A Proxy Season and Annual Report Guide to 2021

Introduction

The 2020 proxy season was a year for the books: voting behavior continued to develop among shareholders; major amendments were made to Regulation S-K (of which has not been amended in over 30 years); and, as one may have guessed, a once-in-a-century global pandemic, the COVID-19 pandemic ("COVID-19" or "pandemic") impacted disclosures and shareholder voting behavior. The following guide comprises:

- A review of the 2020 proxy season;
- A summary of new and anticipated changes to the 2021 proxy season as we continue to see environmental, social, and governance ("ESG") issues and proposals become bigger and bolder;
- A summary of amendments and guidance made to relevant regulations; and
- An analysis of how the lingering impacts of COVID-19 could shape this upcoming 2021 proxy season and thoughts for company management to consider when drafting their proxy statements and Annual Reports on Form 10-K.

2020 in Review

While COVID-19 loomed large over the peak proxy season, most shareholder proposals were already submitted before such shadow came to fruition. Nonetheless, though the proposals themselves may not have been impacted, how shareholders voted may have been affected by both COVID-19, as well as the protests over racial and economic inequality that made headlines throughout 2020.

Overall, there continues to be a call for more uniform ESG disclosures, notably from the Security Exchange Commission's ("SEC") Investor Advisory Committee ("IAC").[1] In terms of trends seen by public companies, approximately 70 percent of public companies opened their proxy with a letter to shareholders that highlighted ESG developments as well as other business achievements, up from 62 percent in 2018.[2] There was continued investor focus on director elections, but a slight decline in average support experienced on say-on-pay vote results compared to 2019. Engagement topics included:

- Use of ESG metrics in executive compensation;
- Oversight by the board of its potential and current employees (e.g., recruitment, retentions, employee engagement, and effectiveness); and
- Diversity and inclusion (e.g., equal pay, median gender or minority pay, and protection from workplace harassment).[3]

[1] SEC Inv'r Advisory Comm., Recommendation from the Investor-as-Owner Subcommittee of the SEC Investor Advisory Committee Relating to ESG Disclosure, 6 (2020).
[2] Kellie Huennekens, *ESG Disclosure in 2020 Proxy Statements*, Nasdaq (May 13, 2020, 8:00 AM), https://www.nasdaq.com/articles/esg-disclosure-in-2020-proxy-statements-2020-05-13
[3] *Id.*

Some interesting and unique proposals that gained traction in this 2020 proxy season related to a resurgence of poison pills in response to COVID-19, a continued push relating to opioids and the cost of prescription drugs, and proposals relating to lobbying/politics.

As always, ESG issues, executive compensation, director elections, and commentary from institutional investors on the aforementioned issues emerged. This year, however, COVID-19 made major waves in the 2020 proxy season as it relates to the previously-mentioned topics and on overall company disclosures.

ESG

The IAC's 2020 recommendations highlight how ESG reporting requirements would benefit companies and investors alike because it would offer investors in-depth information upon which to base their decisions, and would level the playing field among companies.[4] Despite this recommendation, former SEC leadership remained cautious about expanding any mandated disclosure requirements.[5] Notwithstanding, the SEC has begun "an effort to update the reporting requirements of issuers to include material, decision-useful, ESG factors."[6] And instead of waiting for such requirements to be issued, most companies are acting proactively: 92 percent of companies featured their ESG initiatives in their 2020 proxies (up from 82 percent in 2019), including through a section on "ESG highlights." Moreover, 78 percent disclosed that at least one board committee is charged with overseeing environmental sustainability matters, while 68 percent of compensation committees stated that they oversee human capital matters or had a title that included a "people" component (up from 70 percent and 58 percent, respectively, in 2019). Finally, approximately two-thirds of the 429 shareholder resolutions filed during the 2020 proxy season dealt with political spending, climate change, and fair treatment for women on boards and in the workplace.[7]

Highlights broken down by category are as follows:

Environmental:

Of the shareholder resolutions that were submitted and related to ESG, approximately 15 percent of such proposals specifically addressed climate change.[8] Overall, five environmental proposals passed in 2020, whereas none passed in 2019. Such proposals revolved around issues such as seeking the disclosure of how, and if, a company planned to reduce its contribution to climate damage[9], and seeking reports about the health and climate-related risks as it pertains to a company's operations and how such operations align, or don't align, with the Paris Agreement.[10] Investors also continued to vote for board accountability on climate-related issues.[11] Other environmental-related proposals revolved around topics such as reducing emissions, moving to more sustainable energy sources, and reducing waste.

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4 *Id.* At 7, 8.

5 "I believe I have made it clear that, while I believe that in many cases one or more 'E' issues, 'S' issues, or 'G' issues are material to an investment decision, I have not seen circumstances where combining an analysis of E, S and G together, across a broad range of companies, for example with a 'rating' or 'score,' particularly a single rating or score, would facilitate meaningful investment analysis that was not significantly over-inclusive and imprecise." Chairman Jay Clayton, *Remarks at Meeting of the Asset Management Advisory Committee*, U.S. Securities and Exchange Commission (May 27, 2020), https://www.sec.gov/news/public-statement/clayton-amac-opening-2020-05-27. Both former Chairman Jay Clayton and Director of the Division of Corporate Finance William H. Hinman have underscored that caution is necessary when contemplating expanding any SEC-mandated disclosure regime.

6 Bruce Goldfarb, *Companies Need to Engage on ESG Issues Now or Risk a Bruising 2021*, Forbes (Jul. 17, 2020, 08:01 AM), https://www.forbes.com/sites/brucegoldfarb/2020/07/17/shareholder-engagement-esg/" \l "731c7f122c2d.

7 Heidi Welsh and Michael Passoff, *ProxyPreview*, As you Sow, https://higherlogicdownload.s3.amazonaws.com/GOVERNANCEPROFESSIONALS/a8892c7c-6297-4149-b9fc-378577d0b150/UploadedImages/Proxy_Preview_2020_Final_v4.pdf

8 *Id.*

9 *Id.*

10 *Id.*

11 *Id.*

Notably, in March 2020, Institutional Shareholder Services ("ISS") released a new climate proxy voting policy on which it would base decisions regarding climate-related shareholder proposals and decisions regarding directors who are considered by ISS to be abdicating their responsibility to monitor risk or report in this area. ISS's proxy voting guidelines for the 2021 proxy season continues to emphasize the negative recommendations against directors, and updated its list of examples of risk oversight failures to include "demonstrably poor risk oversight of environmental and social issues, including climate change."

Social:

Corporate political activity and diversity-related issues dominated the "S" in ESG. Generally, the volume of shareholder proposals filed about corporate political activity (election spending and lobbying, as well as other corporate influence issues) decreased from its high point in 2014, but continued to be the biggest single issue topic of shareholder resolution interest, as it has been for many years.[12] And while the amount of proposals seeking reporting on lobbying and political contributions decreased to 76 proposals, compared to 101 proposals in 2019, a larger proportion of proposals relating to political contributions were voted on in 2020 compared to 2019 (24 voted out of 27 filed in 2020, versus 37 voted out of 60 filed in 2019).[13]

Proponents were, and continue to be, less likely to withdraw proposals on political spending.[14] However, these proposals will likely be the most impacted by the amendments to Rule 14a-8 and the restrictions on resubmitting proposals (discussed below) as they tend to be the most high scoring.[15]

Generally, human capital proposals revolved around: gender and racial pay equity, formalizing board oversight as it relates to the #MeToo movement, arbitration of employment-related claims, and general company policies, performance, and improvement targets.[16] The constant push by investors for more corporate accountability has led to more companies having oversight in place, but most are still hesitant to disclose expenditure amounts in public reports for investors.[17] The number of shareholder proposals about diversity at work increased in 2020 to 29, compared to just 16 filed in 2019.[18] All proposals shared a concern about discrimination on the basis of race, ethnicity, and gender and support more disclosure and action to provide equal employment opportunities. Of the proposals related to employment diversity, the average support rose to 55.1 percent in 2020, compared to 38.5 percent in 2019. Finally, the average support for board diversity proposals increased to 32.5 percent in 2020, up from 18.7 percent in 2019.

Governance:

The number of corporate governance-related proposals submitted and voted on during the 2020 proxy season increased slightly compared to 2019, but the number receiving majority support decreased significantly compared to 2019, with 27 in 2020 compared to 42 in 2019. Governance-related proposals covered the following topics: desire for an independent board chair; reduction of thresholds for shareholders to call a special meeting; shareholder right to act by written consent; and shareholder approval of bylaw amendments.

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[12] *Id.*
[13] *Id.*
[14] Heidi Welsh and Michael Passoff, *ProxyPreview*, As you Sow, https://higherlogicdownload.s3.amazonaws.com/GOVERNANCEPROFESSIONALS/a8892c7c-6297-4149-b9fc-378577d0b150/UploadedImages/Proxy_Preview_2020_Final_v4.pdf
[15] https://www.sec.gov/news/press-release/2020-220.
[16] Heidi Welsh and Michael Passoff, *ProxyPreview*, As you Sow, at 52 https://higherlogicdownload.s3.amazonaws.com/GOVERNANCEPROFESSIONALS/a8892c7c-6297-4149-b9fc-378577d0b150/UploadedImages/Proxy_Preview_2020_Final_v4.pdf
[17] *Id.*
[18] *Id.*

Of those submitted, a majority of corporate governance-related proposals focused on board diversity and top management diversity, and new this year are proposals specifically looking for more diversity for CEOs.[19] Given that most of the largest public companies have already made a firm commitment to add diversity to the board room, smaller companies continue to come under heightened scrutiny for their failure to address the matter. And while these proposals were more likely to be filed at companies with no women or people of color on the board, proposals were increasingly filed with companies that have "token" board members and with companies where shareholders desire to expand representation.[20]

Director Elections

Average support of director elections has hovered around 96 percent over the past four years. In the 2020 season, 19 directors received less than 50 percent support, of which 4 failed to be elected because of each company's majority voting standard.

Institutional investors continue to focus on director elections. For example, State Street Global Advisors announced in January 2020 that one of its engagement priorities for the 2020 proxy season was to consider voting against board members at companies in the S&P 500 with R-Factor™ (State Street's transparent ESG scoring system) scores in the bottom 10th percentile of their industries that cannot articulate how they plan to improve their score.[21] Then, beginning in 2022, this voting action will extend to all companies within its portfolio whose R-Factor™ scores place them within the 10th to 30th percentile in their SICS industry classification.

BlackRock has also increased its focus on various factors when evaluating its support of director elections. BlackRock announced in 2020 that it expected portfolio companies to provide disclosure aligned with TCFD framework and SASB standards prior to the end of 2020 in the hope that such disclosures will allow BlackRock to better assess its portfolio investments. In the 2020 proxy season, BlackRock continued to stand its ground and vote against management recommendations at 53 companies after finding those companies were not making enough progress on climate issues. BlackRock also placed an additional 191 companies "on watch," a classification it uses to tell those management teams that they have 12-18 months to meet its climate expectations or risk facing voting action in the next year.

Executive Compensation

Say-on-Pay vote results for 2020 saw a small decline in average support experienced within the S&P 500, down 1 percent from 2019 (90 percent in 2020, compared to 91 percent in 2019). Notably, ISS recommended voting against a higher percentage of S&P 500 companies in the 2020 season, mainly because of CEO pay-for-performance misalignment. Proxy advisor Glass Lewis also signaled that boards should "proactively seek changes that align" executive pay with employee and shareholder experiences originating from COVID-19 and its effects.

[19] *Id.* At 58.
[20] *Id.*
[21] State Street Global Advisors, CEOs Letter on SSGA 2020 Proxy Voting Agenda, https://www.ssga.com/library-content/pdfs/insights/CEOs-letter-on-SSGA-2020-proxy-voting-agenda.pdf

Impact of COVID-19 on Proxy Statement Disclosures

The SEC announced guidance in April 2020 regarding COVID-19 and related disclosures, stating, "[c]ompany disclosures should reflect this state of affairs and outlook and, in particular, respond to investor interest in:

1. where the company stands today, operationally and financially;
2. how the company's COVID-19 response, including its efforts to protect the health and well-being of its workforce and its customers, is progressing; and
3. how its operations and financial condition may change as all our efforts to fight COVID-19 progress. Historical information may be relatively less significant."[22]

The full impact on actual proxy votes and shareholder proposals due to COVID-19 will not be fully understood until the end of the upcoming 2021 proxy season, though there was a large impact on the method of holding shareholder meetings. Most meetings moved to a virtual setting, which presented its own challenges. There were still a significant number, approximately 30 percent, of meetings that occurred either in person or in some hybrid manner.[23] The Council of Institutional Investors ("CII") sent a letter to the IAC, urging it to require companies to disclose in their proxy statements how they are complying with state law in terms of shareholders' ability to participate in the meeting and to include a point of contact or email address to which shareholders can address concerns that may not be heard during the virtual meeting.[24] In application, common issues cited by shareholders were: systems not allowing certain classes of shareholder's to ask questions, technical difficulties with login and operations, insufficient time to answer all questions, confusion regarding channels for shareholder participation, and allegations of cherry-picking questions among other concerns and issues.[25]

2021 in Process

Continued 2019 Proxy Disclosures and 10-K Disclosure Modernization Rule

The following disclosures, many of which were changed in 2019 and were in effect for the 2020 proxy season, were often not properly applied in 2020:

- **Item 405**
  Section 16(a) Reporting Compliance: The heading should be changed to "Delinquent Section 16(a) Reports" and encourages companies with no delinquencies to omit the "check box" on the cover of the Form 10-K relating to Item 405 disclosure;
- **Item 407(i)**
  Hedging Disclosure: Originally adopted at the end of December 2018, the SEC requires companies to disclose practices or policies related to the ability of employees or directors to engage in hedging transactions with respect to a company's equity securities. Companies that do not maintain a hedging policy are required to disclose this fact and note, if accurate, that hedging transactions are generally permitted. NOTE: a majority of smaller reporting companies (SRCs) and emerging growth companies (EGCs) do not have to comply with this Rule until 2021;

[22] Public Statement from the SEC, The Importance of Disclosure – For Investors, Markets and Our Fight Against COVID-19 (Apr. 8, 2020) https://www.sec.gov/news/public-statement/statement-clayton-hinman.
[23] An Overview of the Trends from the 2020 Proxy Season, Freshfields at 9, June 25, 2020.
[24] *Letter to Anne Sheehan, Chair, Investor Advisory Committee*, Council of Institutional Investors, https://www.cii.org/files/issues_and_advocacy/correspondence/2020/2020%2005%2003%20IAC%20letter.pdf.
[25] An Overview of the Trends from the 2020 Proxy Season, Freshfields at 9, June 25, 2020.

- While the following were in effect for 2019 Annual Reports on Form 10-K for public companies with a calendar year-end, there continues to be failure to properly apply the following:
  - Part II, Item 5 was amended so that a company does not need the table of stock prices, the ticker symbol is required, among other things;
  - New Exhibit 4(v) requires the description of securities to be filed as an exhibit four with Form 10-K;
  - Processes for confidential treatment and redaction of exhibits now make it so the SEC does not have to pre-approve such redactions; and
  - Inline XBRL is being phased-in, depending on the company's status. Once phased-in, every cover page of a Form 8-K must be tagged on the following schedule:
    - 2019 for large accelerated filers;
    - June 2020 for accelerated filers; and
    - June 2021 for all other filers.

Securities Laws Developments

Given the presidential administration transition, and the fact that most amendments passed in 2020 were done by a 3-2 vote, some rules may be overturned. However, 2020 was filled with an abundant rulemaking agenda driven by former Chairman Jay Clayton. During his tenure, the SEC adopted over 90 new rules, many of which were principles-based and will require interpretation. Thus, 2021 will see a first with, among other changes, some Proxy Advisory principles-based rules, a change in issuer status definitions, and a modernization of Regulation S-K.

Proxy Advisory Firm Changes[26]

In July 2020, the SEC adopted final principles-based rules that require proxy voting advice businesses (PVABs) to take certain actions to maintain a statutory exemption from the information and filing requirements of the federal proxy rules. Specifically, PVABs must comply with certain disclosure and procedural requirements, including the disclosure of material conflicts of interest in their proxy advice, and adopt and publicly disclose certain written policies and procedures reasonably designed to ensure that:

- Public companies that are the subject of proxy voting advice have such advice made available to them at or prior to the time when such advice is disseminated to the PVAB's clients; and
- The PVAB provides its clients with a mechanism by which they can reasonably be expected to become aware of any written statements regarding its proxy voting advice by registrants that are the subject of such advice, in a timely manner before the shareholder meeting (or, if no meeting, before the votes, consents, or authorizations may be used to effect the proposed action).

[26] https://www.sec.gov/rules/final/2020/34-89372.pdf.

Determine Status as Issuer

Effective April 27, 2020, the SEC amended the accelerated filer and large accelerated filer definitions in Rule 12b-2, excluding from those definitions a company that qualifies as a smaller reporting company (SRC) under the SRC revenue test, with business development companies being excluded in analogous circumstances.[27]

The amendments also increased the transition thresholds for accelerated and large accelerated filers becoming non-accelerated filers and for exiting large accelerated filer status, as well as adding a revenue test to the transition thresholds for exiting both accelerated and large accelerated filer status. Many public companies experienced fluctuations in market capitalization as a result of COVID-19, so we recommend reviewing qualifications for scaled disclosures. Issuers who rely on emerging growth company status, or EGCs, should also determine if they are still eligible to remain an EGC. Among other requirements, an issuer may only retain EGC status for five years after its IPO.

Electronic Signatures New Rule Now Effective

The rule requires an initial "authentication document" to be signed the "traditional" way (i.e., with an original signature) and retained by the company. The platform used for electronic signatures must: require the signatory to present a physical, logical, or digital credential that authenticates the signatory's individual identity; reasonably provide for non-repudiation of the signature; provide that the signature be attached, affixed, or otherwise logically associated with the signature page or document being signed; and include a timestamp to record the date and time of the signature. DocuSign is an example of a platform that meets these requirements.

Guidance on 2019 FAST Act Modernization

On Jan. 24, 2020, SEC staff issued three new Compliance and Disclosure Interpretations (C&DIs) in connection with the 2019 rule change to Item 303(a), permitting companies to omit an MD&A discussion of the earliest of the past three years, but only so long as the discussion was previously included in the company's prior filings on EDGAR, provided that the company includes a statement which identifies the location in the prior filings where such omitted discussion can be found. The C&DIs, among other things:

- Clarify that a statement merely identifying the location in a prior filing where the omitted discussion can be found does not incorporate such disclosure into the filing – the company must expressly state that the information is incorporated by reference; and
- Explain that a company may not omit the discussion of the earliest of the three years if it believes it is "necessary to an understanding of its financial condition, changes in financial condition and results of operations."

Modernization of Regulation S-K

On Aug. 26, 2020, the SEC adopted amendments to modernize its rules requiring disclosures about a company's description of business, legal proceedings, and risk factors. These disclosure items have not undergone significant revisions in over 30 years.

[27] https://www.sec.gov/corpfin/secg-accelerated-filer-and-large-accelerated-filer-definitions.

Most notably, the final amendments, among other changes:

- Revise the requirements to discuss the general development of the business to be largely principles-based, requiring disclosure of information material to an understanding of the general development of the business;
- Adopt as a disclosure topic material changes to a registrant's previously disclosed business strategy;
- Include, as a disclosure topic, a description of the registrant's human capital resources to the extent such disclosures would be material to an understanding of the registrant's business; and
- Require summary risk factor disclosure of no more than two pages if the risk factor section exceeds 15 pages.

Accredited Investor Definition Update

The SEC adopted a new amendment that adds additional categories of persons eligible to meet the accredited investor definition, consequently expanding the pool of capital available to the private capital markets. Among the changes, the amendment to the definition now includes as accredited investors those individuals who are "knowledgeable employee[s]" of a fund. A more detailed review of this rule can be found in Dinsmore's alert here.

Proxy Statement Matters and Proxy Season

ESG

While we should not expect a top-down system of regulation in the near future as it relates to ESG issues, as investors, and other jurisdictions besides the United States, become increasingly focused on sustainability issues, and ESG reporting standards continue to converge, companies should reassess their current ESG business and disclosure practices and determine whether changes are warranted.

Late in September 2020, the Big Four accounting firms (Deloitte, EY, KPMG and PwC) issued a white paper announcing a new ESG reporting framework they developed in collaboration with the World Economic Forum and its International Business Council ("IBC"). The framework sets forth 21 "core" and 34 "extended" ESG metrics and recommended disclosures across 4 pillars: principles of governance, planet, people, and prosperity. Many of the metrics and disclosures were drawn from existing ESG reporting standards. The group encourages the approximately 130 large global companies in the IBC and others to adopt the framework for their 2021 reporting.

Additionally, five framework and standard-setting institutions of international significance (CDP, the Climate Disclosure Standards Board (CDSB), the Global Reporting Initiative (GRI), the International Integrated Reporting Council (IIRC) and the Sustainability Accounting Standards Board (SASB)) have co-published a joint statement outlining a shared vision of the elements necessary for more comprehensive corporate reporting and a joint statement of intent to drive towards this goal. These future standards, combined with the Big Four's new framework, will produce more complete, consistent, and comparable information for shareholders in their decision-making in the 2021 proxy season and beyond.

Consequently, many companies are debating whether to voluntarily expand proxy disclosures beyond what is required in order to address ESG issues that are garnering increased attention, especially given the increased pressure from shareholders and institutional investors. Specifically, given BlackRock's wide sphere of influence and its requests regarding ESG issues noted previously, BlackRock's ESG disclosure initiative is likely to have a significant effect in conforming U.S. public company disclosures to the SASB standards and TCFD recommendations. And at a minimum, BlackRock and investors will likely expect management and directors of public companies to be familiar with SASB and TCFD approaches as it relates to sustainability issues and climate-related risks.

Well-prepared companies will adopt the lessons learned from this pandemic and fine-tune their risk assessment accordingly to account for climate change, future pandemics, terrorist and cyberattacks, and supply chain disruptions. Based on a J.P. Morgan poll that questioned investors from 50 global institutions, COVID-19 will likely increase the awareness and actions necessary to tackle high impact/high probability risks such as those related to climate change and biodiversity losses.[28] Companies are also certain to face an increase in proposals regarding diversity and inclusion, racial justice, socioeconomic inequality, health and safety, climate change, economic resiliency, public health, and other ESG-related issues in the 2021 proxy season in light of the pandemic and major 2020 events. Some potential highlights are as follows:

- **Environmental:**
  In many ways, COVID-19 and climate change impact the same ESG performance areas. For example, sustainability, a sector of environmental proposals, may be impacted by COVID-19 as single-use plastic usage has increased due to hygiene concerns, but it is unclear whether that trend will continue into next year.
- **Social:**
  Investors, including institutional investors, continue to push companies to proactively address racial equality within their workforce. For example, Vanguard has been calling for disclosures regarding directors' ethnic diversity, and ISS is requesting disclosure of both directors' and senior executives' ethnic diversity.[29] It is expected that going into 2021, one of the major impacts of COVID-19 will be in the form of proposals relating to human capital management. In fact, one survey of 41 global institutions found that 71% of investors desire additional disclosure on health and safety indicators.[30] Investors seemed to be focused not only on what the company is doing, but how it is doing it, particularly with respect to health and safety, supply chain management, and adopting sustainable business practices for both the short and long-term.
- **D&O Questionnaires:**
  No changes to SEC rules or NYSE standards in 2020 suggest a need for changing annual director and officer questionnaires at this time. However, in February 2020, the SEC approved a Nasdaq proposal to amend the definition of "Family Member" used in its corporate governance rules, which is incorporated into the definition of "Independent Director."[31] The definition will no longer include step-children and will include a carve out for domestic employees who share a director's home. A company's board must still affirmatively determine that no relationship exists that would interfere with a director's ability to exercise independent judgment. Additionally, to the extent companies determine to include self-identified diversity characteristics in their proxy statement, they may want to devise questions for D&O questionnaires to elicit such information. Companies may consider whether to collect self-identified diversity data, and should consider any potential state requirements. For example, California and Washington have minimum diversity mandates; Illinois, Maryland, and New York have diversity reporting requirements; and Colorado, Hawaii, Massachusetts, Mississippi, New Jersey, Pennsylvania, and Ohio currently have pending legislation.

[28] *Why COVID-19 Could Prove to Be a Major Turning Point for ESG Investing* (July 1, 2020), https://www.jpmorgan.com/global/research/covid-19-esg-investing.
[29] *Vanguard Investment Stewardship Perspectives, Board Diversity*, https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/persp_board_diversity.pdf.
[30] *Why COVID-19 Could Prove to Be a Major Turning Point for ESG Investing* (July 1, 2020), https://www.jpmorgan.com/global/research/covid-19-esg-investing.
[31] https://www.sec.gov/rules/sro/nasdaq/2020/34-88210.pdf.

COVID-19 Disclosures in Annual Reports

Disclosure Guidance

The staff issued CF Disclosure Guidance: Topic No. 9 and CF Disclosure Guidance: Topic No. 9A providing guidance on disclosure considerations that companies should consider with respect to COVID-19 related disruptions, which include a range of questions for companies to consider when evaluating the impacts of the pandemic. This guidance should be reviewed as companies evaluate the impact, or lack thereof, the pandemic had on each of the annual report topics. Topic No. 9A emphasizes that operational adjustments in response to COVID-19 could be material to an investment or voting decision, such as transition to telework, supply chain and distribution adjustments, and suspension/modification of operations for health and safety.

Compensation Disclosure

While the SEC's compensation disclosure rules have not changed for the 2021 proxy season, certain isolated circumstances related to COVID-19 may trigger certain disclosures, such as an executive officer forgoing any salary or bonus and instead receiving equity or other non-cash compensation. Moreover, companies should confirm whether any benefits/items provided to executive officers because of the COVID-19 pandemic constitute a perquisite or personal benefit as it pertains to SEC's Division of Corporation Finance C&DI 219.05. Generally, such benefit/items is not a perquisite or personal benefit if it is integrally and directly related to the performance of the executive officer's duties. However, if an item that confers a direct or indirect benefit has a personal aspect, without regard to whether it may be provided for a business reason or for the company's convenience, it is a perquisite or personal benefit unless it is generally available on a non-discriminatory basis to all employees.

The following questions should be considered when analyzing compensation disclosures, as well as the potential impact of COVID-19 on compensation disclosure:

- Has an officer agreed to forgo salary, bonus or perquisites?
- Do officers gain, among other aids, technological assistance to work from home or benefits which do not apply evenly across the board?
- Have any amounts been adjusted? Or has compensation been paid in stock?
- Has the company repriced options?
- Has the company changed the metrics used to evaluate performance, eligibility for bonuses, or other aspects of compensation?

Corporate Governance

In light of the COVID-19 pandemic, the SEC has called upon companies to "provide as much information as is practicable regarding their current status and plans for addressing the effects of COVID-19." As the pandemic continues, there is expected to be an increased focus on ESG issues and risk assessments related to human capital, economic resiliency, and public health. Notably, COVID-19 has highlighted certain ESG issues, such as employee health and safety and remote working issues, as well as increased focus on racial and social justice, raising awareness of issues such as workforce diversity and discrimination and efforts that companies could be doing to address such societal problems.

Companies should provide as much information as is practicable regarding their current status and plans for addressing the effects of COVID-19 and how the board handled its oversight of the challenges posed by, and management's response to, the pandemic. In that regard, note that Item 407(h) of Regulation S-K expressly requires companies to "disclose the extent of the board's role in the risk oversight of the registrant, such as how the board administers its oversight function."

Moreover, the SEC stated, "beyond the income statement and the balance sheet effects, we recognize that COVID-19 may significantly impact operations, including as a result of company efforts to protect worker health and well-being and customer safety. The impact of company actions and policies in this area may be of material interest to investors, and we encourage disclosures that address that interest." It also stated, "[r]obust, forward-looking disclosures will benefit investors, companies and, more generally, our fight against COVID-19." Additional considerations and questions a company should consider are the following:

- How has the board discharged its oversight role?
- Has the board conducted additional meetings?
- Was there consideration by the board regarding reductions in force, closures or other similar measures?
- Was there consideration made by the board of directors regarding workplace safety and human capital measures?
- Has the board or audit committee undertaken additional measures with respect to cybersecurity oversight?

Audit Committee Reports

Consider statements made by the SEC's Chief Accountant, in which he addressed in two public statements the significance of high quality financial information, such as significant judgments and estimates, the effects of the pandemic on disclosure controls, financial reporting and internal control over financial reporting, going concern assessments, and the importance of the audit committee's oversight role.

Letter to Shareholders

Consider addressing COVID-19's impact on the company and the company's response to the effects of the global pandemic here.

Pay Ratio Disclosure

Consider the need for a new determination of the median employee, given any COVID-19 related impacts, such as furloughs, layoffs, and pay reductions. As always, consider any significant acquisitions or dispositions that would trigger a need to identify a new median employee for pay ratio disclosure purposes. If a company determines it does not need to identify a new median employee, it must disclose that it is using the same median employee in its pay ratio calculation and describe briefly the reason for its belief that there have not been any changes requiring a newly determined median employee.

Risk Factors

Depending on the line of business, COVID-19 could have exacerbated current risk factors, or exacerbated non-issues that now would be considered risk factors, such as greater market volatility in an investment portfolio, or the increase in remote working giving rise to greater cybersecurity concerns. COVID-19 could have also impacted business operations generally and key management changes. Moreover, risk factors may need to be updated to include any impact on business relationships due to restrictions on travel and otherwise, liquidity, compliance with financial and operating covenants. At the beginning of the pandemic, many companies introduced a generic risk factor that addressed the pandemic. Now that it has been almost one year since the pandemic began affecting businesses within the United States, companies should include specific, tailored risks. Review the company's risk factors and consider whether these should be revised to address situations that already occurred, and whether additional and new risks have been identified by company management as the pandemic has persisted through 2021.

Business Disclosures

To the extent COVID-19 materially impacted aspects of a company's business, companies should consider whether additional or revised business disclosures are needed, including if COVID-19 is expected to change a company's business. This could include new disclosures, revisions of current disclosures to explain changes, such as competitive conditions or number of employees, or the stalling of a previously announced acquisition or growth initiatives placed on temporary hold.

MD&A; Financial Statement Considerations

Management discussion and analysis (MD&A) must include information that a company "believes to be necessary to an understanding of its financial conditions, changes in financial condition and results of operations." Thus, disclosures should include (1) COVID-19 both as a known trend or uncertainty, as well as (2) management's perspective on the type and extent of COVID-19's effect on the company, to the extent material. Questions similar to the following should be contemplated:

- What is the impact of COVID-19 on revenues and sources and uses of funds? What is the impact of COVID-19 on liquidity?
- What are management's assumptions regarding the magnitude and duration of the impact of COVID-19 on revenues and operations
- Have there been, and are there currently, any limitations on the ability to obtain funding?
- Are there any operational changes related to the implementation of health and safety policies, remote working of employees and/or the return of employees to work?
- Are there any material modifications of payment terms and other arrangements with customers, suppliers, distributors, landlords, lenders and other third parties?
- Has the company received any CARES Act loans and potential implications thereof?

SEC staff further advises that, to the extent management believes there is substantial doubt about the company's capability to stay in business and meet its obligations as they become due within one year after the issuance of financial statements, management should disclose its plans to address challenges in its MD&A section of the Form 10-K. Further, companies should discuss with their accountants: (1) whether COVID-19 disclosure is still needed as part of their financial statement footnotes, and (2) whether the pandemic has led to any impairment of assets.

Other Proxy and Annual Report Matters

Shareholder Proposal Developments

For the first time in 20 years, the SEC adopted controversial rule amendments altering the shareholder proposals submission (and re-submission) framework. This will considerably increase the requirements for submitting and resubmitting shareholder proposals under Exchange Act Rule 14a-8. It will first apply to proposals submitted for meetings held on or after Jan. 1, 2022.[32] The rule amendments are intended "to modernize and enhance the efficiency and integrity of the shareholder-proposal process for the benefit of all shareholders." The changes for shareholder proposals address the following three areas:

1. The ownership thresholds for submission of shareholder proposals have been increased to:
    a. $2,000 of the company's securities for at least three years;
    b. $15,000 of the company's securities for at least two years; or
    c. $25,000 of the company's securities for at least one year.
2. Shareholders will no longer be permitted to aggregate holdings to meet the ownership thresholds; and
3. The voting thresholds for resubmission of a proposal have been increased from 3 percent, 6 percent, and 10 percent for matters previously voted on once, twice, or three or more times in the last five years to thresholds of 5 percent, 15 percent, and 25 percent for those respective periods.

The SEC also adopted the following changes:

- Rule 14a-8(c) was amended to update the "one proposal" rule to clarify that a single person may not submit multiple proposals at the same shareholders' meeting, whether the person submits a proposal as a shareholder or as a representative of a shareholder
- Rule 14a-8(b) was amended to, among other things:
    - Require a proponent to be available to meet with the company regarding the shareholder proposal; and
    - Require a proponent to provide specified information about any representative the proponent is using to submit a proposal or to act on the proponent's behalf.

[32] https://www.sec.gov/rules/final/2020/34-89964.pdf (September 23, 2020)

Recommendations for Companies adopting a framework for ESG

Companies choosing to provide ESG disclosures, or who are adopting a framework for ESG should carefully consider the feasibility of such standards and commitments adopted to ensure they are able to meet such standards. Whatever the format, and as with any public disclosure, companies should ensure their ESG disclosures are subject to robust controls, procedures, and oversight, because ESG-related disclosures are subject to federal securities laws to the extent they are materially inaccurate or misleading, and consequently could have legal, regulatory, and reputational consequences to the extent such disclosures are inconsistent with company actions or industry standards. Additional considerations consist of the following:

- Appoint a team tasked with monitoring ESG disclosures and commitments;
- Identify existing ESG commitments to establish a baseline;
- Implement a procedure or control to monitor ESG disclosures of peer firms;
- Craft ESG disclosures which are noteworthy to investors' investment and voting decisions; and
- Remember the speed at which the internet works and the speed of social media responses.

Risk Factors

- **Cybersecurity:**
  Cybersecurity incidents have continued to plague businesses both large and small, and continue to grow in sophistication and prevalence, and thus remain a significant risk factor that most companies must address in their Form 10-Ks. The mere discussion regarding cybersecurity can be helpful from a shareholder and customer perspective, simply to demonstrate that the company is aware of the potential impact of cybersecurity risks and is taking it into consideration.
- **LIBOR:**
  Particularly for financial institutions, the transition away from LIBOR should be considered in addressing, updating, or elaborating on a current risk factor disclosure. The SEC staff has given comments requesting the inclusion of such a risk factor, and the discussion of how the discontinuation of LIBOR could affect a company's liquidity and results of operations.

Critical Audit Matters (CAMs)

On Dec. 30, 2019, former Chairman of the SEC issued a joint public statement with the Chief Accountant and the Director of the Division of Corporation Finance on the role of audit committees in financial reporting, and encouraged audit committees to "engage in a substantive dialogue with the auditor regarding the audit and expected CAMs to understand the nature of each CAM, the auditor's basis for the determination of each CAM and how each CAM is expected to be described in the auditor's report."[33]

[33] Chairman Jay Clayton, Sagar Teotia, and William Hinman, *Statement on Role of Audit Committees in Financial Reporting and Key Reminders Regarding Oversight Responsibilities* (Dec. 30, 2019), https://www.sec.gov/news/public-statement/statement-role-audit-committees-financial-reporting.

According to PCAOB auditing standards, any matter arising from the audit of financial statements that was communicated or required to be communicated to the audit committee will be a CAM if it both:

- Relates to accounts or disclosures that are material to the financial statements; and
- Involves an especially challenging, subjective, or complex auditor judgment.[34]

MD&A

In addition to COVID-19-related guidance, in January 2020, the SEC released MD&A guidance related to key performance indicators and metrics used in the MD&A. The guidance observed that companies disclose non-financial and financial metrics when describing the performance or the status of their business, which may vary by company and industry and reflect external or macro-economic matters or a combination of external or internal information. Consequently, each company that uses metrics in its MD&A "need[s] to include such further material information, if any, as may be necessary in order to make the presentation of the metric, in light of the circumstances under which it is presented, not misleading." Notably, the SEC expects the following disclosures to accompany any metric presented: a clear definition of the metric and how it is calculated; a statement indicating the reasons why the metric provides useful information to investors; and a statement indicating how management uses the metric in managing or monitoring the performance of the business. The guidance also urges companies to consider whether there are underlying estimates or assumptions for each metric or its calculation that needs to be disclosed in order for the metric not to be materially misleading.

Virtual Meetings

Given the overall positive experience most companies and investors had this year with virtual or hybrid meetings, companies will likely continue to host virtual meetings in 2021 and beyond, provided that shareholders are given a "meaningful opportunity" to participate fully in the meeting, per ISS's view, including the ability to engage in dialogue and ask question of senior management and directors, and that shareholders "be afforded the same rights and opportunities to participate as they would at an in-person meeting, per Glass Lewis's policy. It is expected that proxy statements for virtual shareholder meetings include "robust disclosure concerning shareholder participation." Generally, companies should consider:

- Whether any revisions to proxy statement disclosures regarding virtual meeting practices would be appropriate to clarify procedures for shareholder to virtually attend and vote at meetings;
- Explaining how to handle technical glitches that may occur during the meeting;
- Describing Q&A sessions and how those would be handled;
- Implementing telephonic or internet-based help lines for shareholder support during the meetings; and
- To the extent companies relied on executive orders or temporary rules for the conduct of virtual meetings during 2020, determining whether there have been any changes to those orders or rules.

[34] PCAOB Release No. 2017-001.

Conclusion

As consensus continues to grow with investors regarding the importance of ESG disclosures and companies continue to evaluate the implications and effects of COVID-19, the 2021 proxy season will continue to show certain trends seen in the 2020 proxy season, such as the continued focus on environmental, social, or governance topics, as well as manifest new focuses, such as proposals revolving around employee health and safety and general human capital management. While specific approaches have yet to be announced, given the move from the Trump Administration to the Biden Administration and the change in control of the Senate, the appointment of a new Democrat-leaning SEC chair could produce changes regarding ESG disclosure and a potential requirement for companies to adopt a third-party reporting framework, such as the one developed by the Sustainability Accounting Oversight Board. Companies should continue to reassess proxy disclosures, especially in light of COVID-19's continued impact, focusing on key areas of interest to shareholders.

Questions? Contact the DCS Team

Dinsmore Compliance Services (DCS), an affiliate of Dinsmore & Shohl LLP, offers compliance solutions for investment managers and municipal advisers. DCS will help you develop and maintain high-quality compliance programs customized to your particular business demands and operational realities. We offer these services, all as an affiliate of a coast-to-coast, full-service law firm.

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