Debevoise & Plimpton

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Focus on the Use of Non-GAAP Financial Measures

On May 16, the SEC issued twelve new C&DIs, following recent public statements from SEC staff members warning against perceived abuses of non-GAAP financial measures. The new C&DIs touch on several key issues, including:

- misleading non-GAAP financial measures;
- prominence of non-GAAP financial measures;
- non-GAAP revenue recognition;
- use of non-GAAP per share measures;
- presentation of "free cash flow";
- income tax effects related to adjustments;
- EBITDA reconciliation; and
- presentation of "funds from operations."

In a June 28 speech before the International Corporate Governance Network (ICGN), SEC Chair White reiterated concerns about misleading non-GAAP disclosures and urged issuers to consider whether their non-GAAP financial reporting is subject to appropriate controls and audit committee oversight. Registrants should expect renewed focus on the use of non-GAAP financial measures, in filed documents as well as other public disclosures, by the staff of the Division of Corporation Finance. Following the issuance of the new C&DIs, the Center for Audit Quality released a Q&A guide to non-GAAP financial measures which is intended to provide guidance to audit committees, focusing on transparency, consistency and comparability. The release is available on the CAQ's website at *www.thecaq.org*.

We recommend that prior to the next quarterly reporting cycle companies review their use and presentation of non-GAAP measures in light of the SEC's rules and new guidance. For further details on the C&DIs, see the Debevoise & Plimpton Client Update at http://www.debevoise.com/insights/publications/2016/05/non-gaap-metrics-in-the-crosshairs.

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SEC Approves Nasdaq "Golden Leash" Rule Proposal

As we discussed in our May 2016 Governance Round-Up, Nasdaq proposed a rule change that would require listed companies to disclose so-called "golden leash" payments to directors and director nominees by the party nominating them. On June 30, the SEC approved the proposed rule, which will become effective August 1. Most companies will first be required to comply with the new disclosure obligations during the 2017 proxy season.

Under new Nasdaq Rule 5250(b)(3), listed companies will be required to disclose all agreements and arrangements between any director or nominee for director, and any person or entity other than the company, relating to compensation or other payment in connection with such person's candidacy or service as a director. Listed companies must make the requisite disclosure by no later than the date on which the company files or furnishes a proxy or information

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statement in connection with the company's next shareholders' meeting at which directors are elected (or, if it does not file proxy or information statements, no later than when the company files its next Annual Report on Form 10-K or Form 20-F).

The final rule clarifies several issues identified during the comment and review process, including:

- **Timing of Disclosure:** (i) The required disclosure must be made no later than the date on which the company files or furnishes a definitive proxy statement or information statement (or Form 10-K or 20-F); (ii) newly entered into agreements or arrangements need not be initially disclosed under the Nasdaq rule prior to the next shareholders' meeting at which directors are to be elected; and (iii) disclosure must be made at least annually until the earlier of the resignation of the director or one year following termination of the agreement or arrangement.
- **Disclosure of Material Terms:** The required disclosure is limited to the material terms of agreements or arrangements relating to compensation and payments in connection with a person's board service or candidacy.
- **Pre-Existing Relationships:** A company is not required to disclose agreements and arrangements that existed prior to the nominee's candidacy where the nominee's relationship with the third party has been publicly disclosed in a proxy or information statement or annual report, such as in a director's bio, unless the director or nominee's remuneration is thereafter materially increased specifically in connection with such person's candidacy; in such case, only the difference between the new level of compensation or other payment obligation needs to be disclosed.
- **Remedial Efforts:** A company will not be considered deficient if it has undertaken reasonable efforts to identify all required agreements or arrangements, including asking each director or nominee in a manner designed to allow timely disclosure. The company must promptly make the required disclosure if it subsequently identifies an agreement or arrangement that should have been disclosed by filing a Form 8-K or 6-K, where required by SEC rule, or by issuing a press release.
- **Hyperlinks and Website Disclosure:** Disclosure may be made on or through a company website, or by hyperlinking to another website, so long as the information is available in a timely manner and continuously accessible.
- **Foreign Private Issuers:** Foreign private issuers are permitted to follow home country practice provided they comply with the established conditions set forth in Nasdaq Rule 5615.

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Chair White Addresses Board Diversity and ESG Disclosures

In her June 28 speech before the ICGN, Chair White discussed the SEC's role in U.S. public company governance and addressed the agency's efforts regarding board diversity and sustainability disclosure (in addition to non-GAAP reporting, as discussed above). Chair White lamented the fact that the percentage of minority directors on boards of the 200 largest companies has remained 15% for the last several years and that, despite calls to focus on board diversity and "refreshment", 73% of new directorships in 2015 at S&P 500 companies went to men. She noted that the SEC staff is preparing a proposal to amend the SEC's current disclosure rules on board diversity, which she acknowledged have not resulted in particularly useful disclosure, to require companies to include in their proxy statements more meaningful diversity disclosures where that information is voluntarily self-reported by directors. She commended a number of companies that have begun voluntarily to provide a more in-depth analysis and presentation in their proxy statements to describe the board's composition, including gender, race and ethnic diversity. Any such rule proposal will likely be released in advance of the 2017 proxy season.

In contrast, addressing environmental, social and governance (ESG) disclosures, Chair White emphasized that the SEC's authority to require additional disclosure is limited, even though many of these matters may be of increasing importance to a growing number of investors. However, the SEC's recent concept release on Regulation S-K indicates that the SEC is considering whether it should require specific line-item environmental and social policy disclosure in a company's periodic reports and is seeking input on whether there are specific issues of this type that are necessary for informed voting and investment decisions. This would represent a shift in the SEC's approach to ESG disclosure. On the one hand, the SEC acknowledges that many companies consider this information to be immaterial (and many believe that sustainability or policy-driven disclosure requirements have the goal of altering corporate behavior rather than providing useful disclosure). On the other hand, the SEC takes note of the fact that an increasing number of companies are voluntarily providing sustainability reporting outside of SEC filings.

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Activist Investors Launch Lobbying Effort

A group of activist investors, reported to include Pershing Square, Carl Icahn, Third Point, Elliott Associates and JANA Partners, has formed a trade association. The Council for Investor Rights and Corporate Accountability, or Circa, announced its formation in May with a statement that it is "committed to promoting the actions of shareholder activists, and their positive impact on corporate governance and business policies at publicly traded companies." In recent years, there has been much debate about the impact that activist investors are having on the public markets, including whether corporate strategies employed by some activists value short-term shareholder returns over the long-term health of targeted corporations. Circa's lobbying efforts may be aimed in part at recent Congressional attention to disclosure obligations of activist investors, including the introduction in March of the Brokaw Act, legislation designed to update and tighten the Section 13(d) beneficial ownership reporting requirements.

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Proxy Contest Blocked After Board Determines Investor Failed to Comply with Advance Notice Bylaws

Many companies have advance notice bylaws that require director nominees to provide all information related to the nominee that must be disclosed under SEC rules, including a description of "any plans or proposals" that would result in a sale or transfer of material assets, any extraordinary corporate transactions, any other material change to the corporate structure or any similar actions. In a recent case, the U.S. District Court for the Northern District of Texas granted a preliminary injunction motion by Ashford Hospitality Prime when director candidates proposed by its shareholder Sessa Capital indicated they were not aware of any such plans for Ashford and refused to provide answers to this question.

The court found that Ashford's board reasonably exercised its business judgment in concluding that the Sessa candidates actually had a plan that they refused to disclose and that this refusal rendered them ineligible to stand for election under the company's bylaws. Correspondence among Sessa and its candidates indicated that they discussed coming up with a plan for selling the company after election and having a "real and fair sale process" in order to maximize value and garner support from ISS.

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Congress Focuses on Proxy Advisory Firms

In the midst of proxy season, Republican Congressmen Sean Duffy introduced the Proxy Advisory Firm Reform Act. The bill would require proxy advisory firms to disclose their procedures for advising clients and any potential or actual conflicts of interest, including the amount of revenues from any consulting services as well as a list of the firm's 20 largest clients and how the firm prevents such clients from having "undue influence" on their work. To address concerns about inaccuracies in reports, proxy advisory firms would be required to provide companies with draft voting recommendations and an opportunity to comment on them. The firms would in turn be required to review complaints about accuracy and resolve them in a timely fashion, before voting takes place.

The legislation would also require the SEC to promulgate rules requiring proxy advisory firms to adopt written policies designed to address and disclose conflicts, including how the firms are compensated by clients and how they issue recommendations with respect to companies to which they also provide consulting services. In addition, the rules would prohibit certain alleged activities that issuers describe as coercive, such as conditioning voting recommendations on issuers purchasing services, or changing or threatening negative recommendations based on whether issuers bought subscription services.

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SEC Proposes Overhaul of Mining Disclosures

Responding to the increasing globalization of the mining industry, the SEC has proposed rules that would overhaul the disclosure regime for mining companies listed in the U.S., intended to align U.S. standards more closely with the standards of the Committee for Mineral Reserves International Reporting Standards and create uniformity for companies with cross-border operations. The SEC's proposed rules represent a complete reworking of Industry Guide 7 and would apply to domestic registrants as well as foreign private issuers, other than Canadian issuers reporting pursuant to MJDS. For further details on the final rules, see the Debevoise & Plimpton Client Update at http://www.debevoise.com/insights/publications/2016/06/sec-proposes-overhaul-of-mining-disclosures.

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SEC Adopts Final Rules Reflecting Jobs Act Changes to Registration Requirements and Proposes to Expand Availability of Scaled Disclosure Requirements

In May, the SEC adopted final rules implementing changes to the requirements for registration and termination of registration under Section 12(g) of the Exchange Act and the suspension of reporting obligations under Section 15(d) of the Exchange Act mandated by the JOBS Act and the FAST Act. Among other things, the amendments create a higher threshold – 2,000 holders of record or 500 holders of record that are not "accredited investors" – for registration, termination of registration and suspension of reporting.

When a private company is required to register a class of equity securities under Section 12(g), it essentially goes public without the benefit of an IPO. The JOBS Act provisions are intended to provide greater flexibility to pre-IPO companies to issue equity securities, particularly under employee compensation arrangements, without triggering Exchange Act registration and reporting requirements. For further details on the final rules, see the Debevoise & Plimpton Client Update at http://www.debevoise.com/insights/publications/2016/05/sec-adopts-final-rules-reflecting-jobs-act.

In efforts to update SEC rules and ease the burden of reporting for certain issuers, independent of JOBS Act mandates, the SEC has proposed amendments to increase the financial thresholds in the definition of "smaller reporting company." The SEC estimates that adopting the proposed amendments would expand the universe of companies that benefit from scaled disclosure under Regulation S-K and S-X by an additional 782 registrants, in addition to the current approximately 2,900 registrants that claim smaller reporting company status. The amended definition would include companies with less than $250 million in public float, compared to the current $75 million threshold. For companies with no public float, the amended definition would include companies with annual revenues of less than $100 million, compared to the current $50 million threshold. For further details on the proposed rules, see the Debevoise & Plimpton Client Update at http://www.debevoise.com/insights/publications/2016/07/sec-proposes-to-expand-availability.

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Please do not hesitate to contact us with any questions.

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