Deloitte & Touche LLP Public Company Update 2023

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January 24, 2023

MAKING AN IMPACT THAT MATTERS since 1845

- Highlights from the AICPA Conference
- SEC Update
- FASB Update and Other Accounting and Reporting Considerations
- Non-GAAP Measures and Metrics
- SEC Review Process and Comment Letter Trends
- PCAOB Update

Highlights from the AICPA Conference

Key themes of the 2022 AICPA conference

01 SEC reporting matters and rulemaking

02 Environmental, social, and governance (ESG) matters

03 Auditor independence

04 Digital assets

05 Cybersecurity

06 PCAOB standard-setting update

07 Accounting considerations in the current economic environment

08 Fraud, auditing estimates, and ICFR

SEC Update

SEC update

Cybersecurity disclosures

- It is important to inform investors accurately and timely about material cybersecurity incidents
- Registrants are expected to have procedures in place that ensure that cyber incidents are communicated to individuals at the appropriate levels within the organization who can make disclosure determinations
- It is not sufficient for a company that has experienced a material cybersecurity breach to continue to simply disclose that there is a risk that a breach could occur or to disclose a hypothetical risk that data may be compromised when a company is aware that the data has been stolen

SEC update

Critical accounting estimates (CAEs)

- CAEs are intended to provide the quantitative and qualitative information investors need to understand estimation uncertainty and the impact the estimate has had or will have in the financial statements
- During the Division of Corporation Finance update, Ms. McCord highlighted several questions a registrant should consider when preparing its CAE disclosures, including:
  - Can an investor understand why the estimate is critical?
  - Does the disclosure include numerical information, including dollar amounts?
  - Does the disclosure provide information incremental to disclosures related to the accounting policy?
  - Can an investor understand any past variability in the estimate and assumptions?
  - Does the disclosure include qualitative and quantitative discussion of the sensitivity of the reported estimate to the method and assumptions underlying the calculation?
- Finally, Ms. McCord noted that the analysis should become more robust as a potential effect becomes more likely or increases in magnitude

SEC priorities and rulemaking

Climate disclosures

- Proposed rule issued March 21, 2022; comments due June 17, 2022
- Applicable to domestic and foreign registrants (except asset-backed issuers)
- Disclosures due at time of filing; also required in annual reports and registration statements (including IPOs/SPACs)

Financial Statements

1 **DISCLOSURE:**
For climate-related events and transition activities:
1) Financial impact metrics
2) Expenditure metrics
3) Discuss financial estimates, assumptions

2 **CONTROLS:** Subject to internal control over financial reporting (ICFR)

3 **ATTESTATION:** Part of financial statement and ICFR audit

Outside the Financial Statements (New Item 6)

1 **DISCLOSURE:**
- GHG emission disclosures for Scopes 1 & 2—Scope 3 if material (with attestation)
- Climate governance
- Climate-related risks and opportunities
- Climate risk management
- Climate targets and goals

2 **CONTROLS:** Subject to disclosure controls and procedures

3 **ATTESTATION:** Phase-in to reasonable assurance over Scopes 1 & 2 GHG emission disclosures

Refer to the Comprehensive Analysis and Executive Summary *Heads Up* publications issued by Deloitte for additional detail.

Proposed phase-in period for calendar-year-end companies:

Registrant Type	All Disclosures (Except Scope 3)	Scope 3 GHG Emission Disclosures	Attestation on Scope 1 & Scope 2 GHG Emission Disclosures
Large Accelerated Filer	2023	2024	Limited Assurance – 2024 Reasonable Assurance – 2026
Accelerated Filer	2024	2025	Limited Assurance – 2025 Reasonable Assurance – 2027
Nonaccelerated Filer	2024	2025	Not Required

* Smaller reporting entities would be exempt from Scope 3 GHG emission disclosures and would have an additional year of transition (i.e., all other disclosures would be required in 2025).

SEC priorities and rulemaking

Climate disclosures

Comment letters received on the SEC proposed rule on climate disclosure

Themes from public comment letters, in response to the proposed rule

Financial statement disclosures

- Granular information
- 1% threshold
- Interpretive issues

Emissions

- Disaggregation by gas
- Maturity of Scope 3 reporting
- Organizational boundary
- Availability of information
- Reference to GHG Protocol

Qualitative

- Governance
- Climate risks

Transition and readiness

- Form 10-K reporting rather than other format (e.g., separate furnished report)
- Reporting comparable periods upon adoption
- Initial adoption within a year of the final rule effective date

International convergence and securities law liability

SEC priorities and rulemaking

Climate-related comment letters

- In September 2021, a Sample Letter to Companies Regarding Climate Change Disclosures (“Dear Issuer” letter) was issued
- The sample comments are consistent with topics in the SEC’s 2010 interpretive guidance and focus on (1) description of the business, (2) legal proceedings, (3) risk factors, and (4) MD&A
- Over 35 company-specific letters released for 2021 reviews (several for 2022 reviews as well)

1 — September 2021

DCF issues company-specific comments; publishes “Dear Issuer” letter.

2 — October – November 2021

Registrants respond to comments stating:

- Specific climate-related disclosures not material to their business;
- Existing disclosures are appropriate;
- The users of a CSR are a broader group

3 — November – December 2021

DCF issues follow-up comment letters to registrants requesting more detailed materiality analysis as support.

4 — December 2021 – February 2022

Registrants respond with detailed materiality assessment; or provide expanded disclosures in risk factors and MD&A.

5 — January – March 2022

DCF indicates that comments are closed.

Key topics in the 2010 release:

- International accords
- Impact of legislation and regulation
- Indirect consequences of regulation or business trends
- Physical impacts

To the extent material, discuss the indirect consequences of climate-related regulation or business trends…

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.

FASB Update and Other Accounting and Reporting Considerations

FASB update

Standard setting

- FASB oversight by the SEC
- Investor focus
- Technical agenda: 18 projects outstanding
- Highlighted projects:
  - Disaggregation of income statement
  - Income tax disclosures
  - Segment reporting

Segment reporting

Standard setting and considerations

FASB update:

Proposed ASU issued in October 2022, with comment period open through December 20, 2022

- Introduces significant segment expense principle
- Clarifies that there may be more than one measure of segment profit and loss disclosed
- Clarifies interim reporting expectations for entities with single reportable segments

SEC considerations:

- Identification of operating segments
- Consistency with internal and external information
- Non-GAAP measures

Other topics

Considerations

Consolidation and VIEs

- Consistent observations with foreign VIEs as in prior years
- Consolidation when there is continuing involvement

Business combinations

- Identification of accounting acquirer
- Transactions outside of the combination
- Spin-off versus reverse spin-off

Statement of cash flows

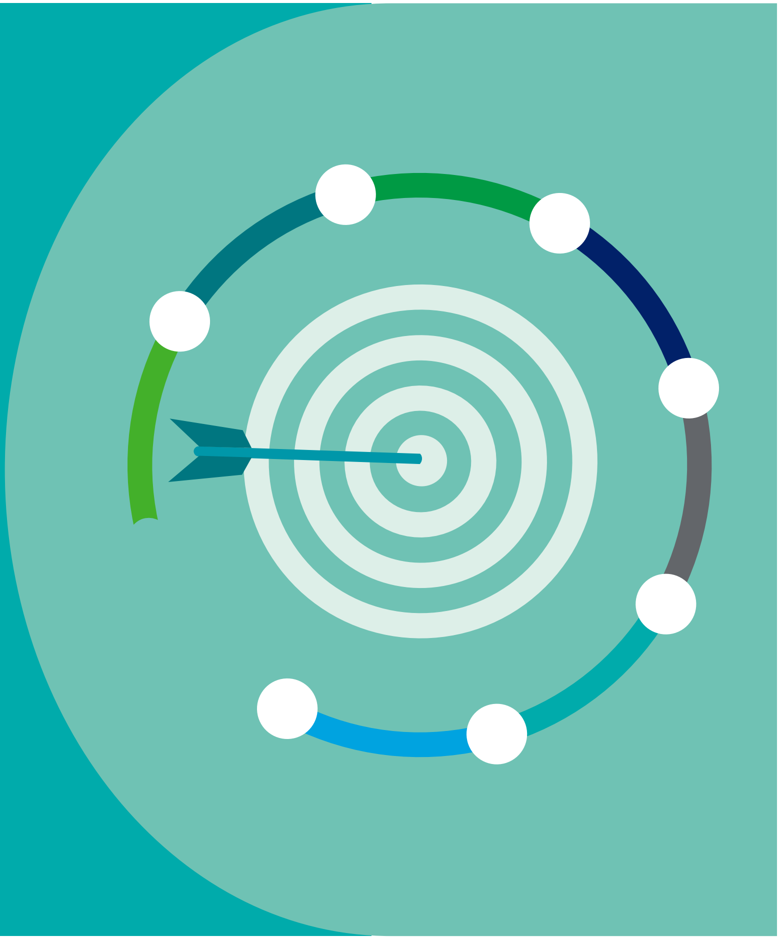
- Consider direct method

Non-GAAP Measures and Metrics

Non-GAAP measures and metrics

Recent areas of focus

- Misleading and tailored accounting adjustments
  - Add-back of normal recurring cash operating costs or of material operating costs
  - Adjusted revenue
  - Adjusted gross profit/gross margin/contribution margin
- Prominence and balanced presentation
- Labeling, purpose, and use
- Use of multiple segment measures
- Industry-specific
  - Collaborative arrangements
  - Crypto-asset impairments



SEC update

Non-GAAP measures and metrics — New and updated C&DIs on misleading measures

These C&DIs memorialize feedback the staff has previously provided to registrants and do not necessarily change the staff's previous position on certain non-GAAP adjustments (i.e., stock comp and restructuring)

C&DI 100.01 — Updated

Enhanced guidance to define what is considered normal and recurring cash operating expenses

C&DI 100.06 — New

Explains that no amount of disclosure can make a measure that is concluded to be misleading, compliant with the non-GAAP rules

C&DI 100.04 — Updated

Clarified that non-GAAP adjustments that change GAAP recognition and measurement principles would be considered individually tailored accounting principles that may be misleading, and added the following examples:

- Presenting non-GAAP revenue as net when GAAP requires gross or vice versa
- Changing from accrual basis to cash basis for revenue or expenses

C&DI 100.05 — New

Non-GAAP measures should be labeled as such and adjustments should be clearly labeled

Examples of misleading labels include labeling a non-GAAP measure:

- Of contribution margin as net revenue
- With a description similar to/the same as the comparable GAAP measure
- As pro forma that is not Article 11 compliant

Lindsay McCord advised that there is no transition period when a conclusion is reached that a non-GAAP measure or adjustment is misleading or otherwise not consistent with non-GAAP rules. The SEC staff expectation is that the registrant will correct such presentation in the next filing.

SEC update

Non-GAAP measures and metrics — New and updated C&DIs on undue prominence

Regulation S-K requires that when a registrant presents a non-GAAP measure, it must present the most directly comparable GAAP measure with equal or greater prominence

C&DI 102.10 — Updated

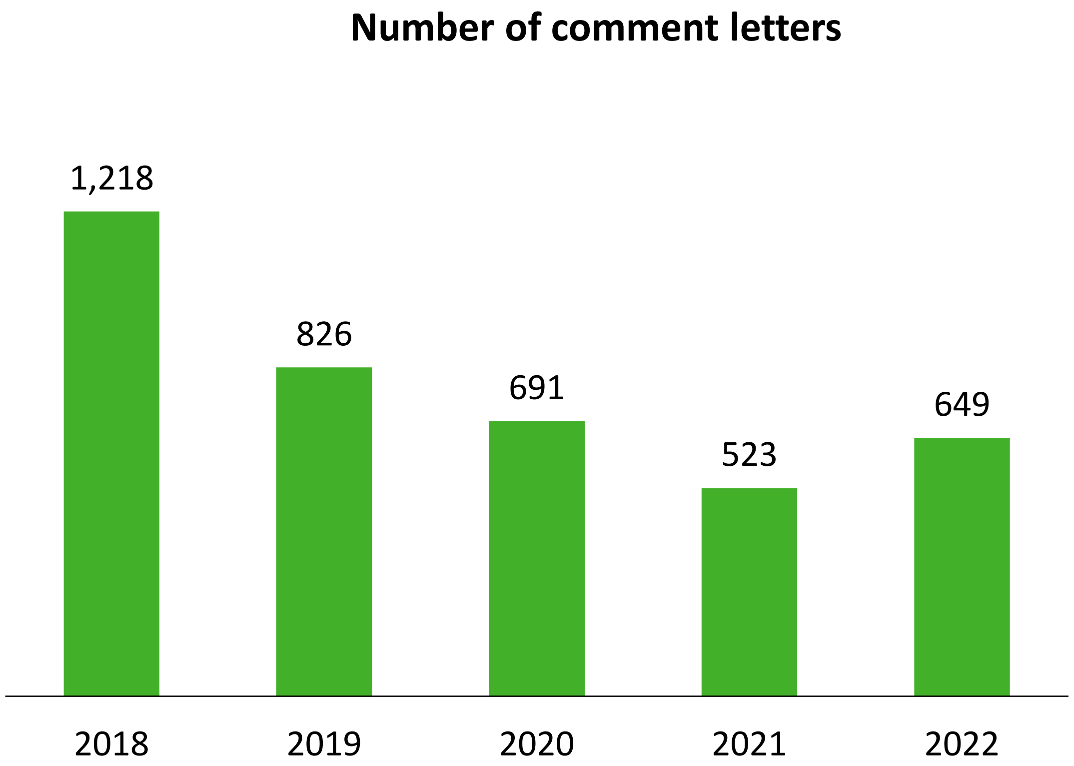
102.10 was updated to include additional interpretive guidance on when a non-GAAP measure is more prominent than the corresponding GAAP measure

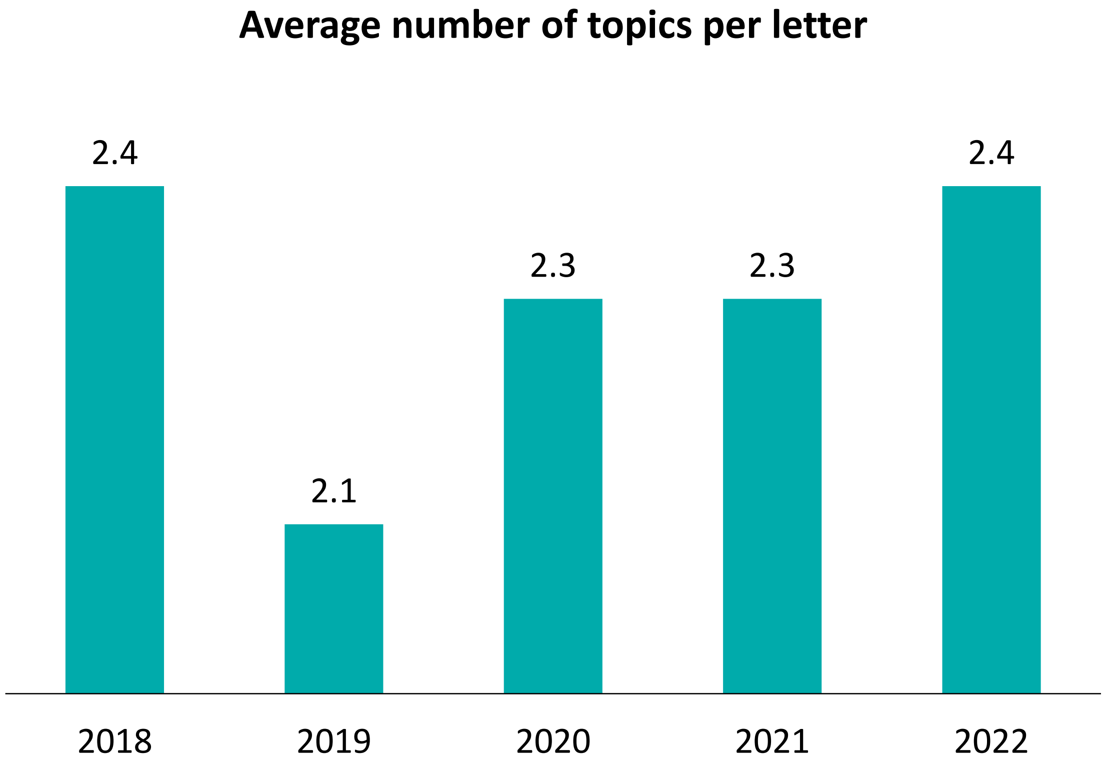
- 102.10(a) highlights scope of what is covered by undue prominence. New examples were added that include:
  - Presenting ratios where a non-GAAP measure is used in the numerator and/or denominator without presenting the equivalent GAAP ratio, or
  - Presenting charts, tables, or graphs of non-GAAP measures without presenting the comparable GAAP measure
- 102.10(b) clarifies that the non-GAAP measure reconciliation must start with the GAAP measure and reconcile to the non-GAAP measure
- 102.10(c) added new guidance on what would constitute a non-GAAP income statement
  - A non-GAAP income statement would include all or most of the line items and subtotals found in a comparable GAAP income statement

SEC Review Process and Comment Letter Trends

SEC review process and comment letter trends

SEC comment letter trends





SEC review process and comment letter trends

SEC comment letter trends (cont.)

Twelve months ended July 31, 2022			
Topic	**Percentage of all reviews**	**Current-year rank**	**Change in rank from prior year**
MD&A	48%	1	—
• Results of operations	*35%*		
• Liquidity	*7%*		
• Critical accounting estimates	*6%*		
Non-GAAP measures	41%	2	—
Segment reporting	13%	3	1 ↑
Revenue recognition	10%	4	1 ↑
Signatures, exhibits, and agreements	9%	5	(2) ↓
Fair value	8%	6	—
Internal control over financial reporting	8%	7	—
Climate change	7%	8	N/A
Inventory and cost of sales	7%	9	—
Acquisitions, mergers, and business combinations	6%	10	7 ↑

Note: Comment letter trend information was derived from data provided by Audit Analytics based on the percentage of all comment-letter-yielding Form 10-K and 10-Q reviews that include a comment on topic. Preliminary results; subject to change.

PCAOB Update

Audit update

PCAOB inspections

Focus areas for 2022 inspection cycle

- Industries and audit areas most affected by the pandemic and macroeconomic environment
- Audit execution risk
- System of quality control

Common deficiencies in 2022 inspection cycle

- Revenue
- Inventory
- Business combinations
- Long-lived assets
- Allowance for credit losses
- Equity
- Critical audit matters
- Audit Committee communications

Focus areas for 2023 inspection cycle

- Financial statement areas that are more complex, require significant judgment, or are susceptible to change
- Risk assessment
- Auditor independence

Audit update

Professional skepticism and fraud

In the current environment of heightened uncertainty and fraud risk:

- Management may be under increased pressure and cut corners or engage in fraud
- Increased opportunity for bias in management's estimates and judgments may exist
- Auditors are reminded to maintain professional skepticism and that a "trust but verify" mindset may create unconscious bias
- Look to what management is doing to create a culture of "see something, say something"
- Ensure sufficient staffing and time to avoid missing or failing to follow up on red flags

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2023 Public Company Update Executive Compensation and Related Tax Developments

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CLE or CPE Credit

- To receive credit, participants must email the 8 provided code words to **hrsocial@hodgsonruss.com**

- Listen for the code words throughout each presentation.

Pay Versus Performance - Introduction

- What reporting companies are subject to Item 402(v)?
  - New Item 402(v) applies to all reporting companies, other than emerging growth companies, registered investment companies, and foreign private issuers.
  - As detailed below, scaled disclosure applies to smaller reporting companies (SRCs).
- When did Item 402(v) become effective?
  - Final rule was effective October 11, 2022 and reporting companies must comply with Item 402(v) in any proxy statement requiring executive compensation disclosure for fiscal years ending on or after December 16, 2022.

Pay Versus Performance - Introduction

- How many fiscal years must be included in the disclosure?
  - In general, five fiscal years of disclosure must be provided, except that reporting companies may initially provide disclosure for three fiscal years and then add an additional fiscal year in each subsequent proxy filing.
  - In the case of an SRC, it must only provide disclosure for three fiscal years, except that an SRC may initially provide disclosure for two fiscal years and then add an additional fiscal year in the next proxy filing.

Code Word

- The code word is **FISCAL**

Pay Versus Performance - Introduction

- Which filings are subject to Item 402(v)?
  - Applies to any proxy or information statement for which executive compensation disclosure under Item 402 is required.
  - Thus, for example, pay versus performance disclosure is not required to be provided as part of Item 11 in Part III of Form 10-K or as part of a registration statement.

Pay Versus Performance

- What is required to be disclosed?
  - Quantitative disclosure through a standardized pay versus performance table disclosing total compensation earned (as reflected in summary compensation table), total compensation actually paid, the Company's total shareholder return ("TSR"), the TSR of the Company's peer group, the Company's net income, and a Company-selected measure;
  - Qualitative disclosure using the information in the pay versus performance table to clearly describe the relationship between the compensation actually paid the financial measures set forth in the table; and
  - Tabular disclosure of at least three, but no more than seven, performance measures used in linking compensation actually paid to company performance.

Pay Versus Performance – Pay Versus Performance Table

- Pay Versus Performance Table. SRC's are exempt from any asterisked items.

Year	Summary Compensation Table Total for PEO	Compensation Actually Paid to PEO	Average Summary Compensation Table Total for Non-PEO NEOs	Average Compensation Actually Paid to Non-PEO NEOs	Value of Initial Fixed $100 Investment Based On:		Net Income	[Company-Selected Measure]*
					Total Shareholder Return	Peer Group Total Shareholder Return*		
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
Y1								
Y2								
Y3								
Y4*								
Y5*								

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Pay Versus Performance – Pay Versus Performance Table

- Is any information required to be included in the table already subject to disclosure in some form?
  - In general, information for four of the columns will already be disclosed in some form by a reporting company:
    - Summary Compensation Table compensation for PEO;
    - Average Summary Compensation Table compensation for non-PEO NEOs;
    - Reporting Company TSR that is presently disclosed (other than by an SRC) as part of the performance graph under Item 201(e); and
    - The Reporting Company’s net income set forth in its audited financial statements.

Pay Versus Performance – PEO and Non-PEO NEO Issues

- What disclosure must be provided if there are multiple PEOs during a fiscal year?
  - If there are multiple PEOs during a single fiscal year, then separate tabular disclosure is required for each PEO.
- If there are more than four non-PEO NEOs, are all NEOs taken into account?
  - Nothing in Item 402(v) limits the non-PEO NEO group to four individuals.
- If a NEO becomes the PEO mid-year, what does Item 402(v) require?
  - Item 402(v) is silent, but would recommend including compensation while not serving as PEO.
- How is partial-year service taken into account?
  - Item 402(v) does not address how to average compensation when an individual only serves as an executive officer for part of the year.
- The name of each PEO and Non-PEO NEO must be disclosed by footnote. Sample footnote disclosures below:
  - If there were no changes, the footnote disclosure could provide "In all relevant fiscal years, [____] was the Company's Chief Executive Officer and the Company's remaining NEOs included [list].
  - If there were changes, the footnote could provide "During the [____] fiscal year, the Company's Chief Executive Officers were [CEO #1 and CEO #2]. In all other relevant fiscal years, [CEO #1] served as the Company's Chief Executive Officer. During the [____] fiscal year, the Company's remaining NEOs consisted of [list #1]. During the [____] fiscal year, the Company's remaining NEOs consisted of [list #2], etc.

Pay Versus Performance – Compensation Actually Paid

- How is the amount of compensation actually paid determined?
  - Starting point is compensation as set forth in the Summary Compensation Table;
    - <u>Deduct</u> the aggregate change in actuarial present value of all defined benefit and actuarial pension plans, but only if the amount is a positive number;
    - <u>Add</u>:
      - the service cost for services rendered during the applicable year; and
      - the prior service cost granted under a plan amendment during the applicable year that is attributable by the benefit formula to serviced rendered in periods before the amendment, in each case calculated in accordance with GAAP;
    - <u>Deduct</u> any equity award amounts set forth in the Summary Compensation Table; and
    - <u>Add/Subtract</u>:
      - Year-end fair value of equity awards granted in the relevant fiscal year that are outstanding and unvested as of the end of the relevant fiscal year;
      - The amount of change as of the end of the covered fiscal year (from the end of the prior fiscal year) in fair value of any awards granted in prior years that are outstanding and vested as of the end of the relevant fiscal year;
      - For awards that are granted and vest in the relevant fiscal year, the fair value as of the vesting date;
      - For awards granted in prior years that vest in the relevant fiscal year, the amount equal to the change as of the vesting date (from the end of the prior fiscal year) in fair value;
      - For any awards that are forfeited during the relevant fiscal year, deduct an amount equal to the fair value as of the end of the prior fiscal year;
      - The dollar value of any dividends or other earnings paid on equity awards in the relevant fiscal year prior to the vesting date that are not otherwise reflected in the fair value of the equity award or otherwise included in the Summary Compensation Table.

If the assumptions made in determining the fair value of any equity awards differ materially from those disclosed as of the grant date for such equity awards, then footnote disclosure to the pay versus performance table of any valuation assumptions is required.

Pay Versus Performance – Disclosure of Adjustments

Adjustments to Determine Compensation “Actually Paid” to [PEO]/[Non-PEO Named Executive Officers]	Year 1	Year 2	Year 3	Year 4	Year 5
Deduction for Change in Actuarial Present Value of Accumulated Benefit under Defined Benefit and Actuarial Pension Plans reported under “Change in Pension Value and Nonqualified Deferred Compensation Earnings” column in SCT					
Increase for “Service Cost” for Pension Plans					
Increase for “Prior Service Cost” for Pension Plans					
Deduction for Amounts Reported under “Stock Awards” Column of SCT					
Deduction for Amounts Reported under “Option Awards” Column of SCT					
Addition of Fair Value of Option and Stock awards granted during fiscal year that remain unvested as of the end of fiscal year end					
Addition of Fair Value of Option and Stock awards granted during fiscal year that vest during fiscal year					
Addition/Deduction for Change in Fair Value from Prior Fiscal Year End to Current Fiscal Year End of Awards Granted in Prior Fiscal Year that were Outstanding and Unvested as of Current Fiscal Year End					
Addition/Deduction for Change in Fair Value from Prior Fiscal Year End to Vesting Date of Awards Granted in Prior Fiscal Year that Vested during Current Fiscal Year					
Deduction of Fair Value of Option and Stock Awards, as of Prior Fiscal Year End, Forfeited During Current Fiscal Year					
Addition for any Dividends or Other Earnings Paid during Current Fiscal Year on Option or Stock Awards prior to Vesting Date					
Total Adjustments					

Pay Versus Performance – TSR and Peer Group TSR

- How may the peer group be determined?
  - Peer Group may consist of either the same peer group used in the performance graph under Item 201(e) or the peer group used in the CD&A.
- How is TSR measured?
  - TSR is measured on a cumulative basis from the last trading day before the reporting company's earliest fiscal year in the table (i.e., TSR for the first year will represent TSR for that first year, TSR for the second year will represent the cumulative TSR for the first and second years, etc.).
- If the company's peer group changes, what disclosure is required by Item 402(v)?
  - If the peer group changes, then footnote disclosure to the pay versus performance table must explain the reason for the change and compare the reporting company's cumulative TSR with that of both the newly selected peer group and the peer group previously used.

Pay Versus Performance – Company Selected Measure

- What financial measure should serve as the company selected measure?
  - The company selected measure should be the financial measure that represents the most important financial measure (not already disclosed in the table) used by the reporting company to link compensation actually paid, for the most recent fiscal year, to company performance.
- May a non-financial measure be used as the company selected measure?
  - No, only financial measures may be used in the pay versus performance table, but non-financial measures may be included in the tabular disclosure discussed below.
- What disclosure must be provided if the company selected measure changes?
  - Item 402(v) requires disclosure of the most important financial performance (not already disclosed in the table) for the most recent fiscal year. If the company selected measure changes, then the change should also be applied to earlier fiscal years shown in the table.
- May non-GAAP financial measures serve as the company selected measure?
  - Yes, non-GAAP measures may be used, but reporting companies must provide disclosure as to how the number is calculated from the reporting company's audited financial statements.

Pay Versus Performance – Qualitative Disclosure

- Item 402(v)(5) requires a clear description of the relationship between the executive compensation actually paid and (i) the reporting company's cumulative TSR, (ii) the reporting company's net income, and (iii) the company selected measure.
- It also requires a comparison of the reporting company's cumulative TSR with the cumulative TSR of the reporting company's peer group.

Pay Versus Performance – Qualitative Disclosure

- Which years must be addressed in the qualitative disclosure?
  - All years covered by the pay versus performance table.
- In what format should the qualitative disclosure be provided?
  - Reporting companies have flexibility to provide the qualitative disclosure in the graphic form, narrative form, or a combination of the two.
- What might the qualitative disclosure look like?
  - In the adopting release, the SEC provided:

    As discussed in the Proposing Release, the required relationship disclosure could include, for example, a graph providing executive compensation actually paid and change in the financial performance measure(s) (TSR, net income, or Company-Selected Measure) on parallel axes and plotting compensation and such measure(s) over the required time period. Alternatively, the required relationship disclosure could include narrative or tabular disclosure showing the percentage change over each year of the required time period in both executive compensation actually paid and the financial performance measure(s) together with a brief discussion of how those changes are related

Pay Versus Performance – Qualitative Disclosure

- What if TSR or Net Income is not used by a reporting company in making compensation decisions?
  - In the adopting release, the SEC provided:

    We acknowledge that these additional requirements will increase compliance costs, but we expect that the descriptions can be scaled depending on their relevance to a particular registrant. For example, if TSR or net income have little correlation, or only a spurious correlation, with pay at a particular registrant, and is not a metric used in their compensation plans, a simple statement to this effect may suffice.

Pay Versus Performance – Tabular Disclosure

- Item 402(v)(6) requires a tabular list of at least three, but not more than seven, financial performance measures which represent the most important financial measures used by the reporting company to link compensation actually paid, for the most recently completed fiscal year, to company performance.

Pay Versus Performance – Tabular Disclosure

- May a non-financial measure be included on the tabular list measure?
  - Yes, non-financial measures may be included if among the three to seven most important performance measures, and the reporting company discloses at least three of its most important financial measures.
- May the tabular list include fewer than three financial performance measures?
  - Generally not, unless the reporting company uses fewer than three financial performance measures.
- May the tabular list include more than seven performance measures?
  - No.
- Must the tabular list rank the measures in terms of their hierarchy in setting compensation actually paid?
  - No.
- Must a reporting company explain why the measures reflected in the tabular list are the most important measures?
  - No, but consider providing an explanation if doing so would promote a better understanding of the reporting company's compensation practices.
- Must a single tabular list be provided?
  - No, more than one tabular list may be provided. For example, a reporting company may provide one tabular list for the PEO and a second tabular list for all non-PEO NEOs. Or a reporting company may provide a tabular list for each NEO. However, each list must have at least three, but no more than seven, measures.

Pay Versus Performance - Miscellaneous

- Where should the pay versus performance disclosure be included in the proxy statement?
  - Reporting companies have flexibility in determining where in the proxy the pay versus performance disclosures are provided. The SEC expressly rejected a requirement to include in CD&A, in large measure because that could imply that the reporting company considered the pay versus performance relationship in compensation decisions, which may or may not have been the case.
- Do the Inline XBRL requirements apply to the pay versus performance disclosure?
  - Yes, the pay versus performance disclosure is required to be separately tagged using inline XBRL.
- Are Supplemental Disclosures Permitted?
  - Yes, so long as any supplemental disclosure is clearly identified as being supplemental, is not misleading, and is not presented with greater prominence than the required disclosure.

Pay Versus Performance - SRCs

- Summary of Special SRC Rules
  - Only required to provide three, instead of five, years of disclosure. No requirement to provide peer group TSR.
  - No requirement to provide TSR for reporting company's peer group.
  - No requirement to provide company selected measure.
  - No requirement to disclose pension amounts.
  - No requirement to provide tabular list.
  - Inline XBRL requirement begins in the third filing including the pay versus performance disclosure.

New Item 402(x)

- Existing Item 402(b)(2)(iv) provides that an example of material information to be disclosed as part of the CD&A includes how the determination is made as to when equity awards are granted.
- New Item 402(x) will require narrative disclosure about the reporting company's granting of options and SARs, including:
  - How is it determined when to grant options/SARs (e.g., is there a predetermined schedule);
  - Whether material nonpublic information is taken into account when determining the timing and terms of options/SARs; and
  - Whether the reporting company has timed the disclosure of material nonpublic information for purposes of affecting the value of executive compensation.

New Item 402(x)

- New Item 402(x) will also require tabular disclosure if any stock options/SARs were granted, during the last completed fiscal year, to any NEO within four business days before or one day after the filing of a 10-K, 10-Q, or an 8-K containing material nonpublic information (other than the granting of an option/SAR). If required, the table must include the following information, on an award-by-award basis:
  - NEO’s name;
  - Grant date;
  - Number of securities underlying the award;
  - The per-share exercise price;
  - The grant date fair value of the award; and
  - The percentage change in the market value of the securities underlying the award between one trading day before and one trading day after the disclosure of the material nonpublic information.

New Item 402(x)

- Effective Date
    - Reporting companies will be required to comply with 402(x) in the first proxy filing covering the first full fiscal period that begins on or after April 1, 2023 (or October 1, 2023 for SRCs).
- The Item 402(x) information is required to be tagged using Inline XBRL.

Code Word

- The code word is **COMPANY**

Notable ISS and Glass Lewis Updates

- Addition to ISS List of Problematic Pay Practices
  - Severance payments made when the termination is not clearly disclosed as involuntary (for example, a termination without cause or resignation for good reason).
  - Note: Problematic pay practices are the #1 reason for a negative say on pay recommendation.
- Glass Lewis increased threshold for minimum percentage of LTIP grants that should be performance-based from 33% to 50%.
- Both ISS and Glass Lewis have indicated that the PVP disclosure under Item 402(v) generally will not affect their pay-for-performance analysis (though ISS will display some of the information in its quantitative screen), but may take the disclosure into account as part of their qualitative analysis.

162(m) Reminder

- For taxable years beginning after December 31, 2026, a covered employee under 162(m) will include an employee who is among the 5 most highly compensated employees for the taxable year other than PEO, PFO, or the next 3 most highly compensated executive officers.
  - Not necessarily limited to executive officers. Most companies have procedures in place for tracking executive offer pay, but not necessarily for other employees.
  - Consider effect on deferred tax assets (e.g., non-grandfathered stock options that may be exercised after 2026).

Tax Reporting Reminder

- ISOs/ESPPs
  - Reminder that if ISOs were exercised under a stock incentive plan or shares were purchased under an ESPP during 2022, Form 3921 (ISO exercises) and Form 3922 (ESPP purchases) must be furnished to employees by January 31, 2023.

Stock Buyback Excise Tax – Overview

- Code Section 4501, which was added as part of the Inflation Reduction Act of 2022, imposes this excise tax (the “Tax”).

  - **Who it applies to**: “covered corporations”, which generally means publicly-traded domestic corporations and surrogate foreign corporations, that repurchase more than $1M of its stock during a tax year.

  - **Rate of tax**: 1% (which is non-deductible).

  - **Tax base**: the fair market value of stock repurchased during a tax year, net of stock issuances in the same year.

- The Tax applies to stock repurchases of “covered corporations” beginning on January 1, 2023.

Stock Buyback Excise Tax – IRS Notice 2023-2

- On December 27, 2022, the IRS released Notice 2023-2 (the “Notice”), which describes proposed regulations that the IRS intends to issue regarding the application of the Tax.

- Taxpayers may rely on the Notice pending the issuance of proposed regulations.

Stock Buyback Excise Tax - Scope

- For purposes of the Tax, a “repurchase” means solely a redemption under Code Section 317(b) (with several notable exceptions) or an “economically similar transaction”.

- The Notice provides important clarifications regarding the scope of “repurchases” that are subject to the Tax.

Stock Buyback Excise Tax – Repurchases

- Certain transactions that constitute Code Section 317(b) redemptions, do not constitute repurchases subject to the Tax.
  - Deemed distributions that occur under Code Section 304(a)(1).
  - Payments in cash in lieu of fractional shares if the payment is part of a Code Section 368(a) reorganization or a Code Section 355 distribution or pursuant to the settlement of an option or similar financial instrument, and certain other requirements are met.

- No exclusion is provided for repurchases of preferred stock, and mandatory redemptions of preferred stock are expressly described in the Notice as subject to the Tax.

Stock Buyback Excise Tax – Economically Similar Transactions

- **Acquisitive reorganizations**
  - The exchange by target shareholders of their target stock as part of the acquisitive reorganization will be considered a repurchase by the target corporation.
- **"E reorganizations"**
  - In a recapitalization that qualifies as an "E" reorganization, the exchange of shares by the shareholders as part of the reorganization will be considered a repurchase.
- **"F reorganizations"**
  - The exchange by the transferor corporation shareholders of their transferor corporation stock as part of the "F" reorganization will be considered a repurchase by the transferor corporation.
- **Split-offs**
  - The exchange by the distributing corporation shareholders of their distributing corporation stock for controlled corporation stock (and, if applicable, other property) will be a repurchase by the distributing corporation.
- **Certain Code Section 331/ Section 332 complete liquidations**
  - In a complete liquidation subject to *both* Code Sections 331 and 332, the distribution subject to Code Section 331 is treated as a repurchase whereas the distribution subject to Code Section 332 is not treated as a repurchase.

Stock Buybacks Excise Tax – Not Economically Similar Transactions

- **Complete liquidations**
  - A complete liquidation that qualifies *solely* under Code Section 331 or Code Section 332 is not a repurchase.
- **Divisive transaction under Code Section 355 other than split offs**
  - A distribution of controlled corporation stock in a Code Section 355 transaction that is not a split-off will not be considered a repurchase.

Stock Buyback Excise Tax – Calculating the Tax

- The Tax base is determined as follows:
  - The taxpayer first determines the aggregate fair market value of all stock repurchased during the tax year, which is then adjusted for any “statutory exceptions” and reduced by the amount of stock issued pursuant to the “netting rule”.

Stock Buyback Excise Tax – Fair Market Value

- "Fair market value" means the market price of the stock on the date the stock is deemed to be repurchased.
  - Stock is "deemed repurchased" at the time ownership of the stock is transferred or exchanged.
  - The market price must be determined based on one of four methods provided in the Notice, and the method selected by the taxpayer must be consistently applied to all repurchases effected in the same tax year.
    - Daily VWAP;
    - Closing price;
    - Average of the high and low prices; or
    - Trading price at the time of the repurchase.

Stock Buyback Excise Tax – The Netting Rule

- Reduces the Tax base by the aggregate fair market value of stock that was either (a) issued or provided to employees of the covered corporation or a specified affiliate or (b) issued to other persons, in each case during the tax year.

  - Stock transferred that is not substantially vested is not treated as issued or provided to the employee until it vests, except in certain situations, such as when the employee makes a valid election under Code Section 83(b).

  - Certain issuances of stock are disregarded for this purpose, including stock splits, issuances to a specified affiliate, deemed issuances under Code Section 304(a)(1), fractional shares deemed to be issued, stock issued by a covered corporation that is a dealer in securities, and stock issued by the target corporation in a transaction qualifying under Code Section 368(a)(2)(E).

Stock Buyback Excise Tax – Statutory Exceptions

- If stock is repurchased in a “repurchase” to which a so-called “statutory exception” applies, the fair market value of the stock both increases and reduces the Tax base, meaning it effectively excludes such repurchases from the Tax base.
  - Qualifying property exception for acquisitive reorganizations.
  - Stock contributions to an employer-sponsored retirement plan.
  - Repurchases by dealers in the ordinary course of business.
  - Repurchases by a RIC or a REIT.
  - Repurchases treated as a dividend.

Stock Buyback Excise Tax – Reporting and Payment Requirements

- It is anticipated that the Tax will be required to be reported annually on IRS Form 720 (Quarterly Federal Excise Tax Return).
  - **When to file**: expected to be due for the first full quarter after the close of the taxpayer's tax year, with no extensions available.
    - Example: For a taxpayer with a tax year ending December 31, 2023, it would report its Tax on Form 720 for the first quarter of 2024, due on April 30, 2024.
    - The IRS also intends to issue an additional form, to facilitate computing the Tax, that taxpayers would attach to the Form 720. (The IRS released a draft Form 7208 on December 28, 2022.)
  - **When to pay the Tax**: expected to be due at the same time as the filing deadline for the Form 720, with no extensions available.

2023 Corporate Governance and Disclosure Update

Craig Fischer
Hodgson Russ LLP
January 24, 2023

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Return of Say-On-Frequency Votes

- Rule 14a-21(b) of the Exchange Act required companies to conduct an advisory vote on the “frequency of the say-on-pay vote” (or “say-when-on-pay votes” or “say-on-frequency votes”) at their first shareholder meeting occurring on or after January 21, 2011, with subsequent frequency votes occurring no more than **every six years thereafter**
  - *Smaller Reporting Companies were not required to hold their first Say-On-Frequency Vote until their first shareholder meetings occurring on or after Jan. 21, 2013*
- In the Say-On-Frequency Vote, shareholders will be asked if the say-on-pay vote should occur every one, two or three years
  - *This vote is needed even if a company is already conducting its say-on-pay vote annually and intends to continue its practice*
  - Proxy advisors and most institutional investors continue to support annual say-on-pay votes
- For many public companies, **the six year cycle means that a Say-On-Frequency Vote needs to be an agenda item at the 2023 Annual Meeting** if it was last an agenda item at the 2017 Annual Meeting
- *Related Form 8-K Requirements*
  - The Form 8-K reporting meeting voting results needs to disclose (i) the results of the say-when-on-pay vote and **(ii) the frequency with which the company intends to conduct the say-on-pay vote in light of the results of the advisory frequency vote**. *(See Item 5.07(d) of Form 8-K)*
  - Item 5.07(d) permits the intended frequency to be disclosed by amendment to the initial Form 8-K, which is filed within 150 calendar days after the shareholders’ meeting as long as the disclosure is made at least 60 days prior to the deadline for shareholder proposals
  - Best practice to include the intended frequency in the initial Form 8-K filing. **Failure to timely disclose intended frequency on Form 8-K will render a company ineligible to use Form S-3 during the 12 months following the date that the Form 8-K should have been filed**

Clawback Rules

- In Oct. 2022, the SEC adopted new Rule 10D-1 related to the clawback of executive compensation. This rule requires that the stock exchanges must establish listing standards requiring all listed companies, including foreign private issuers, emerging growth companies, externally-managed business development companies and smaller reporting companies, to adopt and comply with a written clawback policy
  - *A listed company that does not comply by (i) failing to adopt a clawback policy; (ii) failing to enforce its clawback policy; or (iii) failing to make the required clawback disclosures will be subject to delisting by the stock exchange*

Timing Issues

- Stock exchanges must propose their listing standards within 90 days of when the final rules were published, so by Feb. 26, 2023; those listing standards must in turn become effective no later than Nov. 28, 2023
- A listed company will then only have 60 days to adopt a clawback policy meeting the requirements of the rules after the listing standards have come into effect. If a stock exchange's listing standards become effective as of the last possible date of Nov. 28, 2023, a listed company will need to have its new clawback policy in place no later than Jan. 27, 2024. These dates could occur sooner if the stock exchanges act more quickly
  - *This means that the new disclosure requirements for proxy statements (described below) will come into effect for 2024 annual meetings for calendar year companies*
- The rules require that clawback policies apply to any incentive compensation *received* at any time after the stock exchange listing standards are effective, even if a company has not yet adopted a clawback policy. For purposes of the rules, "received" means the date that the financial measure determining the incentive compensation is achieved (even if payment occurs after the end of that period)

Clawback Policy Requirements Overview

- Policy must require that any *incentive compensation* (including both cash and equity compensation) received by any *current or former Section 16 officer (not just NEOs)* is subject to recoupment if:
  - the incentive compensation was calculated based on financial statements that were required to be restated due to material noncompliance with financial reporting requirements (including both "big R" restatements and "little r" restatements), *without regard to any fault or misconduct* of the relevant Section 16 officer; and
    - Out-of-period adjustments correcting errors that are immaterial to the current period and the prior period do not trigger recovery
  - the noncompliance with financial reporting requirements resulted in overpayment of incentive compensation "received" by a Section 16 officer during any of the three fiscal years preceding the date the restatement was required

Clawback Rules – Continued

<u>Clawback Policy Requirements Overview – Continued</u>

- For these purposes, “incentive compensation” is defined broadly and includes any compensation that is determined based on “financial reporting measures,” including GAAP and non-GAAP measures, and compensation that is granted or vests based on stock price or TSR
  - Includes any measure determined and presented in accordance with the accounting principles used in preparing a company’s financial statements (and any measures that are derived wholly or in part from those measures, including ratios)
  - *Implementation of a clawback policy is likely to be challenging when measuring a financial restatement’s impact on TSR and stock price metrics*
- Does not apply to (i) base salary, (ii) time-based equity awards that vest solely on continued employment and (iii) compensation awarded based upon a subjective measure (i.e. leadership), strategic measure (i.e. acquisition completion) and operational measure (i.e. achieving a regulatory approval)
- ***Amount to be recovered is the difference between what was paid to the Section 16 officer and what would have been paid had the incentive compensation payout been calculated based on the restated financial information***
  - For awards based on stock price and TSR, excess amount determined based on a company’s reasonable estimate of effect of restatement on company’s stock price
- **Rules leave boards and companies with almost no discretion to forgo, release or settle amounts subject to recovery *and prohibits indemnifying or insuring officers***
  - *No exception available for de minimis amounts*
  - Exceptions available if:
    - Company reasonably determines that the expense paid to a third party to recover the incentive compensation would exceed the amount of the incentive compensation to be recovered, making recovery impracticable; and
    - Recovery would likely cause an otherwise tax-qualified retirement plan to fail to meet the requirements of the Internal Revenue Code
  - A company <u>does</u> have discretion to determine the method of recovering the compensation, but is required to recover amounts “reasonably promptly”
- Amounts subject to clawback must be collected on a <u>*pre-tax basis*</u>

Code Word

- The code word is **CLAWBACK**

Clawback Rules – Continued

Disclosure Obligations

- Companies required to file a copy of their clawback policies as an exhibit to Form 10-K
- Two new check boxes forthcoming on Form 10-K – (i) whether the financial statements included in the filings reflect a correction of an error to previously issued financial statements and (ii) whether any of those error corrections are restatements requiring a recovery analysis of incentive-based compensation
- If recovery is necessary, company will be required to provide the date of the relevant accounting restatement and detailed information regarding the recovery of excess incentive compensation in its proxy statement under new Item 402(w) of Reg S-K
    - *Both check boxes and new Item 402(w) disclosure will need to be tagged in Inline XBRL*
- Companies will also be required to update their Summary Compensation Table to subtract the amount recovered from that reported in the table for that year and quantify the amount recovered in a footnote

Effect on Existing Clawback Rules

- CEOs and CFOs still remain subject to the clawback provisions of the Sarbanes-Oxley Act of 2002 (SOX), which apply if a company is required to prepare an accounting restatement because of "misconduct"
- To the extent that the SOX policy and the new policy cover the same compensation, CEO and CFO would not be subject to duplicative reimbursement

Rule 10b5-1 Trading Plan Rules

- Rule 10b5-1 Trading Plans enable (i) public company D&Os to buy or sell their company's stock or (2) companies to repurchase their shares, each at times when they otherwise might be prevented from doing so because they possess material non-public information
- In Dec. 2022, the SEC adopted substantial amendments to Rule 10b5-1 and related regulations governing the use 10b5-1 Trading Plans. These new rules are effective Feb. 27, 2023 (the Effective Date)
- <u>New Conditions on Use of Rule 10b5-1 Plans</u>
  - Rules require that any Rule 10b5-1 Plans that are adopted after the Effective Date, must comply with the new conditions or the person adopting the plan will not be able to rely on the affirmative defense to potential Rule 10b-5 liability in connection with a trade
  - ***Cooling Off Periods*** – Plans adopted by D&Os must provide that trading under the plan cannot begin (i.e. a “cooling off period”) until the later of (i) 90 days after the adoption of the plan; or (ii) two business days following the disclosure of the company’s financial results in a Form 10-Q or 10-K for the fiscal quarter in which the plan was adopted. For other individuals, mandated cooling-off period is 30 days.
    - *Rules do not require a cooling-off period for company plans (which is a significant change from rule proposal)*
    - Modifications to a plan can trigger a new cooling-off period
  - ***Director and Officer Certifications*** – D&Os must include a representation in a plan at adoption or modification that: (i) the D&O is not aware of MNPI about the company or its securities and (ii) the D&O is adopting the plan in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 10b-5
  - ***Restrictions on Overlapping Plans*** – With certain exceptions, rules provide that the affirmative defense is unavailable for trades by individuals who have established multiple overlapping plans during the same period
    - An exception permits individuals to have a separate “sell-to-cover” plans to satisfy tax withholding in connecting with vesting of restricted stock and RSUs (but not stock options)
  - ***Restrictions on Single-Trade Plans*** – For individuals, the rules limit the availability of the affirmative defense to *one* single-trade plan involving open-market transactions (a plan that is “designed to effect” the open-market purchase or sale of shares as a “single transaction”) during any rolling 12-month period
  - ***Good Faith Requirement*** – Rules require that individuals and companies act in good faith with respect to the plan, which includes not only the adoption of, but also any modification to, the plan <u>and actions related to the plan</u> (*seeks to prevent attempts to influence the timing of corporate disclosures to benefit trades under a plan*)
  - SEC has clarified that these requirement will not affect the affirmative defense available under an existing Rule 10b5-1 Plan that was entered into prior to the Effective Date, except if the existing Plan is modified after the Effective Date

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Rule 10b5-1 Trading Plan Rules – Continued

- New Disclosure Requirements
  - Prior to these rules, there were no mandatory disclosure requirements regarding the use of Rule 10b5-1 trading arrangements
  - ***Quarterly Disclosures*** – Under new Item 408(a) of Reg S-K, companies must (i) disclose in Form 10-Q (or Form 10-K for the fourth fiscal quarter) whether, during the most recently completed fiscal quarter any director or officer has adopted, modified or terminated a Rule 10b5-1 Plan and/or any non-Rule 10b5-1 trading arrangement (as defined in Item 408(c)) and (ii) provide a description of the material terms thereof
    - *Note: For purposes of these rules, "officer" means any Section 16 officer of the company*
    - Item 408(a) will be added to Part II, Item 5, "Other Information" of Form 10-Q and Part III, Item 10, "Directors, Executive Officers and Corporate Governance" of Form 10-K
  - ***Annual Disclosures -*** Under new Item 408(b) of Reg S-K, companies will be required to disclose in their Form 10-K whether the company has adopted insider trading policies and procedures **and must file a copy of its insider trading policy as an exhibit to its Form 10-K**
    - Item 408(b) will be added to Part III, Item 10, "Directors, Executive Officers and Corporate Governance" of Form 10-K and Item 7 of Schedule 14A. Like other Part III information required by Form 10-K, the disclosure required by Item 408(b) may be forward incorporated by reference
  - These disclosures must be tagged in Inline XBRL
  - Disclosure requirements will come into effect for a company's first Exchange Act periodic report filing that covers the first full fiscal period beginning on or after April 1, 2023. *For calendar year companies, this means the Q1 23 Form 10-Q filing*
    - For Smaller Reporting Companies, the disclosure requirements will apply to the first Exchange Act periodic report filing that covers the first full fiscal period beginning on or after October 1, 2023
- Section 16 Reporting Changes
  - Rules add a mandatory checkbox to Forms 4 and 5 requiring a reporting person to indicate whether the transaction is pursuant to a plan that is intended to satisfy the Rule 10b5-1 affirmative defense and to provide the date of adoption of the Rule 10b5-1 plan – ***Change goes into effect on April 1, 2023***
  - ***Changes to Gift Reporting –*** Rules will now require the reporting of bona fide gifts of equity securities on Form 4 **within 2 business days** of the gift
    - Corporate insiders who are aware of MNPI should proceed with caution when gifting shares, as they could potentially be liable if they gift securities when they are aware of MNPI and while knowing (or being reckless in not knowing) that the donee would sell the securities prior to the disclosure of the MNPI
  - ***Gift reporting change goes into effect on Feb. 27, 2023***

Filing of Glossy Annual Reports and Form 144s

- **Glossy Annual Report Filings**
  - Under the proxy rules, a reporting company is required to deliver an annual report to its stockholders if it is soliciting proxies for a stockholder meeting at which directors will be elected
    - Companies can satisfy this requirement by preparing a standalone “glossy” annual report or a “10-K wrap” where several glossy pages—such as a cover page and a letter to stockholders—are wrapped around the Form 10-K
  - In June 2022, Rule 14a-3(c) was amended to require that “glossy” annual reports (whether a traditional glossy annual report or a 10-K wrap) must be furnished to the SEC electronically through Edgar
    - These amendments eliminate the option for companies to (i) furnish paper copies of the glossy annual report to the SEC or (ii) post the glossy annual report solely to the company’s corporate website (however, many companies will still need to post to a website to comply with the notice and access rules)
  - The glossy annual report is submitted under Edgar form “ARS,” and Edgar only supports the submission of the glossy annual report as a PDF file
  - Companies are required to comply with the mandatory electronic submission requirements beginning Jan. 11, 2023, so this new rule is applicable for the 2023 proxy season
  - The glossy annual report must be filed on Edgar by the later of (i) the date on which the report is first sent or given to security holders and (ii) the date on which a company’s definitive proxy statement is filed with the SEC
  - The glossy annual report is considered “furnished” and not “filed” with the SEC
- **Form 144 Filings**
  - Effective April 13, 2023, all Form 144s for the sale of securities of reporting companies must be filed electronically through Edgar. Traditionally, Form 144s have been filed through a paper filing sent to the SEC.
  - Form 144 is available as an online fillable document, similar to other fillable forms such as Forms 3, 4, and 5.
  - Rules also eliminate the requirement that an affiliate send one copy of the Form 144 notice to the relevant stock exchange

Proposed Cybersecurity Disclosure Rules

- In March 2022, the SEC issued proposed rules that would require public companies to make prescribed cybersecurity-related disclosures
  - ***New Current Reporting Requirement*** – Proposed rules would require the disclosure of <u>*material*</u> cybersecurity incidents under a new Item 1.05 of Form 8-K
    - Trigger date for the Form 8-K disclosure would be the date of the materiality determination with respect to the cybersecurity incident, not the date of discovery of the incident. However, companies will be required to make the materiality determination as soon as reasonably practicable after discovery.
    - As currently proposed, the rules would <u>not</u> allow for a reporting delay when there is an ongoing internal or external investigation related to the cybersecurity incident
    - The required Form 8-K disclosure would include (i) when the incident was discovered, (ii) a brief description of the incident, (iii) the impact of the incident on company data, (iv) the effect of the incident on the company's operations, and (v) the status of remediation
  - ***Updates on Previously Reported Incidents*** – Under a new Item 106(d) of Reg S-K, a company would be required to provide material updates about previously reported material cybersecurity incidents in the covered period in its Form 10-Ks and Form 10-Qs. Item 106(d) would also require disclosure when a series of previously undisclosed individually immaterial cybersecurity incidents becomes material in the aggregate.
  - ***Cybersecurity Risk Management and Strategy Disclosure*** – Among other specified topics, companies would be required to disclose as part of their Form 10-K their policies and procedures to identify and manage cybersecurity risks and threats, and whether a company engages a third party to assist with its risk assessment
  - ***Cybersecurity Governance Disclosure*** – The proposed rules would require a description of (i) the board's oversight of cybersecurity risk and (ii) management's role in assessing and managing cybersecurity risks, the relevant expertise of such management, and its role in implementing the company's cybersecurity policies, procedures, and strategies
  - ***Director Cybersecurity Expertise*** – Under a new Item 407(j) of Reg S-K, a company would need to annually disclose the cybersecurity expertise of the directors of the company, if any. If a director has cybersecurity expertise, the name of any such director would need to be disclosed along with detail necessary to fully describe the nature of the expertise. The proposed rule includes criteria for the determination.
- Disclosure would be required to be tagged in Inline XBRL
- Under the SEC's recently released rulemaking agenda, the SEC is targeting the finalization of this rule during the first half of 2023.

Nasdaq Board Diversity Rules

- Board Diversity Matrix Disclosure Requirement
  - Diversity Matrix disclosure requirements became effective beginning in 2022
  - During 2022, companies were only required to disclose diversity statistics for current year; for 2023 and beyond, companies will be required to disclose diversity statistics for current year and the immediately preceding year
  - If the matrix is not included in the proxy statement, a company may publish the board diversity matrix on its website no later than Dec. 31 of the relevant year and provide a link to the disclosure to Nasdaq through (i) the submission of a Company Event Notification Form on the Nasdaq Listing Center portal or (ii) via an e-mail to drivingdiversity@nasdaq.com, in each case within one business day after posting
- Appointment of Diverse Directors
  - Rule uses a "Comply or Explain" approach
    - *Listing rule requires Nasdaq-listed companies to have at least two members of the board who are diverse or to explain why they do not have two members who are diverse - including at least one who self-identifies as Female, and at least one who self-identifies as (i) Black or African American, Hispanic or Latinx, Asian, Native American or Alaska Native, Native Hawaiian or Pacific Islander, or Two or More Races or Ethnicities or (ii) LGBTQ+*
      - Foreign issuers and smaller reporting companies permitted to satisfy the diversity objectives with two directors who self-identify as Female
    - If diversity requirement is not met, company must explain the reasons why it does not have required diverse directors in its proxy statement or on its website where it publishes its board diversity matrix. Nasdaq will not assess the substance or merits of the company's explanation, but has stated that it will verify that the company has provided one.
  - Compliance phase-in period based upon Nasdaq listing tier
    - Nasdaq Global and Nasdaq Global Select Markets - at least one diverse director by Dec. 31, 2023, and at least two diverse directors no later than Dec. 31, 2025
    - Nasdaq Capital Market - at least one diverse director no later than Dec. 31, 2023, and at least two diverse directors no later than Dec. 31, 2026
    - Companies with boards consisting of five or fewer directors (regardless of listing tier) must have one diverse director by Dec. 31, 2023
      - *Note that Nasdaq recently changed the timing in each case to Dec. 31 of the relevant year, rather than the previous dates that tied to Aug. 6 of the relevant year*

Risk Factor Updates

Topics to Consider When Updating Risk Factors

- Changes in global economic conditions and their impact on a company's business, including ability to access debt or equity capital markets
- Impact of inflation and interest rate changes
- Streamline or reduce Covid-19 specific risk factors (potentially discuss any negative impacts of the return to work policy)
- Supply chain disruptions
- Labor shortages and other human capital issues (increases in labor costs and increased employee turnover)
- Cybersecurity and data privacy risks
- Environmental, ESG and sustainability issues (climate-related impact risks, scrutiny by stakeholders of ESG issues)
- Ukraine/Russia conflict

- A reminder to avoid using a hypothetical risk description in a risk factor when the risks have actually presented themselves (use of the statements "could" or "may" rather than "did" or "has")
- If your risk factor sections is more than 15 pages, summary risk factor disclosure required (a series of concise, bulleted or numbered statements that is no more than two pages summarizing the principal risk factors)
- Best practice to take a full, fresh look at risk factors each year and obtain review and input from multiple internal depts

Code Word

- The code word is **RISK**

Board Leadership Disclosures

<u>SEC Comment Letters on Board Leadership Disclosures</u>

- In Sept. 2022, SEC issued comment letters to 25+ companies (across industries and of various sizes) requesting companies to expand upon their discussion of their board leadership structure and the risk oversight function of the board (some of the disclosures required by Item 407(h) of Reg S-K). In particular, SEC requested expanded disclosure with respect to:
  - Whether a company would "consider having the Chair and CEO roles filled by a single individual," and if shareholders would have prior input before such a change was made
  - The specific role played by a company's lead independent director and his or her level of authority and specific responsibilities
  - The specific ways in which a board administers its risk oversight function
- Recent SEC Staff comments said that these requests were aimed to "focus and enhance" what might otherwise be "boilerplate disclosure"
  - *Given SEC Staff focus, companies should consider enhancing this disclosure with additional details and increased granularity*

<u>Director Bios and Skills Matrix</u>

- Inclusion of a director skills matrix is becoming a more mainstream practice in proxy statements, even among smaller companies. In addition to including a skills matrix, consider including additional disclosure to explain why each identified skill is relevant for the company's board
  - *A well-crafted director skills matrix can effectively highlight the strength of the company's overall board composition and demonstrate the contribution each director brings to the board*
- Given increased focus from proxy advisors and institutional investors, consider revisiting director bios to refresh how directors' backgrounds, skills and experiences are described.

Universal Proxy Card Rules

- The SEC's universal proxy card rule (Rule 14a-19) became effective for shareholder meetings held after August 31, 2022

Universal Proxy Card Requirements

- The separate proxy cards issued by a company and a dissident shareholder during a proxy contest for director elections *must include both the company's and the dissident's respective nominees,* **enabling shareholders voting by proxy to pick and choose among the different slates of candidates**
  - To the extent there are proxy access director nominees, they will also need to be listed on both the company and dissident proxy card
  - For each slate listed on a card, the nominees must be listed in alphabetical order by last name
  - All nominees have to be presented in the same font type, style and size on the proxy card
  - The proxy card will have to prominently disclose the maximum number of nominees for which voting authority can be granted
  - ***In the case of a contested solicitation for which the universal proxy card rule is applicable, the company will need to file a preliminary proxy statement (which will be subject to SEC review) at least 10 calendar days before it can file and mail the definitive proxy statement***

Dissident Requirements

- In order to use the universal proxy card rules, the dissident must comply with the following:
  - In addition to complying with the company's advanced notice bylaw requirements (if any), the dissident must provide the names of its nominees at least 60 calendar days prior to the anniversary of the previous year's annual meeting date and the company must provide the names of its nominees to the dissident at least 50 calendar days prior to that anniversary
  - Dissident must file its definitive proxy statement with the SEC by the later of 25 calendar days prior to the meeting date or five calendar days after the company files its definitive proxy statement
  - Dissident is required to solicit the holders of shares representing at least 67% of the voting power. Dissident is permitted to make use notice and access, rather than full set delivery, which will make solicitation efforts less expensive

Universal Proxy Card Rules - Continued

Impact of the Rules

- The rules have the potential to lead to increased proxy contest threats and less challenging and less expensive campaigns for activists
    - This *may* result in lesser known or new activists being encouraged to launch campaigns as the rules lower the barriers to success for a dissident's campaign
    - The ability to pick and choose from a combination of candidates *may* make it more likely that a dissident succeeds in electing one or two of the dissident's candidates
- Dissident shareholders *may* try to make use of the availability of the universal proxy card as an additional source of leverage when they make demands to boards

Steps to Consider Now

- Review your advanced notice bylaw to ensure it is thorough, robust and operates as expected
- Consider potential amendment to your bylaws in response to the universal proxy rules, including (i) a requirement that the dissident comply with Rule 14a-19 and provide a certification as to such compliance, (ii) a requirement that the proponent not use the white card, and (iii) a requirement that the shareholder solicit 67% of the voting power *(Note – This is very much an evolving area. Bylaw amendments that are too restrictive may provoke a negative response from proxy advisors and others)*
    - *Best to consider potential amendments on a "clear day" in advance of a contested election*
- Review proxy disclosures to ensure they support the case for each director and properly highlight the board's oversight of important company issues

Rule Amendments Applicable to All Director Elections

- A company is required to disclose in its annual proxy statement the deadline (*60 days prior to anniversary of prior year's annual meeting*) for shareholders to give timely notice to the company of dissident nominations for inclusion on a universal proxy card
- Also, revised proxy rules to reduce ambiguities and inaccuracies in companies' disclosure regarding voting standard disclosures by requiring:
    - inclusion of an "against" voting option for director elections where there is a legal effect to such vote;
    - inclusion of an "abstain" option for director elections where a majority voting standard applies; and
    - disclosure regarding the effect of a "withhold" vote on director elections in the proxy statement.

Shareholder Proposals

Updated Ownership Thresholds

- Beginning for shareholder meetings held on or after Jan. 1, 2023, the shareholder ownership thresholds that must be met in order to submit a shareholder proposal under Rule 14a-8 for inclusion in a company's proxy statement are as follows:
  - $2,000 of the company's securities for at least three years,
  - $15,000 of the company's securities for at least two years, or
  - $25,000 of the company's securities for at least one year.

Shareholder Proposal Exclusions

- Under Staff Legal Bulletin 14L and as a result of recent SEC Staff interpretations, it has become more difficult to exclude shareholder proposals through the no action letter process under the substantive bases for exclusions permitted by Rule 14a-8
- Overall success rate for no-action requests from the SEC Staff plummeted during 2022 annual meeting season

Proposed Amendments to Rule 14a-8

- In July 2022, the SEC proposed amendments to Rule 14a-8 that would significantly narrow three of the substantive bases (substantial implementation, duplication and resubmission) that companies can use to seek no-action letters to exclude a proposal from the SEC Staff
- If finalized, this will make it more difficult to exclude shareholder proposals

Code Word

- The code word is **SHAREHOLDER**

SEC Potpourri

- **Share Repurchase Disclosure Rules** – In Dec. 2021, the SEC proposed amendments to its rules regarding disclosures about purchases of a company's equity securities by or on behalf of the company (commonly referred to as share buybacks)
  - Proposed rules would require (i) daily repurchase disclosure on a new Form SR that would be due one business day after execution of a company's share repurchase order and (ii) enhanced periodic disclosure regarding share repurchases and the structure of the company's repurchase program
  - The SEC reopened the comment period on the proposed rule in Dec 2022 until Jan 11, 2023. Under the SEC's rulemaking agenda, the SEC is targeting the finalization of this rule during the first half of 2023.
- **SEC Reg Flex Agenda for First Half of 2023**
  - Climate Change Disclosure (Finalize Rule)
  - Cybersecurity Risk Governance (Finalize Rule)
  - Share Repurchase Disclosure (Finalize Rule)
  - Modernization of Beneficial Ownership Reporting (Schedule 13Ds and 13Gs) (Finalize Rule)
  - Human Capital Management (Proposal Rule)
  - Regulation D and Form D Improvements (Proposal Rules)

CLIMATE CHANGE AND ESG UPDATE

John J. Zak

January 24, 2023

SEC Climate Change Rules

- Promulgated by SEC in March 2022 (sec.gov/rules/proposed/2022/33-11042.pdf)
- Heavily prescriptive, 500+ pages
  - Require disclosure without reference to materiality: climate-related risk management, governance, impacts on strategy, business model and outlook
- Require disclosure of Scope 1, Scope 2 and potentially Scope 3 greenhouse gas emissions
  - Include outside attestation requirements
- Require financial statement note disclosures
  - E.g., impact of climate-related events and conditions on any line item in financial statements
- Rules drew voluminous comments, both pro and con (sec.gov/comments/s7-10-22/s71022.htm)
- Final rules expected April 2023
- Litigation to follow

Climate Change Disclosures for this Reporting Season

- Public Companies Should Consider The Following For Disclosure, If Material:
  - Whether specific climate-related disclosures should be included in Business, Legal Proceedings, Risk Factors, MD&A, or forward-looking statement disclaimer sections of the 10-K
  - Level of capex for climate-related initiatives
  - Physical effects of climate change on properties/operations
  - Impacts of weather on insurance cost/availability
  - Compliance costs/transition risks related to impacts of climate change
  - Any litigation risks related to climate change
  - Whether climate-related disclosures provided in stand-alone ESG, sustainability, corporate responsibility or other reports should be incorporated into or, at minimum, referred to in SEC filings
  - Board oversight of climate change issues (for proxy)
- Compare your disclosures with those of relevant peers and against internal disclosures reported up to senior management or board of directors.
- Tailor climate-related disclosures to company's business; avoid generic disclosures
- <u>Reminder</u>: Adjust any disclosure controls and procedures to include the consideration and review of climate-related information.

ESG – Status and Disclosures

- What is ESG?
  - "Environmental, social and governance" factors used to measure the investability, sustainability and social impact/social responsibility of a company.
  - The not-so-subtle purpose of ESG disclosures is to engender transparency and accountability and thus influence behavior.
  - "Doing good while doing well." Some investors believe ESG scores correlate with financial performance.

What is the current "state of play" on ESG and related disclosures?

- Continue to be driven by large investors, asset managers, proxy advisors, consumers, customers, directors and employees
- Regulators in the US, UK and EU are promulgating rules and promising more
  - E.g. EU Corporate Sustainability Reporting Directive (Dec. 2022) (applies to EU companies, EU-listed companies and non-EU companies meeting net turnover thresholds in the EU)
- ESG factors being included in executive compensation programs
- ESG litigation is growing (e.g. "greenwashing")
- ESG-related shareholder proposals continue to rise year over year
  - 2022 proposals had low passage rate that declined over 2021

Code Word

- The code word is **ESG**

Take-Aways for 2023 Reporting Season

- Be careful to confirm materiality analysis on climate/ESG disclosures in SEC filings and in non-filed documents like CSR, sustainability or ESG reports.
  - Sample SEC comment: "What consideration have you given to providing the same type of climate-related disclosure in your SEC filings as provided in your CSR report."
  - SEC has asked for details to support lack of materiality determinations
- Understand what ESG reporting is expected by investors, customers and other constituencies, if any, and the framework
- Enhance ESG/climate disclosure controls and procedures
- Follow the golden rule: "If you speak, speak accurately."

Competition and Regulatory Update

Valerie Stevens

Competition and Regulatory Update

Interlocking Directorates

- Renewed FTC and DOJ focus

U.S. Merger Control

- Recent and expected regulatory changes
- Agency enforcement activity

Employee Non-compete Covenants

- Recent proposed FTC rulemaking. Time to panic?

CFIUS

- Alive and well… and busy

Interlocking Directorates

- On October 19, 2022, DOJ announced that seven directors agreed to resign from the boards of five companies due to alleged violations of Clayton Act Section 8 [1]
  - 5 of 7 interlocks involved the same individual serving on the boards of two alleged competitors
  - 2 of 7 interlocks were not the same individual, but different representatives of Thoma Bravo, consistent with stated DOJ priority to increase antitrust enforcement of private equity firms
- DOJ Antitrust Division has recently made public statements about renewed focus on interlocks
- Previously, interlock enforcement typically arose as ancillary to another antitrust investigation, most frequently in merger review

[1] Department of Justice, "Directors Resign from the Boards of Five Companies in Response to Justice Department Concerns about Potentially Illegal Interlocking Directorates, October 19, 2022.

Interlocking Directorate Refresher

Section 8 of the Clayton Act (15 U.S.C. §19) prohibits a person from serving as an officer or director of two corporations where:

Competitors

- The two corporations are competitors
  - Note, Section 8 expressly applies only to corporations, not partnerships or LLCs
  - Whether two corporations are competitors is a (contentious) question of fact, dependent on product, geographic area, substitutes etc.

Size Thresholds Satisfied

- Each corporation must satisfy the threshold for capital, surplus, and undivided profits
  - For 2022, aggregate threshold for capital, surplus, and undivided profits was US$41,034,000
  - Interlock thresholds are adjusted annually, at the same time as HSR thresholds

Sufficient Competitive Sales

- Competitive sales of the two corporations (determined based on the most recently completed fiscal year) do not fall into one of the following three exemptions:
  - One of the corporation's competitive revenues are less than US$4,103,400 (adjusted annually);
  - Either corporation's competitive revenues are less than 2% of its total revenues; or
  - Each corporation's competitive revenues are less than 4% of its total revenues

Interlocking Directorate Refresher

- Statutory remedy for a Section 8 violation is only injunctive relief, but an interlock can lead to Sherman Act claims (i.e. fines and criminal prosecution)
  - Particularly, exchange of competitively sensitive information, allegations of collusion etc., most of which can be enforced under the far more serious Section 1 of the Sherman Act
- While Section 8 refers only to corporations, the FTC issued a Policy Statement in November that FTC Act Section 5 permits enforcement actions involving interlocks for other entity types
  - There is virtually no precedent for this type of enforcement

Federal Trade Commission, "Policy Statement Regarding the Scope of Unfair Methods of Competition Under Section 5 of the Federal Trade Commission Act," November 10, 2022.

Interlocking Directorate Compliance

- How can counsel reduce Section 8 risk? Key element of the corporation's antitrust compliance program, including:
  1. Regular review of all external officer and directorships
     a. For current officers and directors, periodic (at least annual, ideally every 6 months) review of all external directorships held by D&Os against current Section 8 thresholds
     b. For new officers and directors, incoming assessment of other board positions before hiring or joining the board
  2. Event triggered review
     a. Sales growth
     b. Expansion into new business line, new geographic market, or introduction of a new product
     c. Investment in another entity
     d. Initiation of an M&A process, particularly one that is HSR reportable
- In the case of an interlock that arises over time, the director or officer has a 1 year grace period to resign from the prohibited interlock position

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Competition and Regulatory Update

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CFIUS

- Alive and well… and busy

Merger Control

- Continued aggressive posture, particularly FTC
- In the first 2 years of the Biden administration, 22 transactions publicly challenged by the agencies, with 15 voluntarily abandoned or stopped by courts
  - Double the number of challenges compared to Trump administration over the same time period
- Not all have been successful; several high profile losses in 2022[1]
- Simon & Schuster / Penguin agency win, and subsequent abandonment of transaction, may provide foothold for consideration of labor effects in M&A analysis[2]

[1] *Illumina, Inc. and GRAIL, Inc.*, No. 9401 (September 9, 2022); *United States v. UnitedHealth Group, Inc., et al.*, No. 1:22-cv-0481 (CJN) (D.D.C. Sept 19, 2022); *United States v. United States Sugar Corp., et al.*, No 1:21-cv-01644-UNA (D. Del. Nov 23, 2021).
[2] *U.S. v. Bertelsmann SE & Co. KGaA et al.*, No. 1:21-cv-02886 (D.D.C. October 31, 2022).

Merger Control

- Legislative and regulatory developments are ongoing:
  - January 2023 – *Merger Filing Fee Modernization Act* created a 6 tier structure for HSR filing fees. Fees for smaller transactions will decrease, but substantially increase for larger transactions (i.e. deals over $5B will require a fee of $2,250,000, up from $280,000)
  - Expected January 2023 – new HSR thresholds, which will apply for transactions closing after a specified date in February 2023 until 2024
  - Expected any time – joint publication by DOJ and FTC of new merger control guidelines, first announced in January 2022
    - Significant changes expected to current approach, and a departure from singular focus on consumer welfare and price increases
    - Expect to see reference to worker impacts, unique tech sector deal attributes, competitive significance of data etc.

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Context

- As widely reported, FTC proposed a new rule on January 5 that would, if finalized, require employers to rescind all employee non-compete covenants
- Context: Part of a long campaign by FTC and DOJ to reduce post-termination contractual restrictions on employees:
  - 2016 joint FTC and DOJ "Antitrust Guidance for Human Resource Professionals" declared naked no poach agreements *per se* illegal
  - Subsequent enforcement activity since 2020 by DOJ included seeking criminal penalties or fines for no poach agreements [1]
  - Pres. Biden issued an Executive Order in July 2021 encouraging FTC to "use its statutory rulemaking authority under the FTC Act to curtail the unfair use of non-compete clauses and other clauses or agreements that may unfairly limit worker mobility."

[1] *United States v. Patel,* 3:21-cr-00220 (D. Conn.)*; United States v. Hee,* 2:21-cr-00098 (D. Nev.)*; United States v. Surgical Care Affiliates, LLC,* 3:21-cr-00011 (D. N.D.Texas)*; United States v. DaVita, Inc.*, 1:21-cr-00229, 2022 WL 266759.

Code Word

- The code word is **CONTEXT**

Proposed FTC Non-compete Rule

What is Prohibited?

- Enter into or attempt to enter into a non-compete clause with a worker;
- Maintain with a worker a non-compete clause;
- Represent to a worker that the worker is subject to a non-compete clause where employer has no good faith basis to believe the worker is subject to an enforceable non-compete clause

What about existing non-competes?

- Existing non-compete clauses must be rescinded no later than 180 days after publication of the final rule
- Employers must send written notices of rescission to current and former employees within 45 days of the date of rescission of the non-compete

Exceptions?

- Non-competes entered into in connection with a sale of business:
  - For an equity sale, applicable only to owners of 25% or more of interests in the entity
  - Person selling all or substantially all of a business entity's operating assets
- Employers not subject to Section 5 of the FTC Act

Proposed FTC Non-compete Rule

- Significant questions remain:
  1. What is a "non-compete" for purposes of the rule?
     - Proposed rule refers to a "functional test" i.e. any contractual term between an employer and a worker that prevents the worker from seeking or accepting employment post-termination
     - Implicates broad non-disclosure agreements, repayment clauses for costs (i.e. training costs) covered by the employer during employment
     - Rule is silent on non-solicitation covenants, but supplementary materials mention that prohibitions on doing business with employer's clients or customers could function as a non-compete
  2. Effects on employee benefits plans
     - Where vesting schedules are tied to expiration of restrictive covenants, unexpected vesting (and associated taxation) could result
     - Validity of claw back clauses related to breach of non-competes
- Excluded employers notably include: banks, savings and loan institutions, federal credit unions, common carriers, air carriers, and persons and businesses subject to the Packers and Stockyards Act

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What is CFIUS?

- The Committee on Foreign Investment in the United States (CFIUS) is an inter-agency committee comprising 9 Cabinet-level executive agencies (i.e. DOS, DOT, DOD etc.). Its role is to evaluate transactions to determine whether they are detrimental to U.S. national security. The President himself is the ultimate authority in the CFIUS transaction clearance process
- For most in attendance here, CFIUS is of little relevance to day to day
- However, in a sell-side M&A process, it can become critical
- Why? Non-U.S. buyers of U.S. businesses may be subject to CFIUS, and may require that a voluntary CFIUS notice be filed in advance of consummating a transaction
  - Some CFIUS notices are voluntary, others mandatory. Mandatory notices depend on identity and national origin of buyer, as well as nature of U.S. business.
  - The CFIUS process is long and involved. It adds time, money, and uncertainty to transaction processes. Foreign buyers active in M&A are invested in maintaining a positive relationship with CFIUS
- Absent a notice, CFIUS has authority to unwind transactions after consummation

Recent CFIUS Updates

- Foreign Investment Risk Review Modernization Act (2018)
  - Created mandatory framework, institutionalized many CFIUS processes
- Executive Order 14083 (September 2022) directs CFIUS to consider 5 categories of risk when reviewing a transaction:
  1. Effect on supply chain resilience and security
  2. Effect on U.S. technological leadership in certain critical sectors
  3. Cumulative effect of numerous incremental investments in certain critical sectors
  4. Effect on cybersecurity risks
  5. Contemplated use of personal data
- New enforcement and penalty guidelines (October 2022)
  - CFIUS has been notoriously secretive in its processes, and the new guidelines provide more information for parties on compliance and enforcement
  - Penalties are not specified, and are case-by-case

Competition and Regulatory Update

Questions?

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Litigation Developments and Exposures Update

John J. Zak, Esq.
Reetuparna Dutta, Esq.

Securities Litigation

- In the first half of 2022…
  - 110 new securities class actions filed
    - 107 filings in the second half of 2021
  - Class actions relating to SPACs, cryptocurrencies, and Covid remain elevated
  - Filings against Cannabis companies and filings relating to the opioid crisis and cybersecurity are down
  - Only 6 state court securities class actions filed

(*See* Cornerstone Research, Securities Class Action Filings, available at: https://securities.stanford.edu/research-reports/1996-2022/Securities-Class-Action-Filings-2022-Midyear-Assessment.pdf)

SEC Enforcement

- 760 total enforcement actions in FY 2022
  - 9% increase over FY 2021
  - 462 "stand alone" actions
  - 129 actions against issuers for delinquent SEC filings
  - 169 administrative proceedings to bar/suspend individuals
- SEC recovery of $6.439B
  - The highest in SEC history
- $229M and 103 WB awards in FY 2022
  - Second highest year in WB awards (dollar and number)
  - Whistleblower office received more than 12,300 tips

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Code Word

- The code word is **ACTIONS**

SEC Enforcement

- Recordkeeping failures
  - Enforcement actions against broker-dealers for failing to maintain and preserve work-related text messages on employees' personal devices.
  - $1.235B in penalties.
- Individual accountability
  - Executives charged under SOX 304 and ordered to return bonuses and compensation due to misconduct at their firms even though executives not personally charged.
- Actions involving the impeding of whistleblowers
  - Penalties for requiring employees to sign restrictive confidentiality agreements.
- Cybersecurity
  - Failing to safeguard customer information.
- ESG
  - Misleading statements regarding ESG principles.

FCPA

- In 2022, “core” enforcement actions against 10 companies and settlements of $923M.
  - 5 actions originated with a voluntary disclosure; 4 originated with a foreign law enforcement investigation; 2 originated with a DOJ/SEC investigation.
  - In 2021, 4 companies paid $259M.
    - (statistics from The FCPA Professor, available at: https://fcpaprofessor.com/corporate-fcpa-enforcement-2022-compared-prior-years/)

- 2 companies received DOJ declinations.

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DOJ Corporate Enforcement Policy

- Even in the presence aggravating factors, a declination may be appropriate if the company demonstrates:
  - The voluntary self-disclosure was made immediately upon the company becoming aware of the allegation of misconduct;
  - At the time of the misconduct and disclosure, the company had an effective compliance program and system of internal accounting controls, which enabled the identification of the misconduct and led to the company’s voluntary self-disclosure; and
  - The company provided extraordinary cooperation with the Department’s investigation and undertook extraordinary remediation that exceeds the respective factors listed herein.
- Aggravating circumstances that may warrant a criminal resolution include:
  - involvement by executive management of the company in the misconduct;
  - a significant profit the company from the misconduct;
  - egregiousness or pervasiveness of the misconduct within the company; or
  - criminal recidivism.

FCPA: Protecting Privilege

- US v. Coburn *et al.*, 2:19-cr-00120 (D.N.J.).
  - Court required corporation to produce un-redacted versions of memoranda and notes from outside counsel's internal investigation into FCPA violations.
  - Company waived privilege/work product by disclosing details of the investigation to the DOJ.
    - Company could not claim privilege over materials that it furnished to the DOJ (summaries of 42 interviews of employees).
    - Subject matter waiver
      - Waiver as to all memoranda, notes, summaries, or other records of the interviews.
      - If summaries conveyed contents of documents or communications, waiver extends to those documents/communications.
      - Waiver as to documents and communications that were reviewed and formed any part of the basis of any presentation, oral or written, to the DOJ.

Code Word

- The code word is **PRIVILEGE**

MERGER OBJECTION LITIGATION AND OFFICER EXCULPATION

John J. Zak

January 24, 2023

Merger Objection Litigation – The “Deal Tax”

- Litigation filed in federal or state court, usually as a class action, raising “standard” objections to merger or other matter presented to shareholders
- Objections include breach of fiduciary duty by officers and directors, lack of proper disclosures in proxy or tender offer statement
- Cases generally settled with “supplemental” proxy disclosures and payment of “mootness” fee to plaintiff firm

Merger Objection Litigation (cont’d)

- Trend is currently to file objection cases in state court (not federal) as individual shareholder (not class) action
- Avoids limit on repeat plaintiffs imposed by PSLRA in federal securities litigation
- Avoids judicial scrutiny/court approval of class action settlement terms
- Case statistics show that on average individual merger objection cases in 2022 were active for only 40 days – a sign that the “deal tax” is continuing to be extracted

Officer Exculpation Under Delaware Law

- Effective August 1, 2022, Section 102(b)(7) of Delaware General Corporation Law was amended to permit a certificate of incorporation to eliminate the personal liability of corporate officers for monetary damages resulting from a breach of the duty of care.
  (See rlf.com/2022-proposed-amendments-to-the-general-corporation-law-of-the-state-of-Delaware/)
- Similar to protections available since 1986 to directors in Delaware, except liability is only eliminated for "direct claims" (claims brought by stockholders) not for "derivative claims" (claims brought by or in right of the corporation).

Code Word

- The code word is **LAW**

Officer Exculpation Under Delaware Law (cont.)

- Impetus for amendment was recent uptick in claims – mostly in merger litigation – against officers alleging negligent disclosure violations.
- Without officer exculpation, these claims may survive dismissal thereby increasing settlement value of a case, even when claims versus directors have been dismissed.
- Requires amendment of certificate of incorporation which in turn requires stockholder vote and examination of the issue by proxy advisor firms.
  - ISS and Glass Lewis have said they will evaluate these amendments on a case by case basis