
EARNINGS GUIDANCE

Non-GAAP: The Pendulum Swings Back

By Pam Marcogliese and Dase Kim

The practice of reporting non-GAAP earnings is back on the Security and Exchange Commission's (SEC) radar, highlighted in recent speeches by SEC Chair Mary Jo White,¹ Chief Accountant James Schnurr² and Deputy Chief Accountant Wesley Bricker.³ A series of news articles focusing on the increasing number of companies that report non-GAAP earnings (often confusingly called "pro forma" earnings) and the widening gap between these companies' reported GAAP and non-GAAP earnings have also shed negative light on using NGFMs.⁴

The 'New' Old Problem

The use of non-GAAP financial measures (NGFMs) and the concerns they raise are not new. In the 1990s, it was popular for companies, especially Internet technology firms during the first "dot-com" boom, to use NGFMs to report earnings. The SEC took note. In September 1998, Arthur Levitt, then-chairman of the SEC, gave a speech titled "The 'Numbers Game'," in which he expressed concerns about

Continued on page 2

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CONTENTS

EARNINGS GUIDANCE

Non-GAAP: The Pendulum Swings Back	1
By Pam Marcogliese and Dase Kim	

DISCLOSURE

Reinventing Disclosure: The SEC's Regulation S-K Concept Release	7
By Mark Plichta, John Wilson, Megan Odronic, and Richard Dancy	

SHAREHOLDER ENGAGEMENT

Shareholder Engagement: Governance Experts Share Perspectives	12
By Abby E. Brown, Carolyn J. Buller, and Wendy K. LaDuca	

EXECUTIVE COMPENSATION

Gender Pay Equity In Focus	16
By Jon Weinstein and Ashley Meisheid	

CYBERSECURITY

Director Cyber Risk: Insights from Shareholder Derivative Lawsuits	17
By Melissa J. Krasnow	

AUDIT COMMITTEES

PCAOB Again Issues Proposal to Change Audit Report	22
By Michael Scanlon, Brian Lane, Lori Zyskowski, and Michael Titera	

the widespread practice of “earnings management” (lamenting that there is a gray area “where earnings reports reflect the desires of management rather than the underlying financial performance of the company”).⁵

A few years later in October 2000, Lynn Turner, then the SEC’s Chief Accountant, coined the term “EBS” or “Everything but Bad Stuff,” and told investors to be wary of EBS earnings releases that provide “incomplete or inaccurate” information.⁶ As the use of NGFMs continued to proliferate, in December 2001, the SEC issued “Cautionary Advice,” alerting companies and their advisors that an NGFM, “under certain circumstances, can mislead investors if it obscures GAAP results,”⁷ and in January 2002, the SEC brought its first enforcement action based on a misleading use of NGFMs.⁸

After the Enron scandal and the dot-com market crash, the Sarbanes-Oxley Act of 2002 directed the SEC to adopt rules on NGFMs, and in January 2003 it adopted Regulation G and Item 10(e) of Regulation S-K requiring companies to satisfy certain conditions in connection with the use of NGFMs.⁹ The cumulative effect of the Cautionary Advice, the new rules and the related FAQs published in June 2003, and SEC comments on company filings, generally chilled the use of NGFMs for the better part of a decade.

Then in 2010, the SEC seemed to acknowledge that the pendulum had swung too far against NGFMs. The SEC staff published new Compliance and Disclosure Interpretations (C&DIs) in January 2010 that reflected a policy change to allow more liberal use of NGFMs by companies in public disclosures.¹⁰ For example, the SEC staff made it clear in the C&DIs that adjustments reflected in an NGFM would be permissible, subject to Regulation G and Item 10(e) of Regulation S-K, even if such adjustments are not “non-recurring, infrequent or unusual.”¹¹ Companies embraced this new guidance by steadily increasing their use of NGFMs in SEC filings and earnings reports ever since—perhaps a little too enthusiastically.

Not long after publishing the C&DIs, the SEC staff exhibited signs of regret. In December 2011, at an AICPA national conference, then-Director of the SEC’s Division of Corporation Finance Meredith Cross warned companies against abusing NGFMs under the new guidance (telling them to “knock it off”), and Deputy Chief Accountant Craig Olinger reminded the audience that although NGFMs can be helpful to investors, “non-GAAP measures that are misleading are not allowed anywhere.”¹²

In the same year, SEC comments on Groupon’s IPO registration statement led to the removal of an NGFM called “Adjusted Consolidated Segment Operating Income,” because the exclusion of online marketing expenses (which the SEC viewed as a “normal, recurring operating cash expenditure”) from the company’s results of operations was potentially misleading to investors.¹³ In 2013, David Woodcock, chairman of the SEC’s newly created Financial Reporting and Audit Task Force, said in a speech that the task force was scrutinizing companies’ use of NGFMs.¹⁴

Highly publicized news reports about the use of NGFMs by companies whose shares are under-performing, such as Valeant¹⁵ or Twitter,¹⁶ added to the perception that NGFMs were being used by certain companies to mischaracterize their performance.

Renewed SEC Focus

Now it looks as though the swing toward discouraging NGFMs is gathering momentum. The recent speeches by White and Schnurr mentioned previously indicate that the short-lived era of the SEC’s relaxed attitude toward NGFMs is over and there is now a renewed effort by the SEC to scrutinize the use of NGFMs. In her speech, White noted that the use of NGFMs “deserves close attention, both to make sure that our current rules are being followed and to ask whether they are sufficiently robust in light of current market practices.” She recommended that companies’ finance and legal teams, along with audit committees, carefully consider the

reasons for using NGFMs and whether such NGFMs are useful to investors.¹⁷

Schnurr confirmed that the SEC staff will “continue to be vigilant in their review of the use of [NGFMs] for compliance with the rules,” but believed that company management and the audit committee should go beyond mere compliance and ask “probing questions on why” certain NGFMs are appropriate and provide useful information to investors compared to GAAP financial measures. Mark Kronforst, Chief Accountant of the SEC’s Division of Corporation Finance, was more explicit – at a conference held in May 2016, Mr. Kronforst was quoted as saying “[the SEC is] going to crack down” on the companies’ misuse of NGFMs.¹⁸

The SEC staff were not bluffing. On May 17, 2016, the SEC Division of Corporation Finance released new and updated Compliance and Disclosure Interpretations (“C&DIs”) on the use of NGFMs, which introduced new prohibitions on practices that were previously considered permissible and clarified which practices the SEC staff would consider to be misleading.¹⁹ Overall, the C&DIs signal a tightening of the SEC’s policy toward NGFMs and renewed SEC focus on their use.

After these speeches and the C&DIs, we expect the SEC to continue to carefully scrutinize the use of NGFMs in company filings, earnings releases and other public disclosures, and to ramp up its efforts to enforce full compliance with the existing rules and its guidance. Following the release of the C&DIs, Mr. Kronforst reiterated at a PCAOB panel discussion that companies should expect an uptick in the number of SEC comments on NGFMs and that the SEC intends to curb the use of certain NGFMs.²⁰ The SEC appears particularly focused on general prohibition of NGFMs that could be misleading: Even when a company is in technical compliance with the rules, if the SEC is not satisfied with the purported usefulness of the NGFM or finds the NGFM to be potentially misleading to investors, the SEC may issue comment letters requesting that the

company either revise the disclosure or discontinue using the NGFM in question.²¹

What Does the SEC Expect Companies to Do?

The SEC has begun to give some indication of the way it expects companies to act through the C&DIs, as well as the speeches and recent comment letters. So what should a company do?

- Management and the audit committee should re-examine the company’s use of NGFMs in SEC filings and other public disclosures, particularly in light of the SEC staff’s focus on general prohibition of misleading measures, and evaluate the number of NGFMs it uses, the complexity of the NGFMs and whether it has substantive justification for using each of the NGFMs.
- Give equal or greater prominence to the directly comparable GAAP measure consistent with the C&DIs, particularly when a NGFM is used in headings or bullet points in an earnings release. Pay close attention to the order of appearance (a NGFM cannot precede the most directly comparable GAAP measure) and style of presentation (a NGFM cannot be emphasized by using a descriptive characterization or a different font size/style without equally emphasizing the most directly comparable GAAP measure).
- Avoid presenting a non-GAAP revenue measure that backs out the effect of GAAP revenue recognition principles applicable to the company’s business, which the SEC staff could view as *per se* misleading. A similar approach to other financial statement line items may also be problematic under the SEC staff’s guidance.²²
- Do not present a NGFM on a per-share basis if the NGFM *can be* used as a liquidity measure, regardless of whether management presents it as a performance or liquidity measure. For this reason, per-share presentation of EBIT and EBITDA is prohibited.

Avoid asymmetrical exclusion of expense items without similarly excluding revenue or gain items (so-called, “cherry-picking”).

- Use a specific, substantive explanation for making an adjustment to a GAAP measure instead of relying on adjectives like “non-recurring” or “one-time” if the excluded item is of a type that has occurred in the past or is likely to recur in the future. However, if the adjustment is a “normal, recurring, cash operating expense” that is a core element of the company’s business or strategy, the SEC may view the NGFM as misleading.²³
- Be careful about changing the definition of NGFMs from period to period. If a change is necessary, the company should be transparent about the reasons for the change and discuss comparability with prior periods (and provide, if the change is significant, the recast measures for prior periods using the new definition).
- Present non-GAAP income tax effects that are appropriately calculated to reflect the nature of the NGFM. For example, if a company’s income tax rate is low due to certain expenses that are excluded from a non-GAAP income measure, when showing the income tax effects on such NGFM, the company cannot apply the same low tax rate to calculate the non-GAAP tax expense while using the higher non-GAAP taxable income.
- Use customary cautionary statements, such as those advising that the company’s NGFMs may not be comparable to similarly titled NGFMs used by other companies and that an NGFM is merely a supplement to, and not a replacement of, a GAAP financial measure.
- Provide the directly comparable GAAP measure and reconciliation for any forward-looking NGFM (for example, forecast, guidance or projection) unless it requires “unreasonable efforts” (in which case, the company must disclose that fact, identify information that is unavailable, and disclose its probable significance at a location of equal or greater prominence).

- Include the reconciliation in the same disclosure as the NGFMs, except that a link or reference to a Web site containing the required information may be provided if the NGFM is disclosed orally, telephonically, by webcast, by broadcast, or by similar means.
- Ensure that earnings releases comply with the affirmative requirements under Item 10(e)²⁴ of Regulation S-K, even when they are “furnished” under Item 2.02 of Form 8-K. This trap for the unwary catches many companies, so review earnings releases as carefully as any SEC filed document. And, even though the SEC has not required compliance with certain other provisions of Item 10(e) (for example, avoid using titles or descriptions of NGFMs that are the same as or confusingly similar to GAAP financial measures), companies should generally try to comply with those provisions as well.
- Although in many cases foreign private issuers (FPIs) are exempt from the rules regarding NGFMs, disclosures by FPIs in the US press or in the US edition of a foreign newspaper highlighting their financial results may be viewed as targeting persons in the United States. In such cases, FPIs should ensure that any NGFMs used in the disclosure comply with the rules.²⁵

Notes

1. Chair Mary Jo White, “Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility,” Keynote Address at the 2015 AICPA National Conference (Dec. 9, 2015), available at <https://www.sec.gov/news/speech/keynote-2015-aicpa-white.html>, last accessed May 24, 2016.
2. Chief Accountant James V. Schnurr, Remarks before the 12th Annual Life Sciences Accounting and Reporting Congress (Mar. 22, 2016), available at <https://www.sec.gov/news/speech/schnurr-remarks-12th-life-sciences-accounting-congress.html>, last accessed May 24, 2016.
3. Deputy Chief Accountant Wesley R. Bricker, Remarks before the 2016 Baruch College Financial Reporting Conference (May 5, 2016), available at <https://www.sec.gov/news/speech/speech-bricker-05-05-16.html>.
4. See, e.g., Justin Lahart, “S&P 500 Earnings: Far Worse Than Advertised,” *The Wall Street Journal* (Feb. 24, 2016) (subscription required); Dave Michaels, “Fuzzy-Math

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- Accounting Chided by Buffett Gets Fresh SEC Scrutiny,” *Bloomberg* (Mar. 1, 2016), available at <http://www.bloomberg.com/news/articles/2016-03-01/fuzzy-math-accounting-chided-by-buffett-gets-fresh-sec-scrutiny>, last accessed May 24, 2016; Theo Francis and Kate Linebaugh, “U.S. Corporations Increasingly Adjust to Mind the GAAP,” *The Wall Street Journal* (Dec. 14, 2015) (subscription required); and Gretchen Morgenson, “Fantasy Math Spins Losses Into Profits,” *The New York Times* (Apr. 24, 2016).
5. Chairman Arthur Levitt, The “Numbers Game,” Remarks at NYU Center for Law and Business (Sept. 28, 1998), available at <https://www.sec.gov/news/speech/speecharchive/1998/spch220.txt>, last accessed May 24, 2016.
6. Chief Accountant Lynn E. Turner, Remarks to the 39th Annual Corporate Counsel Institute (Oct. 12, 2000), available at <https://www.sec.gov/news/speech/spch418.htm>, last accessed May 24, 2016.
7. Securities and Exchange Commission, *Cautionary Advice Regarding the Use of “Pro Forma” Financial Information in Earnings Release* (Dec. 4, 2001), available at <https://www.sec.gov/rules/other/33-8039.htm>, last accessed May 24, 2016.
8. *In re: Trump Hotels & Casino Resorts, Inc.*, Securities and Exchange Commission Administrative Proceeding, File No. 3-10680 (Jan. 16, 2002), available at <https://www.sec.gov/litigation/admin/34-45287.htm>, last accessed May 24, 2016.
9. Generally, and subject to certain exceptions, Regulation G applies to all public disclosures of NGFMs made by SEC reporting companies, and Item 10(e) of Regulation S-K applies to NGFMs that are used in “filings” with the SEC (except earnings releases that are “furnished” under Item 2.02 of Form 8-K are subject to Item 10(e)(1)(i) of Regulation S-K (*i.e.*, just the “affirmative” requirements under Item 10(e)(1)(i)). Fundamentally, the rules require that, each time an NGFM is used, the disclosure must also present the most directly comparable GAAP financial measure (for Item 10(e) of Regulation S-K, with “equal or greater prominence”) and provide a reconciliation of the NGFM to such GAAP measure. For more in-depth discussions of the technical requirements under these rules, see our memo, “SEC Relaxes Guidance on Non-GAAP Financial Measures” (Jan 15, 2010) and the related memos attached to it, available at <https://www.clearygottlieb.com/news-and-insights/publication-listings/sec-relaxes-guidance-on-non-gaap-financial-measures5>, last accessed May 24, 2016.
10. Securities and Exchange Commission, *Compliance and Disclosure Interpretations—Non-GAAP Measures*, available at <https://www.sec.gov/divisions/corpfin/guidance/nongapinterp.htm>, last accessed May 24, 2016.
11. *Id.*, Question 102.03.
12. Emily Chasan, “SEC: ‘Knock It Off’ on Bogus Non-GAAP Measures,” *The Wall Street Journal* (Dec. 5, 2011), available at <http://blogs.wsj.com/efol/2011/12/05/sec-knock-it-off-on-bogus-non-gaap-measures>, last accessed May 24, 2016 (subscription required).
13. See Groupon, Inc., Response Letter to the SEC (Aug. 10, 2011), available at <https://www.sec.gov/Archives/edgar/data/1490281/000104746911007179/FILENAME1.htm>, last accessed May 24, 2016.
14. Michael Rapoport, “SEC Task Force Probes Use of Non-GAAP Metrics,” *The Wall Street Journal* (Dec. 10, 2013), available at <http://www.wsj.com/articles/SB1000142405270230330204579250654209426392>, last accessed May 24, 2016 (subscription required).
15. Gretchen Morgenson, “Valeant’s Fantastic(al) Numbers,” *The New York Times* (Nov. 1, 2015).
16. Richard Beales, “Tweet Nothings,” *Breaking Views* (Feb. 12, 2016), available at <http://www.breakingviews.com/bad-finance-mind-the-non-gaap-@twitter-and-beyond/21235243.article>, last accessed May 24, 2016.
17. Although Chair White asked in her speech “whether [current rules] are sufficiently robust in light of current market practices,” it is unclear when, or whether, the SEC will propose new rules on NGFMs, particularly insofar as the SEC wishes to address the use of NGFMs it believes may be inherently misleading even though literally accurate. See Dave Michaels and Michael Rapoport, “SEC Signals It Could Curb Use of Adjusted Earnings Figures,” *The Wall Street Journal* (Mar. 16, 2016), available at <http://www.wsj.com/articles/sec-scrutinizing-use-of-non-gaap-measures-by-public-companies-1458139473>, last accessed May 24, 2016 (subscription required), which points out that “Ms. White is likely to leave the commission sometime before the end of the Obama administration, meaning rule changes likely aren’t imminent.”
18. Thomson Reuters Tax & Accounting News, *Non-GAAP Measures Hit With Crackdown* (May 6, 2016), <https://tax.thomsonreuters.com/media-resources/news-media-resources/checkpoint-news/daily-newsstand/non-gaap-measures-hit-with-crackdown>.
19. The C&DIs are available at <https://www.sec.gov/divisions/corpfin/guidance/nongapinterp.htm>.
20. Public Company Accounting Oversight Board, Standing Advisory Group Meeting (May 18-19, 2006), webcast and audio available at <https://pcaobus.org/News/Events/Pages/SAG-meeting-May-2016.aspx>.
21. A recent SEC comment to ConocoPhillips is illustrative. In its 2014 10-K, ConocoPhillips used a “price normalized” NGFM that applied 2013 commodity prices across different time periods. The company’s explanation for normalizing commodity prices to a base year was to show its underlying performance across time periods based primarily on factors that the management could control. Although the 10-K disclosure was compliant with all of the requirements of Item 10(e) of Regulation S-K, the SEC objected to the company’s approach and asked the company to stop using the NGFM, and the company agreed to do so. See ConocoPhillips, Response Letter to the SEC (June 8, 2015), available at <https://www.sec.gov>.
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gov/Archives/edgar/data/1163165/000119312515228129/
filename1.htm, last accessed May 24, 2016.

22. For further discussion on this topic, please see our memo, “SEC Releases New Guidance on Non-GAAP Financial Measures” (May 18, 2016), available at <https://www.clearygottlieb.com/~lmedialcgshlfiles/alert-memo-pdf-version-201653.pdf>.

23. The SEC’s comment on Groupon’s IPO discussed in the text accompanying *supra* note 13 is an example of this prohibition. More recently, the SEC objected to Valeant’s removal of acquisition-related expenses from its NGFMs, given that acquisitions are part of a critical strategy of

the company’s business. See Valeant Pharmaceuticals International, Inc. Response Letter to the SEC (Dec. 18, 2015), available at <https://www.sec.gov/Archives/edgar/data/885590/000134100415000930/filename1.htm>.

24. *See supra* n.9.

25. There may also be local regulatory requirements regarding use of NGFMs to which FPIs are subject. In an effort to harmonize the rules governing NGFMs across different jurisdictions, in June 2016, the Board of the International Organization of Securities Commission published a Statement on Non-GAAP Financial Measures (available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD532.pdf>).

Reinventing Disclosure: The SEC's Regulation S-K Concept Release

By Mark Plichta, John Wilson, Megan Odronic, and Richard Dancy

On April 13, 2016, the US Securities and Exchange Commission (SEC) issued a concept release discussing and requesting public comment on the business and financial disclosure required by Regulation S-K. The concept release represents an important first step toward the reform and modernization of Regulation S-K.

Background: The SEC's Disclosure Effectiveness Initiative

The concept release is part of the SEC's ongoing Disclosure Effectiveness Initiative, which is a broad-based review of the SEC's disclosure requirements and the presentation and delivery of disclosures that registrants make to investors. The Disclosure Effectiveness Initiative began in 2013, following the SEC's production of a report to Congress on its disclosure rules for US public companies, as mandated by the Jumpstart Our Business Startups (JOBS) Act. Following that report, the SEC initiated a comprehensive review of the disclosure requirements in Regulation S-K and Regulation S-X to make recommendations on how to update those requirements to facilitate timely, material disclosure by companies and access to information by shareholders.

The purpose of the concept release is to revisit the business and financial disclosure requirements in Regulation S-K and to assess whether such requirements continue to provide the information that investors need to make informed investment and voting decisions and whether any of the existing rules have become outdated or unnecessary. The SEC intends to use the feedback collected from the concept release to further its goal of optimizing Regulation S-K, a goal that SEC Chair Mary Jo

White has recently referred to as a crucial ongoing responsibility of the SEC.

Key Concepts and Elements

The concept release addresses an expansive list of topics and the SEC's discussion of these topics is extensive; however, there are several key concepts and elements that are discussed throughout the concept release, including the following.

Principles-Based Disclosure vs. Prescriptive Disclosure

The concept release discusses and compares the merits of principles-based disclosure,

the Corporate Governance L a d v i s o r

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which is based on principles such as “materiality,” and the merits of prescriptive disclosure, which is based on objective line-item requirements, bright-line tests, and required tabular presentation. The concept release notes that principles-based disclosure offers a more flexible, management-oriented approach that allows individual registrants to tailor disclosures to provide the information that is most relevant and material to the individual registrant and omit irrelevant or immaterial information. Conversely, the concept release notes that prescriptive disclosure provides investors with the ability to more easily make comparisons between registrants because information is presented in a more standardized form.

The SEC seeks input on which approach is the most effective and cost-efficient by requesting input on a variety of questions, including whether certain line-item disclosures (both narrative and tabular) should be added or removed from Regulation S-K; whether additional industry-specific disclosure should be required in periodic reports; and whether qualitative or quantitative thresholds should be added to or removed from existing disclosure requirements.

Streamlining Disclosure

A significant portion of the concept release is devoted to determining how to make the existing disclosure framework under Regulation S-K more effective and cost-efficient to investors and registrants. The SEC asks whether certain required disclosures and disclosure frameworks should be consolidated with other, similar disclosure requirements or eliminated altogether.

In addition, the concept release includes a discussion of the scaled disclosure requirements available to smaller reporting companies and emerging growth companies. The SEC requests input on how to further scale or eliminate disclosures applicable to these companies in addition to exploring whether additional types of registrants, including larger registrants with established reporting histories, should be eligible for a form of scaled disclosure.

The SEC also seeks input on several alternate approaches to the periodic disclosure regime that could result in less year-to-year repetition and comparison of prior periods and less frequent periodic reporting.

Expanding Disclosure

In addition to requesting comments on methods for streamlining disclosure, the concept release examines the “other side of the coin” and requests comments on whether new or expanded disclosure is necessary to reflect changes in the market and recent stakeholder input. The concept release includes numerous requests for comment on whether the items of Regulation S-K should be expanded or modified to, among other things, adopt disclosure approaches that have become common in certain industries and require greater disclosure of industry-specific metrics. The SEC is also seeking input on the utility of increased periodic and intra-period reporting.

The concept release also explores the value of new disclosure topics not currently required under Regulation S-K. The SEC asks whether (and which) sustainability and public policy issues are important to voting and investment decisions and an understanding of a registrant’s business and financial condition. In addition, the SEC is requesting input on how to create disclosure requirements that adequately address such issues without resulting in disclosure that is immaterial or otherwise obscuring to investors.

Presentation of Information

The SEC acknowledges that technology and the way investors obtain information regarding registrants has changed over time, and is therefore seeking input on how these changes may be reflected in the presentation of information in periodic reports. In particular, the SEC cites the widespread use of the Internet by investors when requesting comments on whether the SEC should permit the increased use of cross references, hyperlinks and registrant Web site disclosure to satisfy the reporting requirements of Regulation S-K.

The concept release further discusses whether changes in technology have made it possible for registrants to provide information in a more disaggregated manner, or whether there is practical and regulatory value in requiring information to be contained in one consolidated source.

Audience Sophistication

The concept release solicits information on the type of investors that are actually reading and utilizing the materials that are filed by registrants on EDGAR. Throughout the concept release, comments are requested regarding whether certain disclosures are for the benefit of, and, as a result, should be tailored toward, more sophisticated institutional investors or less sophisticated retail investors. The concept release indicates that this information is important, in part, because it provides insight into the way disclosures should be tailored, including whether currently required disclosures should be expanded or eliminated. The concept release also discusses the use of third-party data aggregators by different types of investors, and questions whether the functions performed by such aggregators reduces the need for comparative or repetitive disclosure in SEC filings.

Adapting to Changes in the Market

The concept release discusses potential reforms to the SEC's rulemaking process designed to allow new disclosure rules to be adapted or to expire in response to a changing market. The SEC seeks input on how to make its disclosure requirements more adaptive, including through the implementation of automatic sunset provisions on new disclosure rules or by requiring that the staff of the Division of Corporation Finance study and report on the impact of new disclosure requirements.

Specific Disclosure Areas

In addition to the overarching conceptual topics described previously, the concept release discusses certain specific disclosure areas and seeks input on how to improve the quality of

information disclosed in these areas without overburdening registrants or investors.

Core Company Business Information

The concept release seeks comment on expanding, contracting, and otherwise reforming the key business disclosures under Items 101 and 102 of Regulation S-K regarding development of the business; narrative description of the business; technology and intellectual property rights; government contracts; compliance with environmental laws; government regulation; employees; and description of property.

Company Performance, Financial Information, and Future Prospects

The concept release examines the disclosure of selected financial data and supplementary financial information under Items 301 and 302(a) of Regulation S-K, including the line items and time periods required to be covered by such disclosure. The SEC asks whether this disclosure is useful to investors, and whether the current requirements prescribed by Items 301 and 302(a) should be expanded or contracted. The SEC also seeks comment on whether there should be greater auditor involvement in preparing these disclosures.

The concept release also discusses potential improvements to the quality of Management's Discussion & Analysis (MD&A) disclosure under Item 303, with the SEC requesting comment on the required content of MD&A, the thresholds for disclosure, the disclosure of forward-looking information, and key performance indicators. The SEC is also seeking input on whether to require an executive level overview of MD&A; whether to include a principles-based disclosure of key industry metrics; and whether to revisit the current "two-step" test for determining whether forward-looking disclosure is required in MD&A. The SEC is also seeking input on the key components of MD&A disclosure, including results of operations, liquidity and capital resources (including short-term borrowings), off-balance

sheet arrangements, contractual obligations, and critical accounting estimates.

Risk and Risk Management

The concept release discusses improving the disclosure of risk and risk management in periodic reports pursuant to Items 503(c) and 305 of Regulation S-K. The SEC seeks comment on several new approaches to risk factor disclosure, including presentation of risks based on the order of magnitude and the identification of the ten most important risks to a registrant. The SEC has also requested input on whether the inclusion of “generic” risk factors should be discouraged. In addition, the concept release explores the possibility of including risk mitigation disclosure within the discussion of a registrant’s risk factors.

The concept release further examines the quantitative and qualitative disclosures about market risk under Item 305 of Regulation S-K, including a discussion of disclosure objectives, disclosure alternatives, and coordination and comparability of disclosure. In particular, the SEC seeks input on whether the disclosure required by Item 305 remains useful given changes in US generally accepted accounting principles and Regulation S-X that have resulted in the inclusion of similar information in the presentation of financial statements.

Finally, the SEC has requested input on whether the consolidation of all risk-related disclosure would improve the overall quality of disclosure, and whether Regulation S-K should be revised to require new narrative disclosure from registrants describing their risk management processes.

Securities of the Registrant

The concept release discusses the current disclosure framework related to a registrant’s securities, with an emphasis on disclosure under Items 201(b)(1), 202, 701, and 703 of Regulation S-K regarding number of equity holders, description of capital stock, recent sales of unregistered securities, use of proceeds

from registered securities, and registrant repurchases of equity securities. Generally, the SEC is seeking to understand whether these disclosures remain important to investors or whether they have become redundant in the face of overlapping disclosure requirements and other sources of information.

Exhibits

The concept release discusses the current filing requirements for exhibits to periodic and other reports, with an emphasis on the filing of material contracts and subsidiary information under Item 601 of Regulation S-K, as well as the filing of schedules, attachments, amendments, and other modifications to such exhibits.

Industry Guides

The concept release considers the ongoing role of the SEC’s Industry Guides, and asks whether the Industry Guides continue to provide useful guidance for registrants and result in the disclosure of important information to investors. In particular, the concept release asks whether the Industry Guides should be updated or codified into Regulation S-K.

Topics Not Discussed

The concept release does not address certain disclosure requirements in Regulation S-K, such as executive compensation and governance, or the required disclosures for foreign private issuers, business development companies, or certain other categories of registrants. Although the concept release is silent on these requirements, it nonetheless welcomes comments on any disclosure topic not specifically addressed within its text.

Next Steps: Is Reform Imminent?

Although the concept release discusses a broad spectrum of potential changes to Regulation S-K, it is unlikely that such changes are imminent. First, the SEC will review comments received on the concept release, which

are due 90 days following its publication in the *Federal Register*. After reviewing any comments submitted, the SEC may, at its discretion, issue one or more rule proposals, which will be made available for review and comment by the public prior to the publication of any final rules.

Although the concept release is an important step toward the reform and modernization of Regulation S-K, it remains to be seen whether and how the input provided by registrants, investors, and other stakeholders is applied to reform the existing disclosure framework.

Shareholder Engagement: Governance Experts Share Perspectives

By Abby E. Brown, Carolyn J. Buller, and Wendy K. LaDuca

In April 2016, our firm hosted a roundtable discussion, “Strategies and Best Practices for Shareholder Engagement,” during our 2016 Roundtable for General Counsel in the Chemical and Performance Materials Industries, a two-day executive briefing held in Washington DC. The discussion was well timed, taking place in the midst of proxy season when shareholder engagement activities are in the spotlight. The panel addressed various perspectives of shareholder engagement through the eyes of industry experts including Glenn Booraem, Principal and Fund Treasurer for Vanguard (Vanguard); John Roe, Managing Director and Head of Advisory and Client Services, ISS Corporate Solutions (ISS); Amy Borrus, Deputy Director, Council of Institutional Investors (CII); and Matthew Juneau, Senior Vice President, Corporate Strategy and Investor Relations, Albemarle Corporation (Albemarle). The panel discussion was moderated by Abby Brown, partner in the Global Corporate Practice of the firm’s Washington DC office.

What Is Engagement?

Companies engage with investors all the time through their proxy statement disclosure, Forms 10-K and 10-Q, press releases, earnings calls, and other investor presentations and discussions. ISS’s John Roe encourages companies to think of shareholder engagement as more than the limited dialogue regarding say-on-pay or proxy access that might occur during the proxy statement and annual meeting process. Rather, his view is that investors typically want to engage on a broader range of topics, including corporate strategy, management performance, board structure, executive

compensation, and corporate governance. Thinking of shareholder engagement as a more broad-sweeping and long-term relationship will assist companies in keeping a finger on the pulse of their investors and their concerns on an ongoing basis.

Practical Tips for Shareholder Engagement

- **Make inbound engagement easier.** Investors who use shareholder proposals often do so because they feel that they have no other way to get the attention of company management and the board. Prevent this by supplying an easy communication channel for them.
- **Set internal expectations.** Expect that only 25 percent to 30 percent of your engagement invitations sent out will actually result in a meeting (and assume an even lower return rate during proxy season). Take a low response as a sign that these shareholders either lack the resources to engage at that moment, or that they do not have an issue with your company. Also, presume that any outreach is well received and noticed by the shareholder, even if they do not take you up on an offer for a meeting or discussion at that time.
- **Ask questions; do not just give a roadshow.** Use the opportunity for engagement to solicit shareholder feedback on certain issues. Avoid the temptation to walk an investor or the ISS staff through your company’s proxy statement—it should stand on its own. Make sure that you understand each shareholder’s perspective on key issues; do not fall into the trap of justifying your actions and policies against proxy

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advisors' views or recommendations when shareholders have their own guidelines.

- **Follow-up.** After a shareholder engagement meeting, the company should carefully evaluate the shareholder's position, consider how peers have approached similar issues, and consider whether any changes are warranted. If the company does make a change as a result of the engagement meeting, the company should communicate that change to the shareholder even if follow-up is simply a revised proxy disclosure. In addition, some companies are now including in their proxy statements a summary of engagement themes, including any actions taken in response to what they heard from investors as a result of their engagement efforts.

How to Engage

"A company should always tell its best story up front to investors," said Vanguard's Glenn Booraem. Vanguard has seen instances of a standard proxy statement with a great engagement story get lost and only later fully or better disclosed in a proxy supplement. His advice is to spend the time and energy at the outset to include this great information in the initial proxy statement, which will ultimately save time and money, and potentially alleviate investor concerns in the initial filing.

Albemarle's Matthew Juneau indicated that it is important to be *consistent* in how you tell your story. In his view, it is a good idea to tightly manage the disclosure process to ensure that inconsistent messages are not delivered, particularly in light of Regulation FD. For example, before earnings calls, Albemarle takes the time to prepare expected investor questions with proposed answers. While there are occasional surprises, such a process contributes to consistent messages, which in turn builds confidence in company management.

Further, Juneau stated that as part of ongoing shareholder engagement efforts, Albemarle routinely gives its top 35 shareholders extra

attention. For example, after a new message is released, Albemarle issues personalized emails or makes individual phone calls to top investors to make sure they understand why the company is taking a certain action. Another Albemarle initiative is to invite investors to attend a call with executive management to discuss topics of interest. Any such calls, however, should be short (for example, no longer than 30 minutes) and have a clear agenda set in advance.

Practical Tips on How to Engage

- **Be prepared.** Before engaging with an investor, company management or directors should have a clear idea of that investor's concerns and priorities, and an agreed-upon agenda in place (with no more than three to four items for discussion), along with a list of participants.
- **Set the tone of the discussion.** Both companies and investors should approach any meeting with a list of questions (and not demands) and each side should be cordial and give the other side equal time to speak.
- **Avoid boilerplate disclosures about investor engagement.** Good engagement disclosure should describe in detail the way your company engages with investors, discuss outreach over the past year, highlight any changes that occurred as a result, and provide email addresses or other contact information.
- **Small cap companies in particular should spend time at the outset to craft careful proxy statement disclosure.** Small cap companies may not be at the top of an investors' list for communication and, as such, the proxy statement may serve as the main form of communication. With more limited resources, small cap companies may desire to leverage the engagement disclosures of large cap companies and borrow from their approaches and engagement ideas.

Who Should Engage?

Companies should ensure that they have the right people from the company in attendance at investor engagement meetings. Often, that includes members of the company's management team or investor relations. Someone from the compensation committee should always be present at any meeting discussing compensation issues (not necessarily the committee chair) so long as that person is informed about the matters to be discussed. Along the same lines, a director should be present if the discussion is to be focused on board-related topics (for example, board compensation). Booraem shared an ideal shareholder meeting example whereby director(s) excused management at the end of an engagement meeting to give Vanguard an opportunity to ask questions and provide feedback without management present, which was highly effective in reinforcing Vanguard's link to the company's board.

Practical Tips for Those Who Engage

- **Make sure the directors are communication ready.** Engaging with shareholders is part of a board member's job description now. If you do not have directors on your board who possess effective communication skills, now is a good time to recruit them.
- **Identify the right investors.** When looking for shareholders to engage with, do not stop at the top 10, 15 or 25 investors; review your shareholder base as a whole to determine with whom it might be important to engage, including small but strategically important shareholders.
- **If a director is present at an investor engagement meeting, make sure the director is prepared.** Whether you should have a particular director present at a shareholder engagement meeting depends on how well-informed that director is and how comfortable talking about certain potential issues (arrogance or unwillingness to hear suggestions should be avoided).

- **CII's Amy Borrus advised circumventing unexpected drop-ins.** Unexpected drop-ins by a CEO or board chair during an engagement meeting can be off-putting to an investor. Make sure the investor knows ahead of time exactly who is going to be present at the meeting.
- **Ensure you know with whom you are meeting.** Company management and directors in attendance at any shareholder engagement meeting should be familiar with the particular shareholder's equity position, their public views on key governance issues, as well as the history of any engagement and voting results. This enables company responsiveness to specific investor concerns, as well as continuity over time in the engagement dialogue.

When Should Engagement Occur?

Borrus noted that recent years have shown companies are increasingly willing to reach out to shareholders to start a dialogue. She also noted, however, that such engagement should not be a "last minute blitz" before the annual meeting; rather, engagement is an on-going, year-round process. As a matter of fact, the rush of the proxy season can make it difficult for companies to get the attention of investors or ISS in order to engage during the first months of the year. Rather, Borrus indicated that "off-season" engagement outside of the heat of proxy season offers a good opportunity for long-term investor engagement and is critically important to building shareholder relationships that may make it easier to resolve conflicts in the future.

In Booraem's opinion, the ideal time for shareholder engagement is when the ink is not yet dry on the proxy statement—essentially, right after the prior year's annual meeting. Once a company has had the opportunity to digest the meeting vote and think about the broader trends that developed during the proxy season. Similarly, Juneau offered that Albemarle has found that it tends to

be easier to have a dialogue and engage with investors during the late summer and early fall.

Practical Tips on Engagement Timing

- **Do not underestimate the value of “off-season” investor engagement.** Investor engagement during the “off-season” in the annual meeting cycle allows for companies to carefully contemplate investor concerns, make necessary adjustments to the proxy statement months ahead of time, and provide adequate time for board review.

- **Engage with ISS at the appropriate time.** Roe indicated that companies should ideally engage with ISS only *after* they have actively engaged with their investor base.

Conclusion

From these discussions, we learned that it is important for companies to have a good understanding of the “who,” “what,” “when,” and “how” aspects of the shareholder engagement process. Good engagement goes a long way to building positive relationships with an investor base, facilitating solid communications, and helping potentially avoid a future crisis.

Gender Pay Equity In Focus

By Jon Weinstein and Ashley Meischeid

This year's Equal Pay Day (April 12, 2016) produced an extraordinary volume of discourse and disclosure on a vitally important topic—and one that is surfacing more frequently at the compensation committee level. As activist shareholders and a presidential election year bring heightened attention to pay equity in the private sector, companies are increasingly disclosing their own demographic compensation statistics or chartering studies to ascertain where they stand. Further, compensation committees are showing significant interest in the issue as committee agendas have begun to include pay equity as a subject for discussion.

Thus far, a range of prominent companies, primarily in the technology space, have made headlines by voluntarily disclosing their pay equity statistics to the public. Specifically, Amazon, Apple, Facebook, GoDaddy, Intel, Microsoft, and RedFin have all disclosed gender

pay equity statistics showing what women in their companies earn as a percentage of men, with the data ranging from from 99.7¢ to \$1.003. These figures compare favorably to a recent study conducted by Glassdoor that found an “unadjusted” US gender wage gap of 75.9¢ and an “adjusted” wage gap (normalized for differences in education, age, experience, industry, job title, and other factors) of 94.6¢.

On the governmental front, the US Office of Federal Contract Compliance Programs (OFCCP) and Equal Employment Opportunity Commission (EEOC) have issued new requirements on pay transparency/disclosure, and UK Prime Minister David Cameron has proposed rules that would require companies with more than 250 employees to disclose their pay equity data.

While much work and continued progress is still needed, the dialogue on pay equity and focus of major employers on this issue demonstrate a positive trend. We expect to see continued amplification of this critical issue moving forward.

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Director Cyber Risk: Insights from Shareholder Derivative Lawsuits

By *Melissa J. Krasnow*

Shareholder derivative lawsuits regarding the Wyndham, Home Depot and Target cyber attacks provide insights on steps companies can take regarding director cyber risk.¹ These steps include: (1) determining fiduciary duties and monitoring shareholder derivative lawsuits for developments (this article covers both Delaware and Minnesota law), (2) reviewing organizational documents, applicable law and agreements, policies and insurance, (3) reviewing and considering company committee charters and privacy policies and Securities and Exchange Commission disclosures comprehensively and specifically regarding cyber risk, and (4) developing, implementing, testing, and updating incident response plans.

Determining Fiduciary Duties and Monitoring Shareholder Derivative Lawsuits for Developments

Delaware law is applicable in *Palkon v. Holmes* regarding Wyndham and *In re The Home Depot, Inc. Shareholder Derivative Litigation* regarding Home Depot because Wyndham and Home Depot are Delaware corporations. Delaware case law describes the director duty to monitor and oversee risks as derived from the duty of care and the duty of loyalty.²

Palkon v. Holmes addressed three cyber attacks against Wyndham between 2008 and 2010. The plaintiff was required to plead with particularity that the board's decision to refuse his demand to bring a lawsuit regarding the cyber attacks was in bad faith or not based on a reasonable investigation. The Wyndham board's decision to refuse the demand is under

the purview of the business judgment rule, under which there is a presumption that the board refused the demand on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Among other things, the defendants argued that the board's decision to refuse the demand was a good faith exercise of business judgment, made after a reasonable investigation.

The court dismissed the lawsuit with prejudice and described in a footnote the failure to act in good faith that is required to show director oversight liability (as part of the duty of loyalty):

Caremark requires that a corporation's "directors utterly failed to implement any reporting or information system...[or] consciously failed to monitor or oversee its operations thus disabling themselves from being informed." *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006). Yet Plaintiff concedes that security measures existed when the first breach occurred, and admits the Board addressed such concerns numerous times. (Compl. ¶¶ 46, 62, 63). The Board was free to consider such potential weaknesses when assessing the lawsuit.

The actions of Wyndham that were mentioned in this case included:

- (1) Board discussion of the cyber attacks, Wyndham's security policies, and proposed security enhancements at 14 meetings and audit committee discussion at 16 meetings between 2008 and 2012;
- (2) Wyndham hiring technology firms to investigate each cyber attack and issue recommendations on enhancing Wyndham's security;

Melissa J. Krasnow is a partner with Dorsey & Whitney LLP, a Certified Information Privacy Professional/US, and a National Association of Corporate Directors Fellow.

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- (3) Wyndham beginning to implement such recommendations after the second and third cyber attacks, and
 - (4) Presentations of Wyndham's general counsel regarding the cyber attacks and Wyndham's data security generally at every quarterly board meeting.

The defendants' motion to dismiss filed on April 14, 2016, in *In re The Home Depot, Inc. Shareholder Derivative Litigation* states:

Loyalty claims based on alleged failure of oversight are widely recognized as "the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." *In re Caremark Int'l., Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996). To state such a claim, a stockholder must plead particularized facts that the defendants "(a) utterly failed to implement any reporting or information system or controls or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that [defendants] knew that they were not discharging their fiduciary obligations." *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

According to the defendants' motion to dismiss, the plaintiffs failed to state a duty of loyalty claim against any defendants.³

Target is a Minnesota corporation. The Minnesota corporate statute describes the standard of conduct for a director.⁴ Regarding *In re Target Corp. Shareholder Derivative Litigation*, the board of directors appointed a Special Litigation Committee to investigate the claims. The Special Litigation Committee completed its investigation and issued a report in March 2016, determining that it was not in Target's best interests to pursue the derivative claims and seeking dismissal of the claims with prejudice. On June 22, 2016, the Special Litigation

Committee and Defendants will move the court for approval and dismissal of the derivative actions with prejudice, asserting that

- (1) The members of the Special Litigation Committee were disinterested and independent, and
- (2) The Special Litigation Committee's investigative procedures and methodologies were adequate, appropriate and pursued in good faith, in satisfaction of the business judgment rule.⁵

The business judgment rule accords deference to the determination of the Special Litigation Committee regarding the derivative actions.

Finally, both breach of fiduciary duty claims and waste of corporate assets claims were made in *Palkon v. Holmes, In re The Home Depot, Inc. Shareholder Derivative Litigation* and *In re Target Corp. Shareholder Derivative Litigation*. According to Delaware case law, a "claim of waste will arise only in the rare, 'unconscionable' case where directors irrationally squander or give away corporate assets."⁶

In re The Home Depot, Inc. Shareholder Derivative Litigation and *In re Target Corp. Shareholder Derivative Litigation* should be monitored for developments, as should any other shareholder derivative lawsuits regarding cyber attacks.

Reviewing Organizational Documents, Applicable Law and Agreements, Policies and Insurance

According to the defendants' motion to dismiss in *In re The Home Depot, Inc. Shareholder Derivative Litigation*, Home Depot's Certificate of Incorporation contains language that precludes a duty of care claim against its directors.⁷ According to an order filed on May 23, 2016, Plaintiffs must file and serve their opposition to Defendants' motion to dismiss by June 30, 2016 and Defendants must file and serve their reply brief in further support of their motion to dismiss by July 20, 2016.

However, neither the Delaware corporate statute nor the Minnesota corporate statute permits eliminating or limiting the personal liability of a director to a corporation or its shareholders for monetary damages for breach of fiduciary duty for any breach of the director's duty of loyalty to the corporation or its shareholders or for acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law, among other things.⁸

Companies should review their organizational documents and applicable law and their indemnification agreements or policies and directors and officers liability insurance and cyber liability insurance coverage.

Reviewing and Considering Committee Charters, Privacy Policies, and SEC Filings

Palkon v. Holmes, In re The Home Depot, Inc. Shareholder Derivative Litigation, and *In re Target Corp. Shareholder Derivative Litigation* reference the companies': (1) audit committee charters, (2) Securities and Exchange Commission disclosures regarding cyber risk and attacks and (3) privacy policies, including language about the companies using industry standard methods to protect customer information.

Company committee charters and privacy policies and Securities and Exchange Commission disclosures should be reviewed comprehensively and specifically regarding cyber risk and attacks, including in terms of litigation.⁹ The foregoing also can be reviewed against similar items of companies in the same industry or that have experienced cyber attacks.

Developing, Implementing, Testing and Updating Incident Response Plans

Palkon v. Holmes, In re The Home Depot, Inc. Shareholder Derivative Litigation, and *In re Target Corp. Shareholder Derivative Litigation* address preparation regarding and response to cyber risk and attacks. Companies should develop, implement, test via simulated cyber

attack exercises, and update incident response plans in light of insights obtained from testing and legal, business, technological, and public relations developments to bolster preparation regarding and response to cyber risk and attacks.

Directors could ask the following questions regarding incident response plans:¹⁰

- (1) What is the date of the plan and what was the most recent date of testing the plan?
- (2) How frequently is the plan is tested or updated?
- (3) What was the situation that was the subject of the testing?
- (4) What are the results of and insights from the testing or updating of the plan?
- (5) Who are the members of the incident response team?
- (6) Who are the external team members (including service providers)?
- (7) What are team member responsibilities?
- (8) What are the lines of communication?
- (9) What communications, disclosures, and notifications are being considered?
- (10) What is the nature of and how frequently is employee security training and awareness provided?

Conclusion

In re The Home Depot, Inc. Shareholder Derivative Litigation and *In re Target Corp. Shareholder Derivative Litigation* should be monitored for developments, as should any other shareholder derivative lawsuits regarding cyber attacks. Companies also should: (1) determine fiduciary duties; (2) review organizational documents, applicable law, indemnification agreements or policies, directors and officers liability

insurance, and cyber liability insurance coverage; (3) review committee charters, privacy policies, and Securities and Exchange Commission disclosures in a comprehensive and specific manner regarding cyber risk and attacks, and (4) develop, implement, test via simulated cyber attack exercises, and update incident response plans.

Notes

1. See *Palkon v. Holmes*, No. 2:14-CV-01234 (D.N.J. Oct. 20, 2014); *In re The Home Depot, Inc. Shareholder Derivative Litigation*, No. 1:15-CV-2999 (N.D. Ga.) and *In re Target Corp. Shareholder Derivative Litigation*, No. 0:14-cv-00203 (D. Minn.).

2. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

3. Regarding the failure to implement any reporting or information system or controls, the plaintiffs' complaint pleads that "... (i) the Audit Committee was established to assist the Board in reviewing and monitoring the Company's compliance programs (Comp., ¶ 49); (ii) the Audit Committee has 'primary responsibility for overseeing risks related to IT and data privacy and security at Home Depot' (*id.*, ¶ 278); (iii) internal audits were conducted on the Company's data security systems (*id.*, ¶¶ 141, 164, 205, 279); and (iv) the Company's IT Security and internal audit departments frequently reported to the Board and Audit Committee regarding cybersecurity issues (*id.*, ¶¶ 86–88, 97, 99, 103, 116, 120–123, 139–142, 150–153, 155, 157, 158, 160–163, 200, 205–209). Regarding showing that the defendants acted in bad faith by consciously failing to monitor or oversee its operations, the plaintiffs' allegations negate any claim that the defendants acted in bad faith in breach of the duty of loyalty":

- M. Carey "met regularly with Home Depot's Audit Committee and its full Board of Directors and provided the Board with updates regarding Home Depot's data security systems." (Comp., ¶97).
- M. Carey additionally briefed the Board on data breaches at other large retailers. (Comp., ¶¶76, 77).
- Management conducted regular scans and internal audits of the Company's cybersecurity systems, and reviewed those results with the Audit Committee and the Board. (Comp., ¶¶86, 150, 151, 162, 206, 207).
- Based on these scans and audits, M. Carey and his department planned and executed remedial measures and "enhancements" to the Company's data security systems. (Comp., ¶¶ 88, 118, 121, 150, 152, 200, 202–206, 230, 238, 239).
- Third-party consultants were retained to advise the Company on its cybersecurity measures and "to perform a 'health check' on its computer systems." (Comp., ¶¶101, 104, 136).

4. According to the Minnesota corporate statute:

A director shall discharge the duties of the position of director in good faith, in a manner the director reasonably believes to be in the best interests of the corporation, and with the care an ordinarily prudent person in a like position would exercise under similar circumstances. A person who so performs those duties is not liable by reason of being or having been a director of the corporation. Minn. Stat. § 302A.251, Subd. 1.

The Minnesota corporate statute further states:

(a) A director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, in each case prepared or presented by:

- (1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;
- (2) counsel, public accountants, or other persons as to matters that the director reasonably believes are within the person's professional or expert competence; or
- (3) a committee of the board upon which the director does not serve, duly established in accordance with section 302A.241, as to matters within its designated authority, if the director reasonably believes the committee to merit confidence.

(b) Paragraph (a) does not apply to a director who has knowledge concerning the matter in question that makes the reliance otherwise permitted by paragraph (a) unwarranted. Minn. Stat. 302A.251, Subd. 2.

Good faith is defined in the Minnesota corporate statute as "honesty in fact in the conduct of the act or transaction concerned." Minn. Stat. § 302A.011, Subd. 13.

5. "Minnesota case law requires a court to 'defer to an SLC's decision to settle a shareholder derivative action if (1) the members of the SLC possessed a disinterested independence and (2) the SLC's investigative procedures and methodologies were adequate, appropriate, and pursued in good faith.'" *In re UnitedHealth Group Inc. Shareholder Derivative Litigation*, 754 N.W.2d 544, 559 (Minn. 2008).

6. *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 74 (Del. 2006). Under the Minnesota corporate statute, "[a] court may grant any equitable relief it deems just and reasonable in the circumstances... (b) In an action by a shareholder when it is established that... (5) the corporate assets are being misapplied or wasted...." Minn. Stat. § 302A.751, Subd. 1.

7. According to Article 9 of Home Depot’s Certificate of Incorporation:

No director of the Corporation shall be liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, except for liability (i) for any breach of the director’s duty of loyalty to the Corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) under Section 174 of the Delaware General Corporation Law, or (iv) for any transaction from which the director derived an improper personal benefit.

8. Del. Gen. Corp. Law § 102(b)(7); Minn. Stat. § 302A.251, Subd. 4.

9. See Division of Corporation Finance, US Securities and Exchange Commission, CF Disclosure Guidance: Topic No. 2 (Oct. 13, 2011); Melissa Krasnow, “The Securities and Exchange Commission’s Guidance on Cybersecurity and Cyber Incident Disclosure,” *BNA Privacy & Security Law Report* (Oct. 31, 2011).

10. See Melissa Krasnow, “Guidance for Guidance for Incident Response Plans,” International Risk Management Institute (May 2015).

PCAOB Again Issues Proposal to Change Audit Report

By Michael Scanlon, Brian Lane, Lori Zyskowski, and Michael Titera

The Public Company Accounting Oversight Board (PCAOB) recently re-proposed an audit standard to amend the form and content requirements for the independent auditor's report on financial statements.¹ The new proposal retains the pass/fail model present in the existing audit report but also requires the auditor to include new disclosures in the audit report about "critical audit matters" that are identified during the course of the audit. The re-proposal also requires new disclosures about the length of the auditor's tenure and the applicable auditor independence requirements.

The re-proposal is the latest chapter in a standard-setting project that dates back to 2011, when the PCAOB issued a concept release² on potential changes to the audit report, and that evolved in 2013, when the PCAOB issued its original proposal³ on this topic. The PCAOB's re-proposal narrows in some respects the scope of the disclosure requirements for critical audit matters that appear in the audit report, and also drops the component of the original proposal that would have required the auditor to review and report on matters outside the financial statements. But the re-proposal still represents an important development for the financial reporting landscape that issuers and their audit committees should review and consider in detail, including as described later under "Steps to Consider." The deadline for commenting on the PCAOB's proposal is August 15, 2016.

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What are CAMs?—Required Disclosures in the Audit Report about Critical Audit Matters

Under the re-proposal, a critical audit matter (CAM) is defined as "any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment."

The proposed definition thus has three component pieces. *First*, a CAM must be a matter that was voluntarily communicated to the audit committee or that was required to be communicated to the audit committee under Auditing Standard 1301 (formerly AS No. 16), *Communications with Audit Committees*. As issuers and audit committees are well aware, the scope of these required communications is not narrow, with AS 1301 containing more than 15 topics and several dozen related paragraphs that specify what must be communicated to the audit committee. *Second*, a CAM must relate to an account or disclosure that is "material" to the financial statements. Notably, the proposed definition does not require the communication itself to involve a material issue, but rather that the communication must be about an account or disclosure that is material to the financial statements. *And third*, the proposed definition provides that a CAM must have involved an "especially challenging, subjective, or complex auditor judgment." The proposal seeks to inject some objective criteria to help guide this test by laying out several factors that an auditor should take into account in determining whether a matter involved such judgments, specifically:

- The auditor's assessment of the risks of material misstatement, including significant risks;

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- The degree of auditor subjectivity in determining or applying audit procedures to address the matter or in evaluating the results of those procedures;
 - The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter;
 - The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;
 - The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions; and
 - The nature of audit evidence obtained regarding the matter.

The new proposal provides that if the auditor determines that a CAM exists, the auditor must include disclosure in the audit report that identifies the CAM, describes the principal considerations that led the auditor to determine that the matter is a CAM, describes how the CAM was addressed in the audit, and identifies the relevant financial statement accounts and disclosures that relate to the CAM.

The CAM definition offered in the original proposal was more expansive because it did not specifically relate back to disclosure of matters that were communicated to the audit committee. By incorporating the concept of matters required to be communicated to the audit committee, the re-proposal draws on existing AS 1301 to provide some guideposts for determining which matters may be treated as CAMs. However, given the lengthy list of required communications in AS 1301 and that the re-proposal includes both required communications and those that are voluntarily communicated to the audit committee, the range of matters that

could be CAMs remains quite broad and could lead to significant new disclosures in the audit report, as discussed in more detail later under “Steps to Consider.”

The new proposal specifies that CAMs would not have to be disclosed in audit reports issued in connection with audits of brokers and dealers, investment companies other than business development companies, or employee stock purchase, savings, and similar plans.

Additional New Disclosures in the Audit Report

Auditor Tenure. The re-proposal requires the auditor to include in its report “[a] statement containing the year the auditor began serving consecutively as the company’s auditor.” Under the proposed requirement, the auditor tenure would include the years the auditor served as the company’s auditor both before and after the company became subject to SEC reporting obligations. Although the PCAOB unanimously approved the issuance of the proposal, several board members indicated they were not certain this disclosure is needed. These sentiments were expressed in part because many issuers have voluntarily included enhanced audit committee-related disclosures in their proxy statements, and such disclosures often include information about the length of service by the auditor.

Independence. The re-proposal also requires a statement in the audit report that the auditor “is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the SEC and the PCAOB.”

Clarification of Auditor Responsibilities. Under the re-proposal, the auditor also has to include in its audit report the phrase “whether due to error or fraud,” when describing the auditor’s responsibilities under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of

material misstatements. This phrase is not included in the existing auditor's report and the release accompanying the re-proposal says that the phrase is added to clarify that the auditor is responsible for detecting material misstatements, whether such misstatements are due to error or fraud.

Steps to Consider

With this re-proposal, the PCAOB appears to be moving closer to requiring changes to the pass/fail model that has served as the basis for an unqualified audit report for many decades. As a result, issuers and their audit committees would be well served to review in depth the new disclosures contemplated by the proposal—particularly as they are disclosures for which the auditor will have the final say; consider the potential implications and costs associated with the new disclosures, including the questions and potential issues discussed later; and evaluate whether to comment on the proposal. In considering this topic, issuers and audit committees also may wish to engage with their auditors to understand what types of issues in prior audits may be considered CAMs under the proposal and what corresponding disclosures would have looked like if they had been disclosed in connection with those prior audit reports.

- *Scope of the New CAM Definition.* In its re-proposal, the PCAOB made efforts to reign in the breadth of its original concept for critical audit matters, but aspects of the proposed CAM definition still may present concern. The audit standard governing communications that the auditor is required to make to the audit committee is itself expansive, as noted previously. The definition also includes any communication made to the audit committee outside of the required communications. It also appears that CAMs may not be limited to communication about material issues, but rather could include disclosure of an issue that may not itself be material but that may involve a material account or disclosure. And, the question of whether an issue was “especially challenging,

subjective, or complex auditor judgment” by its terms still leaves the auditor with broad discretion to determine whether a matter is a CAM that should be disclosed in the audit report. Auditor discretion in making this determination of course could cut either way, but issuers and their audit committees may wish to consider whether the degree of uncertainty in how the proposed CAM definition will be applied in practice, given its potential breadth and subjectivity, merits comment.

- *Auditor Disclosure of Original Information.* In reviewing the original proposal, a number of commenters expressed concern that the proposal would place the auditor in the position of being the source of disclosure of original information about a company—in other words, having to make disclosures before a company itself has made the disclosure or, in effect, forcing a company's hand to make disclosures. The PCAOB's re-proposal responded to this concern by noting that “[s]ince the auditor would be communicating information regarding the audit rather than information directly about the company and its financial statements, the communication of critical audit matters should not diminish the governance role of the audit committee and management's responsibility for the company's disclosure of financial information.” Companies and audit committees may wish to consider whether this response is sufficient to allay the noted concerns, particularly given the nature of the proposed disclosure topics that have to be addressed once a CAM has been identified—as reflected by the three pages of sample disclosures for a CAM that appear in the proposing release. The PCAOB's proposed standard also includes a note intended to address concerns about the auditor becoming the source of original (and potentially confidential) information about the company. This note says that the auditor will not be expected to provide information about the company that has not been made publicly available by the company “unless such information is necessary to describe the principal considerations that led the auditor

to determine that a matter is a critical audit matter or how the matter was addressed in the audit.” Companies and audit committees may wish to consider whether this exception in effect nearly swallows the rule, and if so, what disclosure considerations may be implicated, including whether it would put the auditor in a position of having to make disclosures in the first instance about any number of matters, such as loss contingency considerations or investigations.

- *Uncertainty in Application.* A number of concerns expressed in relation to the original proposal also appear not to have been fully addressed by the re-proposal. Companies and their audit committees may wish to comment on these issues as well. For example, because the re-proposal may require disclosure of matters that have been voluntarily reported to the audit committee, some have expressed the view that the approach outlined could lead auditors to hesitate in raising matters to audit committees as it would then trigger potential CAM reporting. Conversely, some have expressed concern that there will be a tendency to over-disclose the existence of CAMs given the subjectivity in the proposed standard and the potential adverse consequences for the auditor associated with being second-guessed in whether a CAM should have been disclosed. Still others have expressed concern that the range of CAM disclosure practice among firms and engagement teams will lead to unhelpful variability across audit reports. Concerns expressed about the original proposal with respect

to the increased strain on audit committee resources and timing issues associated with completing the audit—for example, when financial reporting or audit-related issues that have CAM implications arise at the last moment—also seem relevant in relation to the re-proposal. Although varied in nature, the common theme underlying these concerns appears to be that uncertainty in application will result from requiring CAM disclosures in the audit report, particularly in light of the subjectivity inherent in the definition and the significance of the changes to the audit reporting model.

Notes

1. *Proposed Auditing Standard—The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*, PCAOB Release No. 2016-003 (May 11, 2016), available at <http://pcaobus.org/Rules/Rulemaking/Docket034/Release-2016-003-ARM.pdf>, last accessed June 8, 2016.

2. *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*, PCAOB Release No. 2011-003 (June 21, 2011), available at http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf, last accessed June 8, 2016.

3. *Proposed Auditing Standards—The Auditor’s Report on an Audit of the Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor’s Responsibilities Regarding Other Information In Certain Documents Containing Audited Financial Statements and the Related Auditor’s Report; and Related Amendments to PCAOB Standards*, PCAOB Release No. 2013-005 (Aug. 13, 2013), available at http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf, last accessed June 8, 2016.

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EDITOR-IN-CHIEF

Broc Romanek
TheCorporateCounsel.net, Arlington, VA
703-237-9222
<broc.romanek@thecorporatecounsel.net>

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Richard Rubin

MARKETING MANAGER

Steven Santel

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