for the risk and its impact.
- Review peer risk factors, but tailor the risks to the company.
- Consider the probability and severity of the risk.
- Focus discussion to the risk itself, rather than mitigation.
- Organize risks by industry, company, or investment, and prioritize the risks from most to least significant.
- Remember, an abstract discussion may not be enough if a specific risk has materialized in your industry, such as cybersecurity.
- When in doubt, lean toward disclosure. But be prepared to discuss how a risk is being addressed.

Critical Audit Matters

In 2017, the Public Company Accounting Oversight Board (PCAOB) adopted enhancements to auditor’s reports, including communications of critical audit matters (CAMs), which are matters that relate to accounts or disclosures that are material to financial statements, and that involve especially challenging, subjective or complex auditor judgments. Goodwill and intangible assets, revenue, and income taxes have been common topics for CAMs disclosed so far.

The auditor's report is required to identify the CAM, describe the principal considerations that led the auditor to determine the matter is a CAM, describe how it was addressed in the audit, and make reference to the relevant financial statement accounts and disclosures. If the auditor determines that there are no CAMs, the auditor must make that statement in the report.

Communications of CAMs will take effect for audits for fiscal years ending on or after June 30, 2019 for large accelerated filers and for audits for fiscal years ending on or after December 15, 2020 for all other companies to which the requirements apply. The PCAOB expects that most audits will identify at least one CAM. While the requirements only apply to the current audit period, the auditor may also identify a CAM in a prior period if appropriate.

Management should consider whether the existence of a CAM should result in additional disclosure in other areas of the Form 10-K, such as the MD&A. Audit committees of large accelerated filers may have already conducted "dry runs" with their auditor regarding potential CAMs and how they should be drafted. Audit committees of other categories of filers should discuss with their auditor the benefit and timing of conducting such "dry runs."

Proxy Statements

New Hedging Policy Disclosures

Under a new rule on employee, officer and director hedging (Item 407(i) of Regulation S-K), companies are required to either (i) provide a fair and accurate summary of any practices or policies that apply, including the categories of persons covered and any categories of hedging transactions that are specifically permitted or disallowed or (ii) disclose their practices or policies in full. If a company does not have any hedging practices or policies, it must disclose that fact or state that hedging transactions are generally permitted.

Disclosures are required in proxy and information statements for fiscal years beginning on or after July 1, 2019. For smaller reporting companies and emerging growth companies, the new disclosure requirements apply for fiscal years beginning on or after July 1, 2020. The requirements do not apply to foreign private issuers or listed closed-end investment companies.

If they have not done so already, companies should consider adopting a hedging policy, including the categories of persons covered and hedging transactions permitted or disallowed.

CEO Pay Ratios in Year Three

This is the third year of required CEO pay ratios (Item 402(u) of Regulation S-K). The ratio compares the annual total compensation of a company's median employee to that of its chief executive officer. Companies only need to identify a median employee once

every three years, unless there are significant changes to (i) the employee population, (ii) employee compensation arrangements or (iii) the original median employee's circumstances, so that the company reasonably believes its pay ratio disclosure would significantly change.

In cases (i) and (ii), the median employee should be re-identified. In case (iii), the company may use another employee whose compensation is substantially similar to the original median employee, based on the compensation measure used to select the original employee. If the same median employee is used, companies should briefly disclose the basis for the reasonable belief that no change occurred that would significantly impact the pay ratio disclosure.

2020 Proxy Voting Policies

ISS has released its [2020 proxy voting policies](#) for meetings on or after February 1, 2020.

- As with last year, ISS will recommend an “against” or a “withhold” vote for the chair of a company's nominating committee if there are no female directors on the board, absent a firm commitment in 2020 to achieve gender diversity within a year.
- ISS will recommend votes “against” equity-based and other incentive plans with evergreen provisions.
- ISS will include race or ethnicity, in addition to gender, in its pay gap voting policies.
- ISS clarified its voting policies with regard to poor board meeting attendance, excepting nominees who only served part of the year, and clarified its policy on problematic governance and capital structures for newly public companies, as well as its policy on undue restrictions on shareholders' ability to amend bylaws.
- ISS codified existing voting policies on independent board chairs and share repurchase programs.

Companies should evaluate the potential impact of these and other ISS voting policies on their proxy proposals.

Board Diversity

Disclosure of board diversity has become more common. According to the EY Center for Board Matters (EY), 45 percent of the Fortune 100 explicitly disclosed the racial and ethnic diversity of the board of directors and 36 percent disclosed the level of overall diversity on the board, up from 23 percent and 13 percent, respectively, since 2016. EY also reports that 75 percent of the Fortune 100 now use a skills matrix to highlight the diversity of relevant director qualifications in an easily readable format, up from 30 percent in 2016.

Environmental and Social Programs

There continues to be great interest in environmental and social disclosures, with more companies dedicating sections of their proxy statements to describing their initiatives. Before including such disclosure, companies should carefully consider whether they are

focusing on the appropriate initiatives, based on stakeholders' interests and the company's interests, as well as the company's views on corporate citizenship. Information that is included, and in particular, information that is incorporated by reference, need to be vetted for accuracy and completeness. In his remarks on [principles-based disclosure](#) in March 2019, William Hinman, noted that the Staff is watching carefully as market-led approaches develop in this area, and they are actively comparing the information companies voluntarily provide – typically outside of their SEC filings – with the disclosure the Staff sees filed with the Commission.

Director Overboarding

Investors and proxy advisory firms have been adopting more restrictive policies on public company board service for directors as well as executive officers. At the beginning of 2019, ISS started recommending votes against directors who sit on more than five public company boards, and CEOs of public companies who sit on more than two public company boards besides their own. Certain institutional investors are adopting more restrictive limits on outside board service.

Service on outside boards is trending downward. According to the [2019 U.S. Spencer Stuart Board Index](#), 59 percent of S&P 500 CEOs serve on no outside boards, up from 55 percent last year and 51 percent 10 years ago. More than 60 percent of the 113 companies with limits on their CEO's outside board service set the limit at two or more outside boards.

Companies should survey their investors' overboarding policies, their current governance guidelines on other board service, and their director's commitments.

No Action Letter Process

The Staff of the Division of Corporation Finance may respond orally instead of in writing to some shareholder proposal no action letter requests, beginning with the 2019-2020 proxy season. Furthermore, the Staff may now more frequently decline to state a view on a no action request, whereas in the past, it had typically concurred or disagreed with a company's asserted basis for exclusion. The Staff still intends to issue a response letter where it believes doing so would provide value, such as more broadly applicable guidance about complying with Rule 14a-8.

In response to concerns that the streamlined process would lead to less available information. The Staff now contacts parties via email to notify them that a decision has been posted on the SEC website, in a [chart](#) that includes the name of the company and the shareholder, the date of the company's initial submission, the bases asserted by the company, the Staff's response, the date of the response and whether there was a written response. The chart has links to all correspondence related to the no action letter request, and the Staff intends to update the chart once or twice each week.

The Ordinary Business Exclusion

In October 2019, the Division of Corporation Finance published Staff Legal Bulletin No. 14K (SLB 14K), providing guidance on the “ordinary business” basis for excluding a shareholder proposal from a proxy statement.

SLB 14K is the third SLB in three years addressing this basis for exclusion. While the Staff has encouraged issuers to include board analysis in certain circumstances, these attempts have been met with very limited success. SLB 14K clarifies that board analysis is most helpful when it is not clear whether an issue is significant to the company. SLB 14K goes on to provide guidance on two substantive factors (among several examples listed in SLB 14J) that boards may address on significance, namely the delta between a shareholder proposal and prior company action and how to address prior shareholder votes on the issue.

SLB 14K also articulates when a shareholder proposal constitutes micromanagement of a company, and therefore may be excluded: namely, when a proposal seeks intricate detail or imposes a specific strategy, method, action, outcome or timeline for addressing an issue, and thereby supplants the judgment of management and the board.

SLB 14K also includes a reminder for companies not to be too technical in their examination of proponents’ proof of ownership letters. Companies should not seek to exclude a shareholder proposal based on drafting variances in the proof of ownership letter if the language used in such letter is clear and sufficiently evidences the requisite minimum ownership requirements.

If a company is evaluating whether to submit a no action request on the basis of the “ordinary business” basis for exclusion, it should carefully review this new guidance, as well as prior Staff Legal Bulletins.