KUTAKROCK

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Updates for 2019 Annual Reporting Cycle

The beginning of the New Year turns the focus of most public companies to the upcoming annual reporting process. This legal update highlights several of the recent SEC rule changes and noteworthy trends affecting this year's annual reporting cycle.

The Shutdown's Effect on SEC Operations

As a result of the ongoing partial government shutdown, the SEC is currently operating with a limited number of staff members but will continue to accept a number of submissions ranging from corporate securities filings to investor complaints. The shutdown, however, has changed what the SEC is doing in response to those submissions. For example, according to the SEC's plan, companies are able to continue using EDGAR to make filings, but the Division of Corporation Finance is currently unable to process filings, provide interpretive advice, issue no-action letters or conduct most of its other standard activities.

While the shutdown continues, issuers will be limited in their ability to issue securities under new registration statements. With regard to proxy statements requiring a preliminary filing, definitive proxy statements may be mailed 10 days after filing of the preliminary proxy as the SEC will not be identifying proxy statements for review during the shutdown. If you have a pending shareholder proposal no-action letter request, we believe the safest path forward is to include all contested shareholder proposals in your proxy statement that are not clearly excludable under procedural grounds.

Proxy Advisor Updates

ISS and Glass Lewis recently released their 2019 proxy voting guidelines and policies. Most of the changes were related to executive compensation. A full summary of the changes is beyond the scope of this alert, but we want to note two updates:

Board Gender Diversity. Beginning January 1, 2019, Glass Lewis will recommend voting against the nominating committee chair and, depending on other factors, the other nominating committee members of a board with no female members. For any stockholder meeting on or after February 1, 2020, ISS will recommend against the election of the nominating committee chair and, on a case-by-case basis, other directors responsible for the board nomination process, at a company whose board has no female directors. Both Glass Lewis and ISS will consider exceptional circumstances for the absence of board gender diversity. These voting recommendations are in addition to California's passage of an amendment to the California Corporations Code requiring publicly traded companies formed or headquartered in California to include women on their boards (phased in from one director by the end of 2019 to three, two or one director for boards of six (or more), five or four directors, respectively, by the end of 2021).

Environmental and Social Issues. Both ISS and Glass Lewis announced policy updates with respect to environmental and social issues. ISS updated its policy on voting on environmental and social shareholder proposals by adding the criteria of whether there are significant controversies, fines, penalties or litigation associated with a company's environmental or social practices. ISS also announced that it will provide an E&S Disclosure QualityScore in addition to its existing Governance QualityScore. Glass Lewis codified its policy for board oversight of environmental and social risk. Where it is clear that a company has not properly managed or mitigated environmental and social risks to the detriment of stockholder value, Glass Lewis may recommend against board or committee members identified by the company as having oversight over environmental and social risks or, in the event the company has not disclosed board oversight of these matters, against audit committee members.

The SEC's New Hedging Disclosure Rule

On December 18, 2018, the SEC adopted its final rule regarding hedging disclosures, originally required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The final rule, Rule 407(i) of Regulation S-K, requires proxy statement disclosure of a company's practices or policies regarding the ability of its employees (including its officers) and directors to engage in certain hedging transactions in the company's equity securities, including a description of such practices or policies and the categories of persons covered. If a company does not maintain a hedging policy, the company must state that fact or state that hedging transactions by its employees and directors are generally permitted.

In light of the new rule, we recommend reviewing your insider-trading policy and, if there is no limitation on hedging transactions, consider adopting policy amendments that prohibit or appropriately restrict the purchase of equity securities or otherwise engaging in transactions that are designed to hedge the market value of company equity securities. Also, because the new rule extends beyond directors and officers to policies covering *all* employees, companies with a policy already in place should evaluate the scope of its coverage, keeping in mind the disclosure that will be required. It is likely that establishing a policy applicable to all employees would be difficult to police and does not necessarily serve the intended purpose of the new rule.[1] Although not covered by the rule, we recommend that companies also consider adopting a policy that prohibits the use of company equity securities as collateral for a loan or as a holding in a margin account.

The new disclosure will not be required for calendar year-end reporting companies until the 2020 proxy statement or, in the case of emerging growth companies and smaller reporting companies, the 2021 proxy statement.[2] If you already have a policy in place, we recommend voluntary compliance with the rule this year.

Delaware Supreme Court Raises Director Compensation Concerns

A 2017 Delaware Supreme Court case sparked an ongoing discussion within board rooms regarding director compensation limits and the defense of ratification. The court's decision in *In Re Investors Bancorp, Inc. Stockholder Litigation* has limited shareholder ratification as a defense when directors make equity awards to themselves on a discretionary basis. Although the stockholders approved an equity-award plan with aggregate award limits, the court held that because stockholders did not ratify specific awards under the plan, "the directors must demonstrate the fairness of the awards to the Company." While the scope of the holding is not entirely clear and the court faced extreme facts, the decision is significant. It is the first time the Delaware Supreme Court has tackled director compensation ratification since 1952. Going forward, companies drafting proxy disclosures concerning director compensation should consider going beyond the standard requirements and provide a detailed explanation of the decision-making process and the use of any market-based analysis for determining director compensation. Combining a more robust disclosure with meaningful stockholder-approved annual

[1] The voting guidelines for Glass Lewis and ISS, for example, have only requested policies applicable to executives.

[2] SRCs and EGCs must comply in proxy and information statements filed after July 1, 2020. All other companies must comply in proxy and information statements filed after July 1, 2019.

limits may help deter plaintiff firms from viewing a company as a litigation target. In addition, such disclosure could also mitigate any ISS concern regarding high non-employee director compensation pay, which could lead to negative voting recommendations beginning in February 1, 2020.

The Audit Committee's Increased Role in Cybersecurity

We have seen an increase in the number and depth of disclosures related to cybersecurity, including discussions of the audit committee's role in the oversight of cybersecurity. Recent enforcement actions make clear that the SEC views cybersecurity as an area of focus. The swift pace of data and technology growth, and the associated risks underscored by recent high-profile security breaches, demonstrate the importance of understanding cybersecurity as a substantive, enterprise-wide business risk. Audit committees should maintain awareness of cybersecurity trends and regulatory developments, and companies should be mindful of appropriate disclosure regarding the audit (or, as applicable, other board) committee's role in assessing these risks as breaches can have severe economic and business consequences that can significantly affect stockholders. Moreover, companies should review the interpretive release on cybersecurity the SEC issued last year, which provides guidance to public companies relating to the disclosure of cybersecurity risks and incidents and addresses cybersecurity considerations in connection with disclosure controls and procedures and insider-trading policies.

Increased Scrutiny of Virtual-only Meetings

Large investors are growing louder in their criticisms of virtual-only meetings. For example, in 2017, the New York City Retirement Systems adopted a policy in their proxy voting guidelines to vote against incumbent directors serving on a nominating committee where they are up for re-election at a virtual-only meeting. Similarly, Glass Lewis has stated that—beginning in 2019—it will generally recommend voting against members of the governance committee if a stockholder meeting will be held on a virtual-only basis unless the proxy statement contains robust disclosure assuring stockholders that they will have the same rights and opportunities to participate as they would at an in-person meeting. For companies intending to hold a virtual-only annual meeting, we advise that you assess whether your virtual meeting plans adequately align with the new guidelines on this topic.

Accounting Impact of Tax Reform

On February 27, 2018, the SEC issued Staff Accounting Bulletin No. 118 (SAB 118). This SAB provided guidance on the required disclosures related to the accounting impact of the Tax Cuts and Jobs Act of 2017, and established a three-part procedure for companies to follow when accounting for and reporting the income tax effects of the Tax Act in financial statements. The SAB also permitted companies to use provisional estimates to record the effects of the Tax Act while providing a measurement period (ending December 22, 2018) to complete accounting for the law's impact.

Companies preparing financial statements for their annual reports for the 2019 annual reporting cycle should continue to consider the guidance of SAB 118, including the requirements to disclose narrative explanations about the material financial reporting impacts of the Tax Act. Additionally, companies should determine whether they have more information regarding the effect of the Tax Act than they included last year. Finally, given the December 2018 deadline for filers to complete their accounting for the effects of the Tax Act, companies should remember to remove or update risk factors about the uncertain effects of the new law on their financial statements.

Changing Auditor Report Requirements on the Horizon

In June 2017, the PCAOB adopted a new auditing standard concerning auditor reports of financial statements. Among other things, auditor reports must now disclose the year in which the auditor began serving consecutively as the company's auditor. In addition, the new standard imposed changes to clarify the auditor's role and responsibilities and to make the auditor report easier to read. These provisions became effective for fiscal years ending on or after December 15, 2017 and should be reflected in auditor reports pertaining to 2018 audited financial statements for calendar year-end reporting companies.

Another component of the new standard will require that the auditor report disclose any critical audit matters (CAMs) or state that there were none. A CAM is defined as any matter arising from the audit of the financial statements that (1) was communicated or required to be communicated to the audit committee, (2) relates to accounts or disclosures that are material to the financial statements and (3) involves an especially challenging, subjective or complex auditor judgment.

The CAM provision will become effective for audits for fiscal years ending on or after June 30, 2019 for large accelerated filers, and thus the changes will *not* be reflected in auditor reports during the upcoming annual reporting cycle. Companies should, however, coordinate with their auditors now for the anticipated CAM-related disclosure. We suggest that companies and their auditors conduct "dry runs" regarding CAM disclosure this year in anticipation of the requirement.

Pay Ratio – Identifying the Median Employee

As you may recall, a company is only required to identify its median employee for the mandatory CEO pay-ratio disclosure once every three years unless there have been changes that will result in a significant change in its pay-ratio disclosure. If a company uses the same median employee, it must disclose that fact and explain the basis for its belief that there have been no changes that would significantly affect its pay-ratio disclosure. If there have been changes, however, the company's response will be dictated by the type and nature of change. For example, if there has been a material/significant change in the company's employee population or employee compensation arrangements, the company will be required to identify a new median employee. But if there has been a significant change in the original median employee's circumstances, a company may use another employee whose compensation is substantially similar to the original median employee based on the compensation measure used to select the original median employee. Additionally, a company should try to use the same date to identify the median employee as it did last year. If a company uses a different identification date, it must disclose that fact and provide an explanation of the reason for the change.

Presenting GAAP with Equal or Greater Prominence

The SEC's recent settled enforcement action against ADT Inc. is a reminder to all public companies of the consequences of failing to afford equal or greater prominence to comparable GAAP financial measures when reporting non-GAAP measures. Among other deficiencies, in the headline of its Q1 2018 earnings release, ADT presented adjusted EBITDA as up 7% year-over-year, without reference to ADT's GAAP net loss in the headline. Companies should proceed with caution and in full compliance with the rules and SEC guidance, as the SEC continues its focus on what it considers appropriate non-GAAP disclosure.

SEC's Disclosure Update and Simplification

In August 2018, the SEC adopted various rule amendments to update or eliminate certain disclosure requirements that the SEC referred to as "duplicative, overlapping, or outdated." The amendments were extremely detailed, particularly with respect to the accounting rules in Regulation S-X. A detailed discussion of the changes is beyond the scope of this alert, but three notable changes that could impact your upcoming annual report include the elimination of requirements to (i) include financial information by segment or geographic area and amounts spent on R&D activities, which overlapped with MD&A or GAAP requirements, (ii) disclose high and low prices of common equity if traded on a national exchange and the filing includes the company's ticker symbol and (iii) disclose restrictions that are likely to materially limit a company's ability to pay dividends.

Technical Changes to Form 10-K Cover Page

There are two changes to the cover page of annual reports on Form 10-K. The first change resulted from the SEC's June 2018 change to the definition of "smaller reporting company" to increase the threshold for eligibility from a public float of $75 million to $250 million. The second change resulted from the SEC's adoption of rules requiring the use of Inline XBRL.[3] The resulting cover page changes for Forms 10-Q and 10-K were effective in September 2018.

Form 10-K Exhibit Index Hyperlinks

Companies are advised to double check their Form 10-K exhibit hyperlinks being carried forward from last year's annual report to confirm that each properly links to the identified document. Incorrect hyperlinks in Exchange Act reports must be corrected in the next periodic report that includes Rule 601 exhibits.

Additional Information

Complying with SEC rules and regulations is a complex task within an ever-changing environment. If you would like additional information regarding the changes and trends discussed above, please contact your Kutak Rock attorney or one of the authors listed below. For more information regarding our practices, please visit us at www.KutakRock.com.

Contacts			
Kenneth S. Witt	Denver	(303) 292-7722	Ken.Witt@KutakRock.com
John P. Fletcher	Little Rock	(501) 975-3156	John.Fletcher@KutakRock.com
H. Watt Gregory, III	Little Rock	(501) 975-3102	Watt.Gregory@KutakRock.com
C. David McDaniel	Little Rock	(501) 975-3138	David.McDaniel@KutakRock.com
Geoffrey D. Neal	Little Rock	(501) 975-3155	Geoffrey.Neal@KutakRock.com
Steven P. Amen	Omaha	(402) 231-8721	Steven.Amen@KutakRock.com
Mark A. Ellis	Omaha	(402) 231-8744	Mark.Ellis@KutakRock.com
Edward P. Gonzales	Omaha	(402) 231-8734	Edward.Gonzales@KutakRock.com
Deborah S. Froling	Washington, D.C.	(202) 828-2319	Deborah.Froling@KutakRock.com
Jeremy T. Johnson	Washington, D.C.	(202) 828-2463	Jeremy.Johnson@KutakRock.com

[3] Currently, data in XBRL format is attached as an exhibit to SEC filings. Inline XBRL allows filers to embed XBRL data directly into the body of the SEC filing. The use of Inline XBRL will not be required in 2018 Form 10-Ks. However, the SEC has already implemented changes to the Form 10-K cover page to reflect the fact that the Inline XBRL amendments eliminate the need for operating companies to file separate XBRL exhibits or post an interactive data file on their websites. Large accelerated filers and accelerated filers will be required to use Inline XBRL beginning with their first Form 10-Q filing for a fiscal period ending on or after June 15, 2019 and June 15, 2020, respectively.