INSIGHTS

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PROXY SEASON POINTERS

The All-Purpose Proxy Statement?

By Bob Lamm

I've been hearing that shareholders miss the glory days of the annual report to shareholders. For those of you who are too young to remember, the glossy annual report was full of color photo layouts of happy employees and customers and puff-piece disclosures often too generic to be informative (or to risk liability).

Of course, even the glossiest of glossy annual reports had some substance—financial statements, an MD&A, and a letter from the CEO, though the latter was not always as substantive as one might wish. Puffy though they may have been, those annual reports were one of the few instances, or perhaps the only instance, of direct communication between companies and shareholders that weren't couched in legalese and that suggested that the companies were populated by actual human beings.

In other words, it's not really surprising that shareholders miss them. However, rather than go back to the good old days, many companies have opted to turn their proxy statements into Glossy Annual Reports 2.0.

And those companies include not only the photos and puff pieces, but also lots and lots (and lots) of harder information about topics such as the company's environmental/climate change activities, its performance in furthering diversity, equity, and inclusion, and much, much more.

That's not necessarily a bad thing. And it's certainly preferable to proxy statements that are treated as nothing but a legal document and don't contain any information unless it's required; those proxy statements are indistinguishable from proxy statements issued 40 or 50 years ago, and that isn't necessarily a good thing.

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

However, I respectfully suggest that companies opting for the all-purpose proxy statement need to consider whether producing a 200-page (or more) proxy statement that contains heavy-duty substantive information on a wide range of topics is the right approach.

Let's discuss that in a bit more detail. I start with the premise that a principal purpose of the annual meeting proxy statement is to advocate for the election of the directors. (Of course, proxy statements can and do address other topics, but at the end of the day I believe they are all about governance and the role of the board.) Therefore, it seems to me that an effective proxy statement will describe what the directors bring to the table in terms of skills and attributes; what they actually do; and why they should be re-elected—as an institutional investor friend of mine says, why giving that director a seat at the boardroom table is better than leaving the seat empty. That includes, for example, explaining how the board or a committee oversees some of today's important topics, such as those mentioned above (for example, environmental activities, DEI, etc.). (And I note that the companies who don't include that information because it's not "required" are, IMHO, missing a huge opportunity.)

However, I question whether the proxy statement is the place to include detailed statistical and other information on the company's greenhouse gas emissions, gender, racial, and other forms of diversity, and so on. That "stuff" often takes up dozens or pages, or more, and I just have to question whether it's a good, much less the best, use of the proxy statement real estate.

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To be clear, I am not saying that it's wrong to include tons of detailed information about today's hot topics. Rather, I think that including that information just because a peer or other company is including it is risky. In other words, every company needs to consider how best to communicate with its shareholders and act accordingly.

2023 Proxy Season: What to Think About

By Judy Mayo

The Securities and Exchange Commission's (SEC) new pay versus performance rule is foremost in the minds of public companies as they prepare for their upcoming proxy statement. But don't lose sight of other areas where investors and regulators will be paying particular attention this proxy season. Below we discuss topics where we've seen considerable focus:

Board Composition and Refreshment

- **Board diversity** continues to be a focus area for investors and regulators. The topic is not just omnipresent in investor engagement discussions, but also embodied in proxy advisor voting guidelines, institutional investor voting policies, and stock exchange regulations. While California courts have overturned as unconstitutional that state's laws requiring boards of public companies to include mandated numbers of women and members of underrepresented communities (the state of California is appealing), the push for Board diversity is not abating.

  The way diversity is disclosed is also under scrutiny. The SEC's regulatory agenda includes a rule to enhance disclosure about board diversity. While the more common approach among Fortune 100 companies is to provide only Board-level diversity statistics, there is a significant and growing number that identify diversity characteristics by director.

To consider:	— Do you clearly explain the Board's approach to diverse composition? Is it clear what diversity means? — Is it clear to stakeholders what diversity characteristics each director possesses? Would a photograph help communicate diversity? — Do you explain why the composition of the Board, including, or especially, the nominees, contains the appropriate level of diversity, and if not how the Board plans on getting to the ideal composition?

- **Board competency.** Investors are focusing on more than just diversity when they look at Board composition. In assessing Board nominees, investors are evaluating Board competency, informed decision-making and robust oversight. Director skills and expertise are a critical component of this evaluation, and investors are seeking more clarity about what makes a director an expert.

  The SEC's proposed rules on cybersecurity and climate change highlight this push: each rule proposes disclosure about whether any directors have expertise in the rule's subject matter, including supporting detail as necessary to fully describe the nature of the expertise. We expect that the new universal proxy card will result in enhanced

Judy Mayo *is Advisory Director of Argyle.*

description of nominee qualifications even in uncontested elections.

To consider:	— Do you sufficiently explain how the Board as a whole has the necessary skills and expertise to oversee the company's key risks and opportunities? — What experts should be identified? Should expertise be tied to the most significant risks and opportunities? — Do the directors' skills and expertise continue to reflect the evolving direction/ strategy of the company? How does the Board evaluate and refresh its skills?

Risk Oversight

Investor and regulator focus on risk oversight remains strong. They want to know not just *what* risks the Board is overseeing, but *how* they are exercising their oversight function.

- **Oversight Topics.** Consider what topics should be discussed together with risk or through the risk lens. The recent Boeing litigation highlighted the fundamental importance of active board oversight of "mission-critical" risks, and your enterprise risk management program can guide you in determining which risk topics should be on the Board's agenda. Recent SEC comment letters indicate that the SEC is looking for consistency between risk factor disclosure and Board oversight disclosures.

To consider:	— What significant risks does the Board devote significant time discussing? Are these the same as the "mission-critical" and other key risks identified by your environmental resource management (ERM) program? — Does the risk oversight disclosure adequately reflect the material risks disclosed in your financial report filings?

- **Process disclosures.** We are seeing more questions about the ERM process and how risks are identified, assessed, and labeled material or otherwise rise to the level of Board oversight, as well as how and when the Board receives information about those risks. The SEC is also asking those questions. The proposed rules on climate change and cybersecurity propose disclosure about how Board oversight is structured, the process by which the board is informed, the frequency of discussion, and integration of risks into the strategy/risk/financial oversight processes. Recent SEC comment letters also request more information about how the Board exercises oversight over particular risks.

To consider:	— Do you describe how the Board exercises its oversight responsibilities? Can stakeholders determine information flow and what the process entails? — Is your disclosure about the company's risk identification and management program transparent? Does it explain how management interacts with the Board on significant risk topics?

Environmental, Social, and Governance

- **Inter-report disclosure consistency.** Companies should consider consistency of environmental, social, and governance (ESG) disclosures between their proxy statement and their ESG reports, guided by the SEC's comment letters on the topic. The SEC has questioned both more expansive disclosures in ESG reports than in filed reports, as well as disclosure about significant ESG initiatives in proxy statements that aren't reflected in capex or cost disclosures in financial reports.

To consider:	— How does the company determine which ESG disclosures appear in what report?

- **Oversight structure.** We're seeing evolving models of Board oversight of ESG, including an integrated approach involving several committees overseeing different ESG aspects. Additionally, the structures, processes and disclosures for risk management and oversight of

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climate change as required by a final climate change (and cybersecurity) rule may become the best practice for other risk topics, such as ESG. Consider how the rules' requirements can inform your risk management/oversight program more broadly.

To consider:	— How is Board ESG oversight structured? Is this structure, and the rationale for it, clearly explained?

- **Clear link to strategy.** More than 50 "anti-ESG" shareholder proposals were submitted last year, with most of them going to vote. These proposals included demands for disclosure about cost/benefit analyses, charitable contributions and lobbying payments, and policies and training.

  In light of this "anti-ESG" movement, Boards may want to consider a more robust explanation of how their ESG program ties directly to strategy. Such disclosure would also be in line with the proposed climate change and cybersecurity rules that would require more disclosure linking to strategy.

To consider:	— Does your disclosure clearly show the link between the company's ESG program/ efforts and overall strategy? — Are your public political contributions and lobbying efforts, a well as your internal training and strategic planning efforts, consistent with your environmental and social programs and policies? Should that information be public?

- **Additional social disclosures and location.** Investors have been asking for additional data, and regulators are interested as well. Consider what additional data is appropriate and where disclosure should appear. Examples of possible disclosures include:
  a. *Workforce demographics and intersectionality*. Investors are asking for more "intersectional" data—showing diversity by employee classification, whether by disclosing EEO-1 data on the company's website or including intersectional data in public reports.
  b. *Equity*. Interest in pay and racial equity studies has grown, as well as in programs to identify and mitigate bias.
  c. *Workforce well-being*. Employee well-being proposals (such as harassment and safety) were the most common human capital management (HCM) shareholder proposals in 2022. The SEC's regulatory agenda includes a proposal for additional HCM disclosures, which Chairman Gensler has indicated might include training, turnover, and health & safety.
  d. *Social capital management*. This topic, which covers impact on stakeholders other than employees and shareholders (such as racial justice and human rights), constituted one of the largest categories of shareholder proposals last year, up considerably from the prior year. While only about 10 percent passed, the intertest in this topic has grown.
  e. *Hot Topics*. Given the variety of social shareholder proposal topics last year, we would not be surprised to see more proposals related to abortion access and reproductive rights (anti-ESG entities have already indicated they would submit), as well as on the broader impact of company/ products/externalities on the community (2022 saw an increase in proposals regarding "system stewardship").

To consider:	— Are there social topics/statistics that the CEO would like to highlight in his/her proxy letter, or as a "spotlight" of Board oversight? Are cross-references to other company publications containing social information appropriate?

Executive Compensation

- **Pay versus Performance.** The new rule will add considerable volume to the proxy statement. Consider the most effective—readable and understandable—presentation of required disclosures, such as narrative versus graphics, tabular presentations, highlights and callouts. Consider also the iXBRL requirement.
- **Incentive Programs.** Clear and transparent disclosure about incentive programs is a perennial demand.

To consider:	— *Clarity*. Are all your incentive goals described? Are the descriptions and mechanics easy to understand? Can a graphic help illustrate the goal? — *Goal rigor*. An article in the Harvard Law School Forum on Corporate Governance indicates Institutional Shareholder Services (ISS) is scrutinizing goal rigor where goals were lowered following challenging business conditions. Do you show continuing rigor? — *Individual performance/other discretionary elements*. These elements continue to draw scrutiny. Are the parameters for awarding compensation based on individual performance, as well as the exercise of discretion, clearly set out? — *ESG performance metrics*. While an ESG metric in incentive compensation evidences the importance of ESG to the company, investors are not keen on any metric that doesn't advance the company's strategy. As with all goals, does your disclosure clearly communicate how your ESG incentive goals are tied to strategy? Are the metrics and achievements clearly explained?

- **Company-Specific Issues.** As always, it is imperative to clearly explain the rationale behind one-time awards, seemingly unchallenging goals, multi-year guaranteed payments, and unusual pay structures.
- **Board engagement and responsiveness.** While pay/performance alignment is ISS's most prevalent compensation concern, board communications with and responsiveness to shareholders is one of ISS's five key SOP evaluation standards and is the second most common factor where ISS has high concern in companies with a negative recommendation—and in some companies it was the ONLY area of high concern.

To consider:	— Does your disclosure sufficiently describe the breadth of engagement with and feedback from investors, and how the Board responded to that feedback?

Other Topic-Specific Considerations

Climate change	— The proposed climate change rule is complex and entails much more granular disclosure than has been typical. Among other things, companies should be preparing for detailed disclosures about their processes for climate change governance, both at the management and Board levels. — Consider how to describe the Board's oversight of climate-related financial disclosures and ESG reporting; discussion about this seems to center around the audit committee.
Cybersecurity	— Companies should be laying the groundwork for compliance with the requirements of the proposed cybersecurity rule, including, if appropriate, formalizing cybersecurity risk management processes and the cybersecurity governance/oversight structure and process, at both the management and Board levels.
Ukraine	— Per the Division of Corporate Finance's sample comment letter, companies should consider disclosure of the role of the Board in overseeing material risk relating to Ukraine. State Street's guidance on geopolitical risk also highlights the importance of ensuring that companies adequately communicate the Board's involvement in overseeing significant risk topics.

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Reputational Risk	— In several comment letters concerning particular risk topics, the SEC also asked companies about related reputational risk. Consider whether Board oversight of reputational risk is adequately disclosed.
Political Spending and Lobbying	— Stakeholder shave been focusing on the alignment between company values and priorities, on the one hand, and political spending and lobbying on the other. About 20 such "values congruency" shareholder proposals were submitted last year, with average support of the 10 going to vote about 40%. Consider whether proactive disclosure of your company's values congruency is appropriate.

Diversity Disclosure Trends

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

Many public companies now voluntarily provide Board and high-level workforce diversity information in their public filings. Further, Nasdaq-listed companies must now disclose director diversity data in a specifically-formatted disclosure matrix. Notwithstanding these developments, and legal challenges to the Nasdaq rule, investors continue to call on companies to disclose more granular diversity data, including with respect to employees.

To date, the increased prevalence and visibility of diversity disclosures has not been driven by Securities and Exchange Commission (SEC) rules, which require diversity disclosures only in limited contexts. This framework may change in the near term, however, as the SEC is considering whether to mandate diversity disclosures regarding company directors and employees.

We believe that companies will continue to face increased calls for this information from institutional investors, other shareholders and the SEC.

Kerry Burke, **David Engvall**, *and* **Matt Franker** *are partners,* **David Martin** *is senior counsel, and* **Will Mastrianna** *is an associate at Covington and Burling LLP.*

Shareholder Proposals: Focus on Diversity Disclosures

Since late 2020, shareholders have used the shareholder proposal process to request more detailed diversity data from companies. Such requests have asked companies to publish a range of demographic data, including categories of employees who have been awarded equity grants. These proposals have also asked for public disclosures of EEO-1 reports, which are reports that companies with more than 100 US employees are required to file annually with the Equal Employment Opportunity Commission.

These reports are non-public and contain workforce demographic information across 10 employment categories and on an aggregate basis. In response to investor pressure, the majority of the S&P 500 now publicly disclose these reports, typically by posting the report on the company's website and providing disclosure of that fact in their Form 10-K or proxy statement. Certain institutional investors have incorporated disclosure of EEO-1 reports into their voting decisions, most notably State Street, which has stated that it will vote against the compensation committee chair of S&P 500 companies that do not make their EEO-1 reports public. More companies are likely to disclose their EEO-1 reports in light of these developments.

Investors have also begun submitting a relatively new category of shareholder proposal to prompt companies to assess their diversity efforts and disclose the results of these assessments. These proposals often request that companies perform an audit of a particular diversity-related issue, such as racial equity, civil rights or environmental justice. For example, a typical racial equity audit proposal may call for a company to commission a third-party review and assessment of the company's efforts to promote racial equity goals and to mitigate racial equity-related risks. It is likely that these proposals will continue to be submitted to companies in future proxy seasons and more companies will decide to undertake assessments along these lines.

Potential SEC Rulemakings on Director and Employee Diversity

The SEC has signaled that it intends to propose new or amended rules that would require companies to disclose additional information about board diversity and, for the first time, diversity data regarding employees. This would represent a notable change in focus for the SEC. Existing rules only require companies to disclose basic demographic data for directors and officers, and also disclose whether boards of directors and board committees charged with director nominations consider diversity factors when evaluating board nominees.

Existing SEC rules are generally silent regarding employee diversity disclosures. As recently as 2020, when the SEC amended Item 101 of Regulation S-K to require principles-based disclosures regarding human capital management, the SEC decided not to require specific employee diversity disclosures, meaning that under the current disclosure framework, companies have wide latitude when describing their human capital resources and any human capital measures or objectives that they focus on when managing their businesses.

New SEC rulemakings will likely take a different approach and mandate diversity disclosures covering both directors and employees (the latter in the context of human capital management). The SEC seems poised to propose a board diversity rule which may require more detailed diversity disclosures regarding individual directors, nominees and the board as a whole.

A new SEC rule may require a standardized disclosure presentation for diversity data that is similar to the matrix required for Nasdaq-listed companies. The SEC may also propose more prescriptive revisions to the human capital management disclosure rules to require companies to disclose workforce diversity and demographic metrics.

Shareholders Are Looking for Alignment Between Your ESG Disclosures and Political Spending

By June Hu

Consistency in your environmental, social and governance (ESG) messaging is more crucial than ever this proxy season. Given the increasing politicization of ESG, it is important to remember that shareholders and other key stakeholders may be looking at your political spending in addition to your public statements when evaluating your overall ESG story.

For several years now, stakeholders have demanded that companies do more than "talk

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the talk" on ESG. Rather, they have insisted that companies demonstrate their commitment to stated ESG goals and priorities—for example, on diversity, equity and inclusion—though policies, practices and measurable progress, and have sought to hold companies accountable for perceived misalignment. The Securities and Exchange Commission's (SEC) recent enforcement actions and letters to companies demonstrate that the Staff is also scrutinizing ESG disclosures in companies' filings, ESG reports, press releases, website and social media posts and other public statements for potential misalignment.

During the 2022 proxy season, companies in the S&P Composite 1500 received, for the first time, a meaningful number of proposals demanding that they assess (or hire a third party to assess) their stated ESG priorities and their political spending/lobbying activities for potential misalignment. Notably, companies received these proposals from both "pro-ESG" (such as As You Sow) and "anti-ESG" proponents (such as the National Center for Public Policy Research).

Many of the so-called congruency proposals suggested that a company's political contributions are inconsistent with its ESG statements, citing its contributions to candidates who have taken a position on particular issues (for example, reproductive rights, climate change, expanded LGBTQIA+ rights, voter access). In particular, 16 companies received proposals for meetings in H1 2022 regarding the alignment between their lobbying activities and the Paris Agreement goals, which many US companies have adopted and announced as part of their effort to combat climate change.

Proponents managed to obtain a settlement with the company on many of these proposals before the shareholder meeting. (The SEC denied all no-action requests on these proposals.) When these proposals did reach a vote, they managed to attract relatively high shareholder support (generally between 30 percent and 50 percent of votes cast). In light of these results, some proponents have already indicated that they plan to submit more "political congruency" proposals during the upcoming proxy season.

As you are preparing for shareholder engagement this proxy season, it may be a good idea to consider what message your political contributions may be sending to your investors regarding your ESG commitments and priorities. (It may also make sense to do a similar exercise with respect to your charitable donations, since some shareholders are also scrutinizing—and submitting proposals on—the alignment between donations and ESG statements.) Doing so proactively can help you anticipate questions from your investors, and prepare a narrative, which should be vetted by a cross-functional team, that is both accurate and compelling.

If you receive a "congruency" proposal, as a threshold matter, you should consider the identity and policy goals of the proponent. This year, we have seen meaningful differences in voting results where "pro-ESG" and "anti-ESG" proponents submitted proposals on the same topic, even where the proposals were facially indistinguishable. For the upcoming proxy season, management should consider whether it would be appropriate to include information on a proponent's identity and policy goals (to the extent not obvious from the text of the proposal) in their recommendations.

Universal Proxy: Five Takeaways and Five Action Items

By Jurgita Ashley and Julia Miller

The 2023 proxy season is rapidly approaching; among other things, companies will need to keep in mind the Securities and Exchange Commission's (SEC) new universal proxy rules, which are now in effect and already being used in proxy campaigns. What will be different for contested elections? Below are five takeaways:

1. ***Universal Proxy Cards Mandated in Proxy Contests.*** Both companies and activist shareholders are now required to use universal proxy cards, that is, proxy cards listing both company and shareholder nominees, for *contested* shareholder meetings. This gives shareholders greater flexibility in voting by allowing them to "mix and match" from both the company's and the activist's nominees when voting for directors in proxy fights. Before these rules went into effect, unless attending and voting at the meeting, shareholders generally voted using either the company's proxy card, with only the company's nominees, or the activist's proxy card, with only the activist's nominees, with the last card voted cancelling any previous ones.
2. ***No Minimum Ownership Requirements.*** In contrast to proxy access, there are no requirements regarding minimum ownership or how long shares have been held for activist shareholders to use universal proxy cards.
3. ***67 Percent Solicitation Requirement.*** Activists are required to solicit shareholders representing at least 67 percent of the voting power of shares entitled to vote on the director election and to include a representation to that effect in their proxy statement or proxy card. The 67 percent solicitation requirement is for the percentage of the shares, not the percentage of the shareholders, so where there are many large shareholders, it is easier for activists to achieve this threshold. Activists can also use "notice and access" (that is, electronic solicitation after a short paper notice is mailed).
4. ***Company and Activist Notices.*** An activist is required to notify the company of the names of the activist's nominees at least 60 days before the anniversary of the prior year's annual meeting (unless previously disclosed in the activist's preliminary or definitive proxy statement); the company is required to provide the names of the company's nominees to the activist at least 50 days before such anniversary. (These deadlines are different if no annual meeting was held during the prior year or if the meeting date changed by more than 30 days from the prior year.) Activists are also required to file their definitive proxy statement by the later of (a) 25 days prior to the shareholders' meeting and (b) five days after the company files its definitive proxy statement.
5. ***Presentation; Format; and Disclosure.*** Both companies and activists will need to comply with new technical requirements as to information in their proxy card and proxy statements, as well as certain formatting requirements for the proxy card.

Jurgita Ashley *and* **Julia Miller** *are attorneys of Thompson Hine LLP.*

Five Action Items

While obtaining control of the majority of the board is now more difficult, the universal proxy makes it easier for activists to wage proxy campaigns and to obtain a seat, or a few seats, on the board. The

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universal proxy can also be used by some activists as a strategy to get more attention for their causes, potentially including some shareholder proponents who might otherwise submit shareholder proposals rather than director nominations. With that in mind, how should companies prepare? Consider the following five action items:

1. ***Develop a Response Plan.*** More companies are likely to receive director nominations than in the past and will need to be ready to review them and respond. As the 2023 proxy season approaches, develop an action plan and have a team in place, should the company receive any nominations. As activists are still required to comply with any advance notice provisions, companies with such provisions will receive notice of any nominations in accordance with their advance notice deadlines, which will generally provide more than the 60 days' notice required under the universal proxy rule.
2. ***Highlight Directors' Expertise.*** With both the company's and the activist's director nominees on the same proxy card, a limited number of board seats, and shareholders' ability to mix and match candidates from competing slates, there will be intense scrutiny on individual directors in contested elections. As such, board evaluations, skills assessments, and well-developed biographical and expertise disclosures can be impactful.

   Review directors' proxy bios with a fresh eye and consider if any skills or expertise should be highlighted. For example, activists may highlight environmental, social and governance (ESG) and sustainability skillsets of their nominees, as well as diversity of their candidates. Consider also if D&O questionnaires should be built out to obtain or confirm this type of information.
3. ***Keep in Mind New Deadlines and Disclosures.*** The universal proxy rules include technical changes, including for the proxy card used in proxy contests. Companies should also remember to include the deadline for universal proxy nominations in their proxy statements and to monitor any activists' submissions and activity.
4. ***Review Bylaws.*** Companies should take a look at their bylaws and consider if advance notice bylaws should be amended, both to make the universal proxy requirements (such as activists' notice period and 67 percent solicitation requirement) contractual and to tighten other advance bylaw protections, such as the information that activists should provide to companies and the timing of such disclosures.
5. ***Prepare for the Unexpected.*** Universal proxy access is uncharted territory. Companies should monitor trends and developments, particularly at peer companies, as both traditional and non-traditional activists review their strategies in light of the new rules and may engage in similar campaigns at multiple companies.

Pay-versus-Performance Disclosure FAQs

By Cam Hoang and Dale Williams

Reporting companies must begin to comply with the Securities and Exchange Commission's (SEC) new pay-versus-performance disclosure requirements in proxy and information statements for fiscal years ending on or after December 16, 2022. Companies should establish expectations and a process now for collecting, calculating and analyzing the necessary information and modeling the results, particularly since the SEC's version of "executive compensation

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actually paid" may be a departure from how boards and management have historically analyzed pay-versus-performance.

Which Companies Are Subject to the Rules?

New Item 402(v) of Regulation S-K will apply to all reporting companies, except foreign private issuers, registered investment companies, and Emerging Growth Companies. Smaller Reporting Companies (SRCs) will be permitted to provide scaled disclosures.

Where May the New Disclosure Be Located?

The final rules provide reporting companies with flexibility in determining where in the proxy or information statement to provide the required disclosure. The SEC believed that mandating disclosure in the CD&A may cause confusion by suggesting that the company considered the pay-versus-performance relationship in its compensation decisions, which may or may not be the case. The information required by Item 402(v) will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, including Part III of Form 10-K, except to the extent that the company specifically incorporates it by reference.

Will the New Disclosure Be Subject to a Say-On-Pay Vote?

The adopting release specifies that the rules are intended to help investors better assess an executive compensation program when making voting decisions, for example when exercising their rights to cast advisory votes on executive compensation or when electing directors. Shareholders may factor the pay-versus-performance disclosure into their advisory vote on executive compensation, which covers the compensation of named executive officers, as disclosed pursuant to Item 402.

What Disclosure Is Required?

Pay-versus-Performance Table

Reporting companies must provide a table disclosing specified executive compensation and financial performance measures for their five most recently completed fiscal years, or three for SRCs. We have provided a template of the table at the end of this article, with explanatory footnotes as to the information companies must prepare to populate the table. Companies may supplement the tabular disclosure, for example with graphs, so long as any additional disclosure is clearly identified as supplemental, not misleading, and not presented with greater prominence than the required disclosure.

Registrants will be required to include in the table, for the principal executive officer (PEO) and, as an average, for the other named executive officers (NEOs):

- Total compensation as presented in the Summary Compensation Table and
- A measure reflecting "executive compensation actually paid," as prescribed in Item 402(v), with adjustments to the pension values and equity awards disclosed in the Summary Compensation Table and with footnote disclosure of the amounts that are deducted from, and added to, the Summary Compensation Table amounts.
  - Companies will need to calculate the fair value, and changes in fair value, of outstanding equity awards as of the end of each fiscal year and as of each vesting date, and they will need to provide footnotes describing any material changes in underlying assumptions. They can begin these calculations now.
  - SRCs will not be required to disclose amounts related to pensions for purposes of disclosing executive compensation actually paid.

The final rules do not require aggregating the compensation of PEOs in years when a company had multiple PEOs. Instead, the final rules require that, in those years, registrants include separate Summary Compensation Table total compensation

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and executive compensation actually paid columns for each PEO.

The financial performance measures to be included in the table are:

- Total shareholder return (TSR) for the reporting company, calculated on the same cumulative basis as is used in Item 201(e) of Regulation S-K, measured from the market close on the last trading day before the company's earliest fiscal year in the table through and including the end of the fiscal year for which TSR is being calculated, and based on a fixed investment of one hundred dollars at the measurement point;
- TSR for the reporting company's peer group, weighted according to the respective issuers' stock market capitalization at the beginning of each period for which a return is indicated, using either the same peer group used for purposes of Item 201(e) of Regulation S-K or a peer group used in the CD&A for purposes of disclosing registrants' compensation benchmarking practices; if the peer group is not a published industry or line-of-business index, the identity of the issuers composing the group must be disclosed in a footnote or incorporated by reference from another filing;
- The reporting company's net income; and
- A financial performance measure chosen by the reporting company and specific to the company (Company-Selected Measure) that, in its assessment, represents the most important financial performance measure the company uses to link compensation actually paid to the NEOs to company performance for the most recently completed fiscal year.

As the Company-Selected Measure must be a measure included in the tabular list of performance measures described below, the determination of "most important" that registrants must use for selecting Company-Selected Measures is the same as the determination they must use for selecting required measures for the tabular list. As a result, the SEC acknowledges that the Company-Selected Measure could change from one filing to the next.

SRCs are exempted from disclosing peer group TSR and the Company Selected Financial Measure.

Clear Description of Relationships

Item 402(v) also will require a reporting company to provide a clear description of:

- The relationships between each of the financial performance measures included in the table and the executive compensation *actually paid* to its PEO and, on average, to its other NEOs over the company's five most recently completed fiscal years; and
- The relationship between the company's TSR and its peer group TSR.

Reporting companies have flexibility as to the format in which to present the descriptions of these relationships, whether graphical, narrative, or a combination of the two.

- For example, a graph may provide 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.

Reporting companies also will have the flexibility to decide whether to group any of these relationship disclosures together when presenting their clear description disclosure, but any combined description of multiple relationships must be "clear."

SRCs will only be required to present such clear descriptions with respect to the measures they are required to include in the table and for their three, rather than five, most recently completed fiscal years.

Tabular List of Most Important Performance Measures

- Reporting companies other than SRCs also will be required to provide an unranked, tabular list of the three to seven most important financial performance measures used to link executive compensation *actually paid* to its NEOs during the last fiscal year to company performance. There may one list for all NEOs, one for the PEO and one for the remaining NEOs, or separate lists for each NEO.
- If fewer than three financial performance measures were used for the most recently completed fiscal year, the tabular list must include all such measures that were used, if any.
- Reporting companies are permitted, but not required, to include non-financial measures in the list if they considered such measures to be among their three to seven "most important" measures.

Are Performance Measures Subject to Rules Regarding Disclosure of Non-GAAP Financial Measures?

Because the disclosure is intended, among other things, to supplement the CD&A, the SEC believes it is appropriate to treat non-GAAP financial measures provided under Item 402(v) of Regulation S-K consistently with the existing CD&A provisions. As a result, the final rules specify that disclosure of a measure that is not a financial measure under generally accepted accounting principles will not be subject to Regulation G and Item 10(e) of Regulation S-K; however, disclosure must be provided as to how the number is calculated from the company's audited financial statements.

May Reporting Companies Keep Existing Pay-Versus-Performance Disclosure, or Supplement the Information Required by Item 402(V)?

Reporting companies may provide additional pay-versus-performance information beyond what is specifically required by Item 402(v) of Regulation S-K, but they should weigh the potential for confusion against the benefit of representing the board and management's point of view. For example, companies that are already providing voluntary pay-versus-performance disclosures may generally continue to provide such disclosures in their present format, or could include disclosure of long-term performance metrics measured over periods longer than a single fiscal year.

Companies will be permitted to include additional compensation and performance measures, or additional years of data, in the newly required table. Any supplemental measures of compensation or financial performance and other supplemental disclosures provided by companies must be clearly identified as supplemental, not misleading, and not presented with greater prominence than the required disclosure.

Must the Disclosure Be Tagged Using Inline XBRL?

Reporting companies will be required to use Inline XBRL to tag their pay versus performance disclosure. An SRC will only be required to provide the required Inline XBRL data beginning in the third filing in which it provides pay versus performance disclosure, instead of the first.

How Will Disclosure Be Phased In?

Reporting companies other than SRCs will be required to provide the information for three years in the first proxy or information statement, adding another year of disclosure in each of the two subsequent annual proxy filings that require this disclosure. SRCs will initially be required to provide the information for two years, adding an additional year of disclosure in the subsequent annual proxy or information statement that requires this disclosure.

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					Value of Initial Fixed $100 Investment Based On:			
Year (a)	Summary Compensation Table Total for PEO (b)	Compensation Actually Paid to PEO (c)	Average Summary Compensation Table Total for non-PEO Named Executive Officers (d)	Average Compensation Actually Paid to non-PEO Named Executive Officers (e)	Total Shareholder Return (f)	Peer Group Total Shareholder Return (g)	Net Income (h)	[Company-Selected Measure] (i)
[Year]								
[Year]								
[Year]								
[Year]								

Pay-versus-Performance Table Template

The following template and accompanying footnotes are intended to assist reporting companies in their preparation of the pay-versus-performance table required under Item 402(v) of Regulation S-K for annual proxy and information statements. The footnotes are a summary subject to the full set of requirements established under Item 402(v).

(a) The information in the Pay Versus Performance Table should be provided for each of the registrant's last five completed fiscal years, or last three completed fiscal years for Smaller Reporting Companies. Registrants must begin to comply with these disclosure requirements in proxy and information statements that are required to include Item 402 executive compensation disclosure for fiscal years ending on or after December 16, 2022. Smaller Reporting Companies are only required to provide this disclosure for the last two fiscal years in the first applicable filing and then for an additional year in the subsequent annual filing. All other registrants are required to provide the disclosure for three fiscal years in the first applicable filing and to provide disclosure for an additional year in each of the two subsequent annual proxy filings where disclosure is required.

(b) The total compensation of each Principal Executive Officer (the "PEO") who served during the covered fiscal year, as reported in the Summary Compensation Table. Use separate columns for multiple PEOs.

(c) Start with total compensation from the Summary Compensation Table for the covered fiscal year. Deduct the aggregate change in the actuarial present value of the accumulated benefit under all defined benefit and actuarial pension plans reported in the Summary Compensation Table and add, for all defined benefit and actuarial pension plans reported in the Summary Compensation Table:

(i) the service cost, calculated as the actuarial present value of the benefit under all such plans attributable to services rendered during the covered fiscal year (GAAP); and

(ii) prior service cost, calculated as the entire cost of benefits granted (or credit for benefits reduced) in a plan amendment (or initiation) during the covered fiscal year that are attributed by the benefit formula to services rendered in periods prior to the amendment (GAAP).

Deduct the amounts reported for stock and option awards from the Summary Compensation Table and then include an

amount calculated as follows for all stock and option awards, with or without tandem SARs (including awards that subsequently have been transferred):

(i) add the fair value as of the end of the covered fiscal year of all awards granted during the covered fiscal year that are outstanding and unvested as of the end of the covered fiscal year;
(ii) add the amount equal to the change as of the end of the covered fiscal year (from the end of the prior fiscal year) in fair value (whether positive or negative) of any awards granted in any prior fiscal year that are outstanding and unvested as of the end of the covered fiscal year;
(iii) add, for awards that are granted and vest in the same year, the fair value as of the vesting date;
(iv) add the amount equal to the change as of the vesting date (from the end of the prior fiscal year) in fair value (whether positive or negative) of any awards granted in any prior fiscal year for which all applicable vesting conditions were satisfied at the end of or during the covered fiscal year;
(v) subtract, for any awards granted in any prior fiscal year that fail to meet the applicable vesting conditions during the covered fiscal year, the amount equal to the fair value at the end of the prior fiscal year; and
(vi) add the dollar value of any dividends or other earnings paid on stock or option awards in the covered fiscal year prior to the vesting date that are not otherwise included in the total compensation for the covered fiscal year.

For any awards that are subject to performance conditions, calculate the change in fair value as of the end of the covered fiscal year based upon the probable outcome of such conditions as of the last day of the fiscal year. Fair value amounts must be computed in a manner consistent with methodology under GAAP.

Use separate columns for multiple PEOs. Footnote the amounts that are deducted from, and added to, the Summary Compensation Table amounts, the name of each NEO included as a PEO, and the fiscal years in which such persons are included. For equity awards, footnote any assumption made in the valuation that differs materially from those disclosed as of the grant date of such equity awards.

(d) Average summary compensation of the non-PEO NEOs as reported in the Summary Compensation Table.
(e) See instructions to footnote (c). Footnote the average amounts that are deducted from, and added to, the Summary Compensation Table amounts, the name of each NEO included, and the fiscal years in which such persons are included.
(f) For each fiscal year, start with cumulative total shareholder return (TSR) as calculated for the performance graph under Item 201(e) of Regulation S-K, by dividing the sum of the cumulative amount of dividends for the measurement period, assuming dividend reinvestment, and the difference between the share price at the end and the beginning of the measurement period; by the share price at the beginning of the measurement period. The term “measurement period” must be the period beginning at the “measurement point” established by the market close on the last trading day before the registrant’s earliest fiscal year in the table, through and including the end of the fiscal year for which cumulative TSR is being calculated. The closing price at the measurement point must be converted into a fixed investment of one hundred dollars, stated in dollars, in the registrant’s stock (or in the stocks represented by the peer group). For each fiscal year, the amount included in the table must be the value of such fixed investment based on the cumulative TSR as of the end of that year.

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(g) See instructions to footnote (f). The returns of each component issuer of the peer group must be weighted according to the respective issuers' stock market capitalization at the beginning of each period for which a return is indicated. For purposes of determining the TSR of the registrant's peer group, the registrant must use the same index or issuers used by it for purposes of the performance graph under Item 201(e)(1)(ii) of Regulation S-K or, if applicable, the companies it uses as a peer group for purposes of its disclosures under the CD&A. If the peer group is not a published industry or line-of-business index, footnote the identity of the issuers composing the group or incorporate by reference. If the registrant selects or otherwise uses a different peer group from the peer group used by it for the immediately preceding fiscal year, explain, in a footnote, the reason(s) for this change and compare the registrant's cumulative TSR with that of both the newly selected peer group and the peer group used in the immediately preceding fiscal year.

(h) Net income of the registrant.

(i) A financial performance measure chosen by the registrant and specific to the registrant (Company-Selected Measure) that, in the registrant's assessment, represents the most important financial performance measure the registrant uses to link compensation actually paid to the registrant's NEOs to company performance for the most recently completed fiscal year.

SEC RULEMAKING

SEC Adopts Final Rules Mandating Compensation Clawback Policies

By Joshua A. Agen, Jessica S. Lochmann, Leigh C. Riley, John K. Wilson, and Samuel J. Winer

On October 26, 2022, the Securities and Exchange Commission (SEC) adopted final rules implementing Section 954 of the Dodd-Frank Act by directing national securities exchanges and associations, such as the New York Stock Exchange and Nasdaq, to adopt listing standards that will require listed companies to develop and implement compensation clawback policies.[1]

Under the final rules, listed companies will be required to have written compensation clawback policies that require the recoupment of certain incentive-based compensation received by current or former "executive officers" when an issuer has an accounting restatement. Listed companies will also be required to make certain disclosures about their clawback policies. The listing standards will generally apply to all issuers with a class of securities listed on a national securities exchange or association, including foreign private issuers, controlled companies, smaller reporting companies and emerging growth companies.

The final rules materially expand the scope of the SEC's original compensation clawback policy proposal published in 2015. Public companies and their audit and compensation committees, executive officers and outside advisors should begin preparing now to deal with the significant implications of the final rules.

Joshua A. Agen, Jessica S. Lochmann, Leigh C. Riley, John K. Wilson, *and* **Samuel J. Winer** *are attorneys of Foley & Lardner LLP.*

Required Elements of the Clawback Policies

The clawback policies mandated by the new Rule 10D-1 will have to meet various requirements as to their scope and application, as summarized below.

Type of Restatement Triggering Recovery of Compensation

The clawback policy will be triggered when an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws. Triggering restatements will include any required accounting restatement to correct an error in previously issued financial statements that is material to the previously issued financial statements, or that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period.

Thus, in a change from the proposed rule, under the final rule, triggering restatements will include both "Big R" restatements and "little r" restatements. In determining when a restatement is triggered, the SEC reminded issuers that SEC Staff has provided guidance on making materiality determinations in Staff Accounting Bulletin No. 99, *Materiality*, and Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements.*

Rule 10D-1 does not define "accounting restatement" or "material noncompliance" as existing accounting standards and guidance set forth the meaning of those terms. Under current accounting standards, certain changes would not constitute an error correction, including the following: retrospective application of a change in accounting principle;

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retrospective revision to reportable segment information due to a change in internal organization structure; retrospective reclassification due to a discontinued operation; retrospective application of a change in reporting entity; retrospective adjustment to provisional amounts in connection with a prior business combination; and retrospective revision for stock splits, reverse stock splits, stock dividends or other changes in capital structure.

Individuals Covered

The clawback policy will be required to apply to any individual who served as an executive officer at any time during the performance period that applied to the incentive-based compensation that the individual received. Accordingly, the policy will apply to both current and former executive officers.

Rule 10D-1 uses a definition of "executive officer" similar to the definition under Rule 16a-1(f) of the Securities Exchange Act of 1934 (Exchange Act), rather than the definition of "executive officer" under Rule 3b-7 under the Exchange Act. This definition generally includes the issuer's president, principal financial officer, principal accounting officer (or, if none, the controller), any vice-president in charge of a principal business unit, division or function, and any other officer who performs a policy-making function, or any other person who performs similar policymaking functions.

It will not be relevant whether there is any fault on the part of the executive officer or whether the executive officer was involved in preparing the financial statements. Companies will not be able to indemnify officers or pay for insurance to cover amounts that are clawed back.

Definition of "Incentive-Based Compensation" Subject to Recovery

The clawback policy will be required to apply to "incentive-based compensation," which is defined as compensation that is granted, earned or vested based wholly or in part upon the attainment of a "financial reporting measure." "Financial reporting measure" is defined as a measure that is determined and presented in accordance with the accounting principles used in preparing financial statements, and any measures derived from such measures.

This includes non-GAAP financial measures and other measures not presented in the financial statements or SEC filings. "Financial reporting measure" is also defined to include stock price and total shareholder return (TSR).

The SEC noted that "incentive-based compensation" is to be determined in a principles-based manner so that new forms of compensation and new measures of performance will be captured. The SEC provided in the adopting release a non-exhaustive list of examples of "incentive compensation":

- Non-equity incentive plan awards that are earned based wholly or in part on satisfying a financial reporting measure performance goal;
- Bonuses paid from a "bonus pool," the size of which is determined based wholly or in part on satisfying a financial reporting measure performance goal;
- Other cash awards based on satisfaction of a financial reporting measure performance goal;
- Restricted stock, restricted stock units, performance share units, stock options, and stock appreciation rights (SARs) that are granted or become vested based wholly or in part on satisfying a financial reporting measure performance goal; and
- Proceeds received upon the sale of shares acquired through an incentive plan that were granted or vested based wholly or in part on satisfying a financial reporting measure performance goal.

The SEC also provided examples of compensation that is not "incentive-based compensation":

- Salaries (unless an increase is based wholly or in part on satisfying a financial reporting measure performance goal);
- Discretionary bonuses not paid from a "bonus pool" determined by satisfying a financial reporting measure performance goal;

- Bonuses paid solely upon satisfying one or more subjective standards or completion of a specified employment period;
- Non-equity incentive plan awards earned solely upon satisfying strategic or operational measures; and
- Equity awards for which the grant is not contingent on achieving any financial reporting measure performance goal and vesting if contingent solely upon continued employment or attaining nonfinancial reporting measures.

Time Periods Covered

The clawback policy will apply to incentive-based compensation "received" during the three fiscal years (and certain transition periods resulting from a change in fiscal year) preceding the date on which the issuer is required to prepare the accounting restatement. Compensation will be deemed "received" when the performance condition is satisfied, even if the compensation is not actually paid or granted until a later date. The SEC noted in the adopting release that the date of receipt of the compensation depends on the terms of the award and provided the following examples:

- If the grant of an award is based, either wholly or in part, on satisfaction of a financial reporting measure performance goal, the award would be deemed received in the fiscal period when that measure was satisfied;
- If an equity award vests only upon satisfaction of a financial reporting measure performance condition, the award would be deemed received in the fiscal period when it vests;
- A non-equity incentive plan award would be deemed received in the fiscal year that the executive officer earns the award based on satisfaction of the relevant financial reporting measure performance goal, rather than a subsequent date on which the award was paid; and
- A cash award earned upon satisfaction of a financial reporting measure performance goal would be deemed received in the fiscal period when that measure is satisfied.

The date on which the issuer is required to prepare the accounting restatement will be the earlier of (a) the date the board, committee or authorized officer concludes, or should reasonably have concluded, that the issuer is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement or (b) the date a court, regulatory or other legally authorized body orders a restatement. The SEC noted in the adopting release that the determination an issuer is required to prepare an accounting restatement may occur before the precise amount of the error has been determined.

For an accounting restatement for which an issuer is required to file an Item 4.02(a) Form 8-K, the conclusion that the issuer is required to prepare an accounting restatement is expected to coincide with the occurrence of the event disclosed in the Form 8-K. Furthermore, in determining when there should reasonably have been a conclusion to prepare an accounting restatement, the SEC noted that an issuer would have to consider any notice it may receive from its auditor that previously issued financial statements contain a material error.

Amount of Recovery

The amount of the recovery will be the amount by which the incentive-based compensation the executive officer actually received exceeds the amount the executive officer would have received based on the restated numbers. The amount of the recovery will be calculated on a pre-tax basis. Where the incentive-based compensation is based on stock price or TSR, reasonable estimates can be used to calculate the excess amount, but the issuer must maintain documentation of the determination of the reasonable estimate and provide the documentation to its national securities exchange or association.

The SEC noted that the definition of erroneously awarded compensation is intended be applied in a principles-based manner but provided the following guidance:

- For cash awards, the erroneously awarded compensation is the difference between the amount of the cash award (whether payable

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as a lump sum or over time) that was received and the amount that should have been received applying the restated financial reporting measure.

- For cash awards paid from bonus pools, the erroneously awarded compensation will be a pro rata portion of any deficiency that results from the aggregate bonus pool that is reduced based on applying the restated financial reporting measure.
- For equity awards, if the shares, options, or stock appreciation rights (SARs) are still held at the time of recovery, the erroneously awarded compensation will be the number of such securities received in excess of the number that should have been received applying the restated financial reporting measure (or the value of that excess number). If the options or SARs have been exercised, but the underlying shares have not been sold, the erroneously awarded compensation will be the number of shares underlying the excess options or SARs (or the value thereof).

Amounts recovered from the executive under Section 304 of the Sarbanes-Oxley Act of 2002 may be credited as a reduction in the amount required to be recovered under the Rule 10D-1 clawback, but the adopting release states that recovery under Rule 10D-1 will not preclude recovery under the Sarbanes-Oxley Act to the extent any applicable amounts have not been reimbursed to the issuer.

Recovery Mandatory Unless Impracticable for One of Three Reasons

Recovery of incentive-based compensation subject to the clawback will be mandatory unless the issuer's compensation committee comprising independent directors, or a majority of independent directors in the absence of a committee, determine that recovery is "impracticable" for one of the following three reasons:

- The direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered. This basis for impracticability would be available only after the issuer has made a reasonable attempt to recover compensation, documented such attempt and provided the documentation to its national securities exchange or association.
- Recovery would violate home country law where the law was adopted prior to the date of the final rule's publication in the Federal Register. This basis for impracticability would be available only after the issuer has obtained an opinion of home country counsel as to the violation and provided the opinion to its national securities exchange.
- Recovery would likely cause an otherwise tax-qualified, broad-based retirement plan to fail to meet the requirements of Section 401(a)(13) or Section 411(a) of the Internal Revenue Code of 1986, as amended.

Boards will be permitted to exercise discretion, subject to reasonable restrictions, as to the means of recovery.

The recovery, however, must be effectuated reasonably promptly. The rule does not define "reasonable promptness," but the SEC noted in the adopting release its expectation that the issuer and its directors will pursue the most appropriate balance of cost and speed in determining the appropriate means to seek recovery in light of their fiduciary duty to safeguard the assets of the issuer, taking into account the time value of money.

The SEC also noted in the adopting release that an issuer may be acting reasonably promptly in establishing a deferred payment plan that allows repayment as soon as possible without unreasonable economic hardship to the executive officer.

Clawback Policy Disclosures

The final rules include several disclosure requirements relating to the clawback policy. An issuer's compliance with the disclosure requirements will be an element of the listing standards.

Filing of Clawback Policy

The issuer will need to file the clawback policy as an exhibit to its annual report on Form 10-K.

Proxy Statement/Annual Report Disclosures

The rule amends Item 402 of Regulation S-K to require disclosure by listed issuers if at any time during or after the last completed fiscal year the issuer was required to prepare an accounting restatement that required recovery of excess incentive-based compensation or, as of the end of the last completed fiscal year, there was an outstanding balance of excess incentive-based compensation attributable to a prior restatement.

The required disclosure under Item 402 will include:

- For each restatement, (a) the date on which the issuer was required to prepare the restatement, (b) the aggregate dollar amount of erroneously awarded compensation attributable to the restatement, including an analysis of how the amount was calculated, (c) if the financial reporting measure related to stock price or TSR, the estimates that were used in determining the erroneously awarded compensation attributable to the restatement and an explanation of the methodology used for such estimates, (d) the aggregate dollar amount of erroneously awarded compensation that remains outstanding at the end of the last completed year, and (e) if the amount of erroneously awarded compensation has not yet been determined, that fact and the reasons for such non-determination.
- If recovery would be impracticable, disclosure of the amount of recovery forgone (for each current and former named executive officer individually and for all other executive officers as a group) and a brief description of the reason the issuer decided not to pursue recovery.
- For each current and former named executive officer, the amount of outstanding unrecovered excess compensation that had been outstanding for 180 days or longer since the date the issuer determined the amount owed.

If the issuer was required to prepare a restatement during or after the issuer's last completed fiscal year and concluded that recovery of compensation was not required under the issuer's policy, the issuer must briefly explain why application of the policy resulted in that conclusion.

As long as an issuer provides the new Item 402 disclosure with respect to clawbacks, the issuer need not also make a disclosure under Item 404(a) relating to related party transactions with respect to the clawback activity.

The Item 402 disclosure will need to be provided in XBRL format, but will be required only in annual reports on Form 10-K and proxy statements whenever other Item 402 disclosure is required. The disclosure, therefore, will not be required in registration statements under the Securities Act of 1933. In addition, the disclosure will not be deemed incorporated by reference into any filing under the Securities Act of 1933 unless specifically incorporated by reference.

For any registered management investment company subject to Rule 10D-1, information mirroring the new Item 402 disclosure will need to be included in annual reports on Form N-CSR and in proxy statements and information statements relating to the election of directors. Foreign private issuers will be required to provide the new Item 402 disclosure in annual reports filed with the SEC under Section 13(a) of the Exchange Act.

The Summary Compensation Table rules are amended to require that any amounts recovered under a clawback policy reduce the amount reported in the table for the fiscal year in which the original payment was reported and be identified in a footnote.

Form 10-K Checkboxes

The rule adds two new checkboxes to the cover page of Form 10-K relating to whether the financial statements included in the Form 10-K reflect the correction of an error to previously issued financial statements and whether any of those error corrections are restatements that require a recovery analysis

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of incentive-based compensation received by executive officers.

Timing of Effectiveness of the Final Rules

The national securities exchanges will have to file with the SEC proposed listing standards implementing the rule no later than 90 days after the SEC final rules are published in the Federal Register. Those new listing standards will need to become effective no later than one year after the publication of the SEC final rules.

Issuers then will need to adopt clawback policies no later than 60 days after the exchanges' listing standards become effective. The clawback policies will need to apply to all incentive-based compensation received by current or former executive officers (after beginning service as an executive officer and who served as an executive officer during the applicable performance period) on or after the effective date of the applicable listing standard. The clawback policy will be expected to apply to such compensation even if the compensation is received under a pre-existing contract or arrangement.

Compliance with the new Item 402 disclosure rule will be required for all applicable filings with the SEC after the effective date of the exchanges' listing standards.

Recommended Actions for Listed Companies

- Review any existing clawback policies to determine what revisions will be needed to comply with the final rules and listing standards. Among other items, revisions may be needed relating to the individuals covered, the types of compensation covered, the types of restatements that trigger the policy, the lookback period of the policy, the required mandatory nature of clawbacks and the exceptions to mandated clawbacks.

  While we do not expect the national securities exchanges to add any additional requirements in their listing standards, it is possible that they may do so, and therefore issuers should not finalize their policies until the listing standards are published.
- Review existing incentive-based compensation arrangements and any other plans or agreements that are affected by, or require the payment of, incentive compensation to determine whether there is an existing contractual right to recover compensation, and consider whether to modify the arrangements to permit recovery in the future.
- Consider the impacts on internal control over financing reporting, quarterly financial reporting closing and disclosure committee processes, determinations of when a restatement is required, procedures and controls through which clawback policies will be implemented if there is a restatement, and compensation program design. Audit committees and compensation committees will need to work together closely on these items.

Note

1. *https://www.sec.gov/rules/final/2022/33-11126.pdf.*

DRAFTING TIPS

A Few Etiquette Tips for Corporate Attorneys in Dealing with Other Attorneys

By Andrew Abramowitz

Over my 25 years of practicing transactional law, I've often been mildly (or sometimes not so mildly) exasperated by common inconsiderate behaviors by opposing counsel on my deals. Of course, our primary job as attorneys is to represent our clients and not befriend opposing counsel, but unnecessarily agitating other attorneys does not, in the long run, serve our clients' interests. The following are some frequently-occurring examples of bad corporate attorney etiquette to avoid:

Sending Uneditable Drafts. Often, I will receive initial drafts of an agreement in PDF or read-only form. In other words, I can't easily get into the document to provide edits. Sometimes it's possible to convert the PDF to Word, but the formatting is garbled. Of course, I can provide the comments in other ways besides directly editing the document, but the point is that you've made it harder for me to do my job. If the intent in doing this is to discourage commenting, at least with me it may have the opposite effect, by reducing my trust of the other side. The time to create PDF versions is when both sides are in agreement and ready to execute.

Providing Comments in Installments. When you provide a set of comments, they should represent all of your side's input on the agreement, unless you state otherwise explicitly (for example, the client is still reviewing, it's subject to tax counsel's review, etc.). When you've received a set of comments, you can decide with the client that of the, say, 10 substantive comments, you'll compromise on five of them and push back on the remainder.

Andrew Abramowitz *is the founder and head of Andrew Abramowitz, PLLC.*

If, however, the other attorney then announces that they have five new substantive comments that they could have raised earlier, then the universe of comments is larger than you had understood when responding to the initial set.

Feigned Outrage over Business Issues. Part of our role as attorneys in a negotiation is to negotiate legal issues, such as those that allocate risk, but we also are involved in business issues, such as the amount of a purchase price and timing of payment, by communicating our clients' positions and ensuring they're documented correctly.

Most attorneys understand that, for those issues, they are mainly just the messenger, but some take their obligation to "zealously" advocate for their clients a bit too literally and lay on the rhetoric on an attorney-only call.

Inaccurate Blacklining. If you send your comments to an agreement with a markup showing your changes (which you should), please be sure that the markup actually shows all of the changes you've made from the appropriate previous version.

As a matter of course, I run my own blackline on incoming revisions showing the changes that the attorney made, and fairly often, the blackline sent by the other attorney isn't accurate. Probably more often than not, this is an inadvertent failure of version control by the attorney, but it inevitably suggests the possibility that the attorney was trying to slip a change past you.

Failure to Explain Comments. If you're commenting on my draft, unless the changes are completely self-evident, don't just send the markup without explaining in a cover note where you're coming from. At the very least, offer to go through the changes in a subsequent phone call.

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THE STATE OF DISCLOSURE

Not Only Too Long But Sometimes Too Convoluted: The Perplexing State of Modern Securities Law Disclosures

By James A. Deeken

In the maze of every expanding disclosure in securities offering documents, a basic tenet is at risk of being lost: It is always easier to get someone to read something short than something that is long. There are counters to the benefits. A shorter document has less in and to the extent that omitted material is important, there is a cost to a short document.

However, a longer disclosure also has a cost as well in that few people in a certain segment of the target audience might actually read it. In addition, a long document can obscure important disclosure in that especially material information can be "drowned out" and not noticed when it is encompassed with pages and pages of boiler plate language. What is also ironic is that lengthy disclosures sometimes miss fundamental items of importance despite their length.

At a time when the Securities and Exchange Commission (SEC) is considering new disclosure requirements and also enhanced investor protections, there is a fundamental tension and question that is worthy of consideration. Is it better to have (1) a shorter document that has less in it but more people are likely to read or (2) a longer document that has more in it but that fewer people are likely to read and that might actually obscure important disclosures?

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A Longer Document or a Shorter Document?

It is a difficult question that lacks a simple answer. There is no "one size (one length) fits all" approach. There is no one type of homogeneous audience for a securities offering document. There are generally two types of audiences that a securities disclosure has: (1) a "retail" audience consisting of individual investors; and (2) an institutional investor audience consisting of investment funds, insurance companies, pension plans and other large financial institutions.

A random survey of randomly selected prospectus has an average length, excluding F pages, of 184 pages long.[1] If you assume that it would take an investor 60 seconds to read and digest a page of a prospectus that would generate a three-hour reading time. Keep in mind that this excludes the F pages. Is it reasonable to assume that an analyst at an institutional investor would spend three hours reviewing and a prospectus? That would not be an unreasonable assumption. Although that is certainly not universally the case.

I am confident in saying that most retail investors would not be inclined to read through a 184 page long small type prospectus. Perhaps it would have been likely 30 years ago. Although I suspect very unlikely even then. However, in today's modern world with work schedules spilling into evenings and weekends, constant bombardment of emails, text messages and social media and consistently available streaming, there is "always something on" and always something going on. I venture that most typical retain investors don't have a three-hour block of

solitude to read anything let alone either the time or motivation to slug through a dense prospectus.

It wasn't always this way. The first initial public offering that I worked on as a securities lawyer in 2001 had a prospectus that was 88 pages long, largely due to the size of the issuer, and that was at the long end of range. Over the years, securities disclosures have had their growth fed by expanding risk factor disclosures and by Securities and Exchange Commission guidance requiring more in-depth disclosure. Presently, there are pending considerations for requiring additional pages of information related to various social benefit metrics.

Risk factors are a particular area where disclosure has become over-written and convoluted. The disclosures have gotten longer over the years as issuers piggyback on new risk factors that other issuers originate. We are left with a growing Christmas tree that never gets shorter and only grows in size. Securities practitioners will often start with a set of risk factors from another recent offering and add to them when preparing a prospectus.

The situation is made worse by the growing escalation of "stock" risk factors that seem to form the stem of any starting point for risk factor disclosure. Each time there is a new disaster or negative event in the world it seems like it leads to a new risk factor, at times with no or questionable benefit. For example, it is really necessary that a number of public issuers now have a generic COVID risk factor that is not already covered by more general risk factors? We may get arid of COVID someday but will never get rid of the new risk factor that a pandemic or health crisis may negatively impact a company that seems to be becoming standard for many issuers. Risk factors that generically apply to businesses generally do little to add any real insight about a company's meaningful risks, especially when they may already overlap with broader risk factors. Some of this risk factor hoarding is driven by a tendency to mimic other disclosures.

The tendency is also not helped by the need that some securities counsel feel to practice "preventative medicine" to error to on the side of the disclosure of excess risk factors to foil an ever aggressive plaintiffs' bar. Modern risk factor practices have a lot to do with litigation prevention instead of meeting the original goal of risk factors, which was to inform prospective investors about the practical or unique risks that an issuer may face.

The result is that it is hard for an investor to tell what the real practical risks are. The most material risks are drowned out by pages of boiler plate and theoretical risks. A general rule of thumb that could be followed is that if you have bad news to disclose, disclose a lot of other information too so the bad news part does not stand out. When I started my practice in 1999, I heard of one issuer that was criticized for having too many risks factors in their prospectus. That issuer had about 35 risk factors.

In contrast, a review of the same recent prospectuses reveals that they contain an average of 66 separate risk factors. Sixty-six risk factors sound daunting by its very nature, but that is before considering that a number of these "risk factors" are several paragraphs long and address a number of sub-risks. With 66 risk factors, there could be two or three absolutely horrendous ones buried in the "middle of the stack" that don't get adequately noticed in the context of being surrounded by pages and pages of more mundane, routine ones. The inordinate number of risk factors makes it challenging for even the most sophisticated financial investor to sort through. I would go further and suggest that it is impractical to think that most retail investors could sort through that number of risk factors in an attempt to sort the wheat from the chaff, or the most practical and material ones from the boilerplate ones.

The plain English rules that the SEC adopted in 1998 were intended to make the disclosure in prospectuses simple, easier to understand and thus more likely to be read. Given the current state of disclosure offering documents it is hard to view them as a complete success. Even though it would be easy to conduct, has the SEC ever done a study on what percentage of retail investors have read a prospectus before investing? Alternatively, has a study ever been done showing what percentage of retail investors

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have read any part of a relevant prospectus before making an investment decision?

It is time that we rid ourselves of the unrealistic assumption that retail investors have either the time or the patience to wade through 184 pages of densely written prose. There is a substantial risk that we as a securities legal industry are creating tomes whose main reading audience is not investors, but the lawyers who write them as issuers counsel and the lawyers on the plaintiff's side who try later to pick them apart when and if the issuer's stock price crashes.

We may very well be at a point where we need to consider adjusting securities disclosures for two separate audiences: (1) disclosure for the average retail investor; and (2) disclosure for institutional investors who might actually read through the voluminous disclosure in prospectuses. Although there may be a number of different approaches on how to take into account the different audiences and the practical realities laid out above, one possible approach would be to retain the current prospectus construct but to supplement it with a free-standing form of summary disclosure.

A Possible Shorter Disclosure with Better Information

Does the current summary section of the prospectus, that is, the "box," already effectuate the summary disclosure goal? In a way it does, but when it is folded into a longer document, the sheer "weight test" of the entire document certainly makes it less likely that a retail investor will crack the cover. Secondly, many of the current summaries seem to miss crucial information that might be buried back in the rest of the prospectus, if disclosed at all. Lastly, many of the current summaries are littered with opinions and sales promotion information that obscures the disclosure of basic important facts.

It is well worth considering a short summary document that would accompany a prospectus, either in printed form or accompanying electronic form that would address the items below, the size of which could likely be limited to 5 to 10 pages.

- *What does the issuer do*: Something very simple that is no longer than two sentences. The problem with a lot of the equivalent disclosure in prospectuses is that it is mixed with opinionated statements about the issuer's business that make the actual disclosure confusing. For example, most of them tend to say in the first few lines explaining what they do that they are the "leading," "premier," they have the "next generation" or related statements.

This short section would prohibit any opinions and instead require a short description of what the company actually does. Opinions can be distracting from a reader's understanding of an issuer factually does, especially when strong opinions are interjected when the business of the company is first described. The point would be that before getting into trying to sell the company, start by just neutrally explaining what the issuer does in plain English terms. To the extent that technical terms are used in a description of business, which are often seen in the context of life sciences or technology companies, those terms could be explained in a few non-technical phrases before being used repeatedly throughout a prospectus.

- *How does it make money*: A very simple disclosure statement that says how the issuer receives revenue in connection with the goods or services that it provides. This is currently scattered about in different portions of a prospectus, but would be clearly stated here.
- *Who are its major customers*: For issuers with a concentrated customer base, this could include some customers by name or those with disbursed customer bases, the types of customers.
- *What competitors does it have?* What barriers to entry are there for new competitors emerging? Do any competitors have known material advantages? These questions address the long-term business viability of the company. Yet, while there are references to competition in most prospectuses, usually sprinkled in risk factors and potential certain portions of Management's Discussion and Analysis and the Business sections, there is no one succinct

portion of most prospectuses that addresses these fundamental business issues in a succinct, upfront (as opposed to being risk factor #34, for example) manner.

- *Does the issuer rely on any key suppliers or supplies*? Are there any particular risks of cost or availability of supplies rising? Similar to the foregoing, there may be references to these items in risk factors, in the MD&A and the Business sections of a prospectus, but there is often no cohesive, upfront disclosure that addresses this business item that may be of extreme relevance for many issuers.
- *What are the top five risks the company faces*? This would be the issuer's determination and a cross reference could be made to the pages and pages of risk factors in the accompanying prospectus. The point of this disclosure would be to pull out the five most important risks so that investors could notice and understand them, rather than having them buried in a 25 page long fine print risk factor section in a prospectus. Certainly, there would be some fear that selecting only five risk factors would leave the company open to liability claims. For the risk factor selection to work effectively and in a manner that is fair to the issuer, liability protections would need to be extended to the issuers in this regard, as long as there is an appropriate cross reference to the risk factors in the prospectus.
- *How does management compensation create different incentives on the part of management that might conflict with stockholder interests*? The Executive Compensation section of prospectuses goes into great detail describing what executive compensation exists. This component would describe to what extent executive compensation might create incentives that might conflict with those of stockholders. For example, if management can exercise options with a strike price lower than that paid by investors by investors in the applicable securities, does that create any misalignment of interests? A number of issuers might conclude there are no conflicts with the particulars with their executive compensation practices, but in some cases, there may be conflicts that are worth highlighting in summary fashion.
- *What relationships do independent members of the board of directors (or equivalent governing body) have with the company leaders/founders*? This would be the issuer's disclosure as to whether there are any relevant relationships, notwithstanding that the independent directors meet the requisite legal requirements for independence.
- *To what extent are related party transactions and how might they impact the company*. While the prospectus would disclose these transactions in great detail, this item would entail disclosing in a few sentences the nature of any transactions and then in another few sentences describe the impact on, or general risks to, the issuer arising from such transactions, accompanied by a cross reference to the longer prospectus disclosure.
- *Who are the major stockholders and what control over the issuer will they have post-offering*? While some of this information is in the Description of Securities section of a prospectus, this item would be disclosure in summary fashion addressing who or what group effectively controls the issuer post-offering.
- *Are there any major liabilities or risks of litigation*? While this would cross reference to various sections of the prospectus for further information, this item would disclose in one place succinctly any pending or possible liabilities.
- *What is the current and anticipated capital structure of the issuer*? To the extent there is preferred stock or debt that may limit dividends on the class on securities being offered, this item would highlight that. With possible cross reference to Management's Discussion and Analysis of Financial Condition and Results of Operation, or MD&A, this item would also disclose any upcoming debt or large payments becoming due and the issuer's plans for payment related thereto.

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Further Steps

Regardless of the idea for a summary document or not, the exercise of considering the various items may act as a "cleansing" exercise. The consideration may serve as a step back to realize that material elements of disclosure are lost and scattered around an average of 184 pages of fine print. At times, the important matters are "lost in the detail." Is the function of securities disclosure to provide helpful, practical disclosure to investors? If that is the goal, then the current standards for disclosure seem to fail as they rely upon unrealistic expectations about the amount of time that an investor will expend reading a fine print prospectus.

The current standards allow material details to be surrounded by and encompassed by disclosure of a more boilerplate nature. At the same time, Form S-1 and the incorporated sections of Regulation S-K, do not provide for issuers to draw out in one place important matters to be succinctly summarized in a coherent manner. Rather materials items are often disclosed piecemeal through a lengthy prospectus document that requires an investor to "hunt and peck" for all related items of disclosure.

In the current form, it seems that the primary de facto role of a prospectus is to be a legal risk management document, rather than to be a useful investor disclosure document. Separate from any suggestion to create a useful summary document, proactive steps could be taken to make prospectuses better:

- Apply scrutiny to any proposals to add further disclosure requirements to prospectuses. If the information is desirable for a social benefit effect on the theory that having the information available to the press and public sources puts needed "sunlight" on certain issues, consideration should be given to requiring that information to be disclosed in Part II of Form S-1, rather than Part I of the form. That way the information is out there, but no further length is added to prospectuses where are already too long.
- Consider ways to shorten current disclosures. Some of this could be done by revising regulations but a lot of it could be done informally. For example, the SEC staff in reviewing registration statements could consider working with issuers to reduce duplicative disclosure and to apply summaries disclosures that tie various items together.
- Focus groups of investors have the potential to yield suggestions to make prospectuses more readable and possibly more succinct. There is little reason to consider the nature of disclosure requirements without input from retail end-user readers, who don't always write comment letters on proposed SEC rule changes. The views of typical readers could go a great way towards supplementing the views that the SEC normally hears.
- Although it would be an ambiguous exercise, consideration could be given to whether the very technical MD&A section could be rewritten to bring together coherent themes and be more succinct. An average reader might get lost in the line-by-line narrative of why certain metrics changed from year to year, which constitutes much of MD&A. Someone without an accounting background may find themselves confused by discussions of items related to "gross margin," "deferred expenses," "accrued liabilities," and "revenue recognition." MD&A may do a good job at great length of painting a picture that helps a reader see the trees in the forest, but without in all cases presenting a clear view of the forest itself. Even when a normal reader can see the trees, in this case the detailed analytics, unless they have a sophisticated financial background they might not appreciate what they are seeing.
- Lastly, although it would difficult to enact, consideration should be given with respect to whether liability protections under securities offering documents could be enhanced without exposing investors to additional risk. The goal would be to find ways to reduce the perceived

needed of issuers to practice "preventative medicine" by adding voluminous disclosure, which in many cases may only be added with the goal with the intent of defending against a lawsuit later. The over-arching goal would be to help transform something that in its current form is a legal risk management document into something that is primarily a reader friendly disclosure document, consistent with the original intent of the Securities Act.[2]

Notes

1. KinderCare Learning Companies, Inc. (170); Sweetgreen, Inc. (225); Nu Holdings Ltd. (332); HashiCorp., Inc. (205); SONO GROUP N.V. (198); FinWise Bancorp (188); Sidus Space Inc. (87); Fresh Vine Wine, Inc. (86); Braze, Inc. (166).
2. A slightly different version of this article was originally published as "More is Better?: Concerns on the Growing Amounts of Securities Disclosure in Offering Documents and Public Filings," *Securities Law Regulation Journal*, Vol 50:2 2022. Reprinted in part from *Securities Regulation Law Journal*, with permission from Thomson Reuters. Copyright © 2022. Further use without permission of Thomson Reuters is prohibited. For further information about this publication, please visit:*https://legal.thomsonreuters.com/en/products/law-books*, or call 800.328.9352.

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