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Looking ahead for public companies: What you need to know for 2021

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The year 2020 has been challenging in many respects, and as public companies prepare for the upcoming year-end reporting and 2021 proxy season they will continue to face a variety of challenges and risks—including those relating to the ongoing impact of the pandemic on their business and resulting disclosure obligations, as well as new Securities and Exchange Commission (SEC) reporting requirements and disclosure changes stemming from the SEC's recent efforts to move to a more principles-based disclosure regime and to modernize and simplify disclosure. This alert will highlight key issues every public company should be thinking about as 2021 approaches, including with respect to Form 10-K and proxy statement disclosure developments, shareholder meetings and upcoming developments.

Disclosure developments

Form 10-K disclosure highlights

COVID-19-related disclosures

Since January 2020, the SEC has made it clear through public statements, disclosure guidance, and enforcement initiatives that a public company is expected to provide investors with as much information as possible regarding the impact of the COVID-19 pandemic on its business operations and financial position, including current operational and liquidity positions and expected financial resource needs, as well as forward-looking disclosures reflecting management's views of the potential future effects of the pandemic. The SEC has also repeatedly emphasized the importance of maintaining and following established disclosure controls and procedures. Underscoring these expectations, several weeks ago the SEC filed its first enforcement action against a public company for misleading disclosures made in late March and early April 2020 about the financial impact of the pandemic. That enforcement action, now settled, highlights the need to ensure that disclosures in Form 10-K (and otherwise) accurately inform investors of the extent of the effects of the pandemic.

For many calendar year-end companies, the fiscal year 2019 Form 10-K was the first filing to address the pandemic. Most such disclosures were necessarily fairly general given the early stage of the pandemic and high level of uncertainty. Since those initial disclosures, companies have implemented a host of measures and adapted operations in response to the pandemic and its effects on their business, operations, and financial and other resources, while at the same time grappling with the challenges of providing accurate and meaningful disclosures regarding quarterly operating and financial results, evolving trends, and potential future impacts of events that continue to be unsettled.

Although COVID-19 is no longer a novel consideration from a disclosure perspective, the landscape continues to shift with business restrictions again intensifying even as the much-awaited vaccine rollout begins. Against this backdrop, as reporting companies approach the upcoming reporting season and prepare to complete their year-end processes and fashion Form 10-K disclosures that reflect their current situation and expectations, companies should consider whether and to what extent additional or updated disclosures regarding the risks from COVID-19 and its actual or anticipated effects, should be included in their Form 10-K.

To assist in this process, we strongly recommend revisiting with a fresh eye CF Disclosure Guidance: Topic No. 9 and CF Disclosure Guidance: Topic No. 9A issued by the staff (Staff) of the SEC's Division of Corporation Finance in March and June 2020, respectively (together, the Guidance). The Guidance, which provides an illustrative list of questions for companies to consider when assessing COVID-19-related risks and effects, remains the best starting point for evaluating the COVID-19-related topics and issues that should be covered, to the extent material, in Form 10-K for the 2020 fiscal year.

We highlight below some of the key COVID-19-related topics companies may want to address in their Form 10-K disclosures. Each company must give careful consideration to its own particular facts and circumstances, however, to determine the nature and scope of disclosures needed to provide an accurate and meaningful discussion of the material impacts of COVID-19 on the company's business, results of operations, financial condition and the material risks and uncertainties it faces, as seen from management's perspective.

Business

If a company's business has materially changed or is expected to materially change as a result of the COVID-19 pandemic, the business description should include relevant updates and related discussion—including at the segment level where appropriate. Material changes to the previous business description disclosures may result, for example, from business unit or facility closures, changes in the types or method of delivery of key products produced or services offered, changes in competitive conditions or customer composition, modifications to previously disclosed business strategies or new product or service initiatives, changes in manufacturing or logistical functions, changes in order backlog, changes in the availability of raw materials or other resources material to the business, or changes in the size or composition of the company's workforce.

Companies should evaluate whether any such changes, or similar expected changes, require revisions and updates to the most recently filed business description.

Additionally, companies will need to consider recent amendments to Item 101 of Regulation S-K business description disclosure requirements (see "*Business section — Item 101*" below).

Litigation
Companies should review any pending or recently settled litigation matters arising from COVID-19 to determine whether new or updated legal proceedings disclosure is needed in their Form 10-K. For example, disclosure may be necessary for litigation involving contract performance, insurance coverage, or workplace health and safety disputes.

Additionally, companies will need to consider recent amendments to Item 103 of Regulation S-K legal proceedings disclosure requirements (see "*Legal proceedings — Item 103*" below).

Management's Discussion and Analysis (MD&A)
MD&A disclosure regarding the historical and potential future effects of COVID-19-related changes to a company's business and outlook should be carefully assessed and updated as needed in light of current conditions. As noted above, the Guidance continues to serve as a useful starting point for determining the types of information that should be included in MD&A in order to provide investors the information necessary to understand the material impacts of COVID-19 on the company's financial condition, changes in financial condition and results of operations. In addition to discussing the impacts of COVID-19 on financial resources, liquidity, and operational results, forward-looking discussion of known trends and uncertainties that may, as viewed from management's perspective, cause future results to differ materially from historical results may, depending on the company's specific situation, be particularly relevant and useful to investors. To receive the greatest possible protection of the safe harbor for forward-looking statements included in MD&A or elsewhere in their Form 10-Ks, companies should review their cautionary statements and modify or update as needed to reflect key risks related to the effects of COVID-19, which are tailored for the specific forward-looking statements included in the filing.

Additionally, to the extent available at the time of filing, companies may want to consider recent amendments to Item 303 of Regulation S-K MD&A disclosure requirements (see "*Upcoming Changes; Voluntary Compliance — MD&A — Item 303*" below).

Non-GAAP Financial Measures
It is important to note also that the Staff has also repeatedly reminded companies of obligations under Regulation G and Item 10 of Regulation S-K when using non-GAAP financial measures in the context of COVID-19-related disclosures. The use of individually tailored accounting principles —which are considered per se misleading—and failures to present the comparable GAAP measure with equal or greater prominence have been areas of particular focus in Staff guidance and comment letters, and companies should continue to be mindful of Staff guidance and comments in preparing and reviewing MD&A or other Form 10-K disclosures containing any non-GAAP financial measures. When considering providing any non-GAAP financial measures which adjust for the effects of COVID-19-related items, companies should also pay particular attention to ensure that the non-GAAP financial measure is a measure that management actually uses, including in its reports to the board of directors and the audit committee, and that adjustments are not made for "normal" items (which may involve difficult judgments as to the nature of certain adjustments in the COVID-19 environment). Similar care should be taken when including key performance indicators or other operating metrics that are not themselves non-GAAP financial measures (see "*MD&A — Item 303*" below for discussion of recent SEC guidance relating to such operating metrics). In either case, clarity and transparency of disclosure are important, as is consistency in application and presentation. To the extent a company chooses to present a non-GAAP financial measure or performance metric adjusted for COVID-19-related impacts, it should also provide an explanation which highlights why management finds the measure or metric useful and how it

helps investors assess COVID-19- related impacts on the company's financial position and results of operations. Companies are reminded of the importance of ensuring that all such disclosures are properly addressed through robust disclosure controls and procedures.

Risk Factors

COVID-19-related risks may impact a variety of a company's risk factor disclosures, including, for example, risks relating to financing and liquidity needs; supply chain, manufacturing or transportation disruptions; changes in competitive conditions and customer demand; workplace safety; increased cybersecurity risks from remote working arrangements; and litigation. Risk factor disclosures should be thoughtfully and continuously reevaluated in light of the still-evolving effects of the pandemic and revised as needed to provide discussion of relevant COVID-19-related risks tailored and specific to the company's situation as of the Form 10-K filing date. In drafting risk factor discussions of COVID-19-related risks (and other risks as well), it is also important to avoid presenting risks as hypotheticals and to instead focus the discussion on the actual specific risks the company faces.

Additionally, companies will need to consider recent amendments to Item 105 of Regulation S-K risk factor disclosure requirements (see "*Risk factors — Item 105*" below).

Financial Statements

Companies should be prepared to address a variety of financial statement implications of COVID-19 for their Form 10-K financial reporting and internal controls assessments. Depending on the company's specific situation, COVID-19-related disclosures may involve, for example, asset impairments, loss contingencies, or going concern qualifications. Companies should also review disclosures on an on-going basis prior to filing to determine whether subsequent events disclosure is needed to address material developments that take place after the end of the reporting period but before the filing date.

Controls and Procedures

Throughout 2020, companies and their auditors have adapted processes to the changing environment, including for many an extended remote working environment. In conducting their evaluations of the effectiveness of the company's disclosure controls and procedures and internal controls over financial reporting in connection with Form 10-K reporting, it will be important to evaluate carefully any changes made during the year as a result of COVID-19 impacts, as well as whether any additional adjustments are necessary to facilitate on-going effectiveness as the pandemic's effects continue to evolve.

Business section — Item 101

The SEC revised the business section disclosure requirements effective November 9, 2020.

Significantly, the amendments require new disclosure regarding human capital resources. Item 101(c) now requires, to the extent such disclosure is material to an understanding of the company's business taken as a whole, a description of a company's human capital resources, including the number of persons employed and any other human capital measures or objectives that company management focuses on in managing the business. The SEC specifically declined to adopt a definition of "human capital." However, it did note measures or objectives that address the attraction, development and retention of personnel as examples of relevant human capital measures or objectives companies may want to address in their disclosure.

Early Form 10-K filings subject to the new human capital resources rules indicate significant differences in the lengths of the disclosure and the topics considered material. The topics considered material will vary by industry as well as by the particular circumstances of each company. According to a report published by FW Cook on November 27, 2020, these early Form 10-K filings had approximately 13 common disclosure topics: extensive headcount data; diversity and inclusion; employee development/training; competitive pay/benefits; safety; employee benefits; culture/values/ethics; employee engagement; tenure/promotion/turnover; recruitment; mental health; pay equity; and succession planning. There are several organizations that have published guidelines for companies to refer to when determining the disclosure topics to consider. Still, we expect that it will be some time before a consensus approach emerges.

Companies should begin working on their human capital resources disclosure as soon as possible. Because the new human capital resources disclosure rules adopted by the SEC are a principles-based disclosure framework, the disclosure should be tailored to fit each companies' specific workforce and facts and circumstances. It will take considerable time to identify the disclosure topics material to the company and craft the appropriate disclosures. Companies should consider human capital disclosure made in company documents outside of SEC filings and make sure the new human capital resources disclosure in their Form 10-K is consistent. Companies should also consider whether any changes to their disclosure controls and procedures are necessary, including changes in the composition of their disclosure committee, such as to include human resources personnel.

The amendments to Item 101 of Regulation S-K eliminated the five-year disclosure timeframe, and companies are now required to focus on the information material to an understanding of the general development of their business, regardless of a specific timeframe.

The amendments also provide an optional method for companies, in filings after the company's initial registration statement, to provide only an update on the general development of the business, focused on all of the material developments that have occurred since its most recent full discussion of the development of its business from a single previously filed registration statement or report, which must be hyperlinked and incorporated by reference.

Legal proceedings — Item 103

The SEC revised the legal proceedings disclosure requirements effective November 9, 2020.

Revised Item 103 of Regulation S-K allows companies to use hyperlinks or cross-references to legal proceedings disclosure elsewhere in the filing (such as in MD&A, risk factors, or the notes to the financial statements) to avoid duplicative disclosure and help streamline presentation.

In addition, the amendments increased the disclosure threshold to $300,000 for environmental proceedings in which the government is a party, to account for inflation (the current $100,000 threshold was set in 1982), but allows a company to select a different threshold that it determines is reasonably designed to result in disclosure of material environmental proceedings, provided that the threshold does not exceed the lesser of $1 million or 1% of the current assets of the company and that the company discloses such selected threshold (including any changes thereto).

Risk factors — Item 105

The SEC revised the risk factor disclosure requirements effective November 9, 2020.

Under the revised rules, if the risk factor section exceeds 15 pages, companies are required to include summary risk factor disclosure of no more than two pages, with a series of concise, bulleted or numbered statements disclosed at the beginning of the risk factor section summarizing the principal factors that make an investment in the company or offering speculative or risky.

To focus disclosure on the risks to which reasonable investors attach importance in making investment decisions, the disclosure requirement was revised to require disclosure of "material" risks as opposed to the former requirement of "most significant" risks. In practice, we do not expect this change will have a major impact on the way companies approach their risk factor disclosure.

In addition, companies are required to organize risk factors under relevant headings, with any generic risk factors included last under a separate heading.

MD&A — Item 303

On January 24, 2020, the Staff issued three new Compliance and Disclosure Interpretations (C&DIs) C&DIs providing guidance in connection with the recent rule change permitting companies to omit a discussion of the earliest of the past three years. Instruction 1 to Item 303(a) provides that companies that include financial statements covering three years in a filing may omit the discussion of the earliest of the three years if such discussion was already included in the company's prior filings on EDGAR, provided the company includes a statement that identifies the location in the prior filings where the omitted discussion may be found. The C&DIs clarify that a company that relies on Instruction 1 and includes a statement merely identifying the location in a prior filing where the omitted discussion can be found will not have incorporated such disclosure into the filing unless the company expressly states that the information is incorporated by reference. Consequently, the C&DIs clarify that without such express incorporation by reference, the omitted discussion will not be incorporated by reference into a registration statement that incorporates the Form 10-K by reference. The C&DIs also confirm that a company may not omit a discussion of the earliest of the three years if the company believes that discussion to be necessary to an understanding of its financial condition, changes in financial condition, and results of operations.

In January 2020, the SEC issued guidance on the disclosure of key performance indicators and metrics in MD&A disclosure. The guidance reminds companies that, when including metrics in their disclosure, they should consider existing MD&A requirements and the need to include such further material information, if any, as may be necessary in order to make the presentation of the metric, in light of the circumstances under which it is presented, not misleading. The SEC stated that it would generally expect, based on the facts and circumstances, the following disclosures to accompany the metric:

- A clear definition of the metric and how it is calculated;
- A statement indicating the reasons why the metric provides useful information to investors; and
- A statement indicating how management uses the metric in managing or monitoring the performance of the business.

Companies should also consider whether there are estimates or assumptions underlying the metric or its calculation and whether disclosure of such items is necessary for the metric not to be materially misleading. In addition, if a company changes the method by which it calculates or presents the metric from one period to another or otherwise, the company should consider the need to disclose, to the extent material:

- The differences in the way the metric is calculated or presented compared to prior periods;

- The reasons for such change;
- The effects of any such change on the amounts or other information being disclosed and on amounts or other information previously reported; and
- Such other differences in methodology and results that would reasonably be expected to be relevant to an understanding of the company's performance or prospects.

For additional information about upcoming changes to MD&A disclosure requirements, see "*Upcoming Changes; Voluntary Compliance – MD&A — Item 303*" below for a description of the SEC's most recent amendments to Item 303 MD&A disclosure requirements.

Amendment to financial disclosure for guaranteed or collateralized debt securities

On March 2, 2020, the SEC adopted amendments to the rules governing the financial disclosures for guaranteed or collateralized debt securities. The revised rules will be effective January 4, 2021. The amendments are intended to simplify and streamline the financial disclosure requirements applicable to registered offerings of debt securities guaranteed by related entities. The amendments also revised the rules relating to the presentation of financial information of affiliates whose securities are pledged as collateral in connection with offerings of registered debt securities.

When a company issues a registered debt security that is guaranteed by a subsidiary, the guarantee of the debt security is a separate security under the Securities Act of 1933 (Securities Act), and accordingly, offers and sales of these guarantees must be registered or exempt from registration. Each issuer and guarantor of a registered debt security would, in the absence of relief, be required to include in the applicable registration statement its own audited annual and unaudited interim financial statements as required by Regulation S-X and become subject to ongoing SEC reporting requirements under Section 15(d) of the Securities Exchange Act of 1934 (Exchange Act). The existing Rule 3-10 of Regulation S-X provides relief from these rules under specified circumstances to allow subsidiary issuers or subsidiary guarantors, as applicable, to omit financial statements separate from the consolidated financial statements of an SEC-registrant parent company issuer or guarantor and to suspend ongoing Exchange Act reporting requirements for that subsidiary registrant. Also, SEC rules require a company to provide separate annual and interim financial statements for each affiliate whose securities constitute a "substantial portion" of the collateral for any class of securities registered as if the affiliate were a separate registrant.

Certain aspects of the amendments will impact the preparation of Form 10-K. Some of the significant changes included in the amendments are that they: (i) replace the condition that a subsidiary issuer or guarantor be 100%-owned by the parent company with a condition that it be consolidated in the parent company's consolidated financial statements; (ii) replace the requirement to present stand-alone financial information, or consolidating information for guarantors and non-guarantors, with a requirement to present summarized financial information for subsidiary issuers and subsidiary guarantors, which may be presented on a combined basis; (iii) expand the qualitative disclosures about guarantees and guarantors, including the disclosure of additional narrative information about each guarantor that would be material for investors to evaluate the sufficiency of the guarantee; (iv) permit financial and non-financial information about subsidiary issuers and guarantors to be provided outside the footnotes to the parent company's audited annual and unaudited interim consolidated financial statements included in any Exchange Act report; (v) replace the requirement to present stand-alone financial information of pledged affiliates whose securities collateralize a "substantial portion" of the collateral for the registered securities with a requirement to present summarized financial information of the issuers and affiliates whose securities are pledged, to the extent material; (vi) expand the qualitative disclosures about the securities being collateralized, including disclosure of additional information about each affiliate that would be material for investors to evaluate the pledge of the affiliate's securities as collateral; and (vii) permit financial and non-financial information about issuers and affiliates to be provided either in a registrant's financial statements or elsewhere in the applicable Exchange Act report.

In addition, a new Exhibit 22 will be required for Form 10-K. In this new exhibit, the parent company must list each of its subsidiaries that is a guarantor, issuer, or co-issuer of registered securities that the parent company issued, co-issued, or guaranteed, and each of its affiliates whose securities are pledged as collateral for securities registered, and also identify the securities pledged as collateral.

Critical audit matters

Currently, the audit reports of large accelerated filers are required to include disclosures relating to critical audit matters (CAMs), which are matters arising in the audit that (i) are required to be or actually are communicated to the audit committee, (ii) are related to accounts or disclosures material to the financial statements, and (iii) involves especially challenging, subjective or complex auditor judgment. This requirement will become effective for fiscal years ending on or after December 15, 2020, for all other issuers. The CAM disclosure requirement does not apply to emerging growth companies, investment companies, or business development companies. Companies may also want to consider the impact of the COVID-19 pandemic on CAMs.

Electronic signatures

On November 17, 2020, the SEC adopted amendments to Regulation S-T and the EDGAR Filer Manual to permit the use of electronic signatures in connection with electronic filings on EDGAR. The amendments became effective December 4, 2020. Prior to the amendments, Rule 302(b) of Regulation S-T (Rule 302(b)) required each signatory of an electronic filing with the SEC to manually sign a signature page or other document (authentication document) that authenticates, acknowledges, or otherwise adopts his or her signature that appears in typed form within the electronic filing, before or at the time of the filing with the SEC. The Commission amended Rule 302(b) to make it more practical for today's environment by permitting a signatory to an electronic filing who follows certain procedures to sign an authentication document through an electronic signature meeting certain requirements. Companies are still required to retain the authentication document for a period of five years.

The signing process for the electronic signature must, at a minimum:

- Require the signatory to present a physical, logical, or digital credential that authenticates the signatory's individual identity;
- Reasonably provide for non-repudiation of the signature;
- Provide that the signature be attached, affixed, or otherwise logically associated with the signature page or document being signed; and
- Include a timestamp to record the date and time of the signature.

Before a signatory initially uses an electronic signature to sign an authentication document, the signatory must manually sign a document attesting that the signatory agrees that using an electronic signature in any authentication document constitutes the legal equivalent of the individual's manual signature for authentication purposes. Companies must retain this manually signed document for as long as the signatory uses an electronic signature to sign authentication documents and for a minimum of seven years after the date of the most recent electronically signed authentication document.

Exhibit 21 list of subsidiaries

On May 21, 2020, the SEC adopted amendments to the rules governing financial disclosures public companies must provide when they buy and sell businesses. The revised rules will be effective January 1, 2021. The amendments included changes to the definition of “significant subsidiary” under Regulation S-X. The amendments update the significance tests of Rule 1-02(w) of Regulation S-X by revising the investment test and income test. The amendments do not change the asset test except for a number of non-substantive revisions. The amended investment test will compare the company’s and its other subsidiaries’ investments in and advances to the subsidiary to the aggregate worldwide market value of the company’s voting and non-voting common equity when available, as opposed to the total consolidated assets of the company. The amended income test adds a revenue component that compares a company’s and its other subsidiaries’ proportionate share of the subsidiary’s consolidated total revenues from continuing operations (after intercompany eliminations) to the company’s consolidated total revenues for the most recently completed fiscal year. To satisfy the income test, as amended, the subsidiary must meet both the revenue component and the net income component when the revenue component applies. The revenue component does not apply if either the company or the subsidiary did not have material revenue in each of the two most recent fiscal years.

Item 601(b)(21) of Regulation S-K requires companies to file an exhibit listing their subsidiaries with their Form 10-K. The rules provide that the names of particular subsidiaries may be omitted if the unnamed subsidiaries, considered in the aggregate as a single subsidiary, would not constitute a significant subsidiary as of the end of the year covered by the Form 10-K. The term “significant subsidiary” in Item 601(b)(21) is referenced to the definition in Rule 1-02(w) of Regulation S-X. Public companies that omit certain subsidiaries from their Exhibit 21 list will need to re-evaluate the subsidiaries that may be omitted based on the amended definition of significant subsidiary.

Confidential treatment renewals

On September 9, 2020, the Staff updated guidance regarding renewals of expiring confidential treatment orders. Under this guidance, companies may:

- Refile an unredacted copy of the exhibit if the contract is still material and none of the information needs to be protected from public disclosure;
- File an application to extend the period of confidential treatment under Rules 406 or 24b-2 if the contract is still material and the previously redacted information continues to be confidential; or
  - If the order is about to expire and was initially issued less than three years ago, companies may use the short form application;
  - If the order is about to expire and was initially issued more than three years ago, companies may file a new, complete application for confidential treatment under Rule 406 or Rule 24b-2;
- Transition to the new rules governing the filing of redacted exhibits under Regulation S-K Item 601 if it has been more than three years since the initial confidential treatment order was issued and the contract continues to be material.

The Staff noted in the guidance that it would not recommend enforcement action if a company refiles a redacted exhibit in compliance with the redacted exhibit rules in the company's first report under the Exchange Act following the expiration of the confidential treatment order.

Companies are reminded to review their Form 10-K exhibits to update the list of exhibits referenced and to identify expiring confidential treatment orders that may need to be addressed in a manner consistent with Regulation S-K and Staff guidance.

Applicability of amendments to large accelerated filer and accelerated filer definitions

Companies are reminded to evaluate their filing status based on the amended definitions of "accelerated filer" and "large accelerated filer" under Rule 12b-2 of Exchange Act, which became effective April 27, 2020 and apply to annual reports filed on or after that date.

SEC rules require "accelerated filers" and "large accelerated filers" to have an outside auditor attest to the adequacy of the issuer's internal control over financial reporting (ICFR). Under the amended rules, smaller reporting companies with annual revenues of under $100 million are excluded from the definitions of "accelerated filer" and "large accelerated filer," and therefore are not subject to the auditor attestation requirement. Business development companies are also excluded from the "accelerated filer" and "large accelerated filer" definitions under analogous circumstances.

The amendments also increased the public float threshold for accelerated and large accelerated filers to become a non-accelerated filer from $50 million to $60 million and the threshold to exit from large accelerated filer status from $500 million to $560 million. Additionally, the amendments added a revenue test to the transition thresholds for exiting from accelerated and large accelerated filer status.

Companies benefitting from this rule change still need to establish and maintain effective ICFR, and their principal executive and financial officers are still required to certify that they are responsible for and have assessed the effectiveness of the company's ICFR. In addition, these companies continue to be subject to a financial statement audit by an independent auditor, and, even without the attestation requirement, an independent auditor is required to consider ICFR in the performance of its audit of the company's financial statements.

Cover page

The cover page of Form 10-K has been revised to add a new checkbox indicating whether an ICFR auditor attestation is included in the filing.

Proxy statement disclosure highlights

COVID-19-related disclosures

Proxy statements for 2021 annual meetings will, in most cases, reflect the effects of COVID-19 and company responses to the pandemic in a variety of areas, including, for example, compensation discussion and analysis (CD&A), pay ratio disclosure, and board risk oversight. We highlight below some of the key COVID-19-related topics companies may want to address in their 2021 proxy statement disclosures. Each company must give careful consideration to its own particular facts and circumstances, however, to determine the nature and scope of disclosures needed to provide an accurate and meaningful discussion of the material impacts of COVID-19 on the governance and compensation-related matters and other topics addressed in the company's proxy statement.

Companies may also want to consider addressing in the audit committee report COVID-19-related matters that impacted the company's financial reporting and audit procedures.

Named Executive Officer (NEO) compensation

As a result of the pandemic and its impacts on business conditions, operating performance, and market volatility, companies and their compensation committees and boards of directors have in many cases taken actions during 2020 or are now considering taking actions to change executive compensation arrangements established earlier in the year. COVID-19-related adjustments to executive compensation have taken a number of forms, depending on the severity of the pandemic's impact on the company's industry and various company-specific factors. Initial actions typically involved temporary salary reductions and/or bonus payment waivers or deferrals, reflecting heightened liquidity concerns at the onset of COVID-19-related shutdowns and restrictions. Later actions most commonly involved modifications to 2020 annual short-term cash incentive plans in the form of, for example, adding compensation committee discretion to determine award payouts (to the extent legally allowed and not already permitted under the governing plan documents), adjustments to previously established performance goals, the addition of new performance metrics reflecting emergent COVID-19-related priorities, reductions in or elimination of performance thresholds for award payouts (often accompanied by reduced or capped payout opportunities), changes from absolute to relative metrics, or modifications to performance periods. In many cases, however, companies elected to take a "wait and see" approach, and compensation committees have exercised discretion or will use their discretion to determine short-term incentive plan award amounts in light of COVID-19-related impacts on individual and company performance. Modifications to existing long-term incentive plans have been less common, in part reflecting the fact that modifications of awards under such plans continue to be strongly disfavored by proxy advisors and institutional investors. In some cases, compensation committees approved discretionary supplemental awards to offset the expected diminution in value of outstanding incentive plans.

As a threshold matter, companies will need to ensure that all compensation elements and decisions are taken into consideration and properly reported in the summary compensation table and its explanatory footnotes. For many companies, this will entail taking a fresh look at the technical requirements of Item 402(c) and Item 402(e) (Item 402(n) and Item 402(o) for smaller reporting companies (SRCs)) of Regulation S-K and related C&DIs to determine the appropriate treatment of the relevant compensatory items, including any adjustments made. This is an essential step in the process of determining and verifying which executive officers, other than any principal executive officer and principal financial officer who served during the year, must be included in the NEO cohort for 2021 reporting purposes.

We expect that effective communication through proxy statement CD&A disclosure and shareholder outreach will be particularly critical for the passage of say-on-pay votes in 2021, and this will be especially true for companies who have made changes to 2020 executive compensation arrangements in light of the effects of COVID-19. Proxy advisors and institutional investors will be focused on identifying any misalignment between stated pay-for-performance policies and practices and actual outcomes, as well as issues of fairness in a company's treatment of management, employees, and investors. Where adjustments to NEO compensation were made in response to the effects of the pandemic, the CD&A should clearly and fully tell the story of the process and rationale behind the chosen approach, including a fulsome discussion of the specific reasons for the adjustments that were made and the resulting outcomes. In the event the compensation committee exercised discretion to modify existing awards or grant supplemental awards, the CD&A should include clear and transparent disclosure, describing why and how that discretion was exercised to allow investors to evaluate the approach taken and decisions made. As circumstances warrant, companies may also need or want to consider widening the compensation discussion to address the company's broader management and employee population in order to provide further context for the decisions made with respect to NEO compensation. Institutional investors and proxy advisors can be expected to take a hard look at these disclosures to assess whether the actions taken demonstrate appropriate alignment of NEO compensation with the company's shareholders, employees, and other constituents considered by the reader to be relevant.

Companies that made adjustments to NEO compensation for 2020 are encouraged to review the preliminary FAQs issued by Institutional Shareholder Services (ISS) in October 2020 (discussed further below) for helpful insights into how their CD&As will be expected to address adjustments made to NEO compensation.

ISS FAQs issued in October 2020

On October 15, 2020, ISS published FAQs related to compensation policies and the COVID-19 pandemic. The FAQs are intended to serve as general guidance as to how ISS may approach COVID-19-related pay decisions in the context of ISS's pay-for-performance qualitative evaluation.

Temporary reductions for executives. ISS stated that temporary salary reductions will be given mitigating weight to the extent they decrease total pay, but will be considered more meaningful if targeted incentive payout opportunities are decreased to reflect the reduced salary.

Bonus/annual incentive programs. In light of the extraordinary circumstances of the current economic environment, ISS may view changes to annual incentive programs to be a reasonable response so long as the justifications and rationale are clearly disclosed, and the resulting outcomes appear reasonable. ISS said it expects that companies may change metrics, performance targets, and measurement periods or even suspend their programs and make one-time discretionary payments. The ISS provided the list below of key disclosure items that would help investors evaluate COVID-19-related changes to the annual incentive program:

- The specific challenges incurred as a result of the pandemic and how they rendered the original program design obsolete or the original performance targets impossible to achieve, as well as how the changes are not reflective of poor management performance;
- For companies making mid-year changes rather than one-time discretionary awards, an explanation of why that approach was taken and how such actions further investors' interests;
- Since one-time discretionary awards should still carry performance-based consideration, the underlying criteria of the award even if not based on the original metrics or targets, avoiding generic descriptions;
- Discussion how the resulting payouts appropriately reflect both executive and company annual performance and clarification how the resulting payouts compare with what would have been paid under the original program design. ISS noted that above-target payouts under changed programs will be closely scrutinized; and
- Any positive changes to the following year's (2021) annual incentive program, which could mitigate concerns.

Also, for companies that lower performance targets, they should disclose how the board considered corresponding payout opportunities, particularly if such payout opportunities are not commensurately reduced.

Equity/long-term incentives. ISS stated that since long-term incentive programs should be designed to smooth performance over a long-term period, changes to in-progress, long-term incentive cycles will generally be viewed negatively, particularly for companies that exhibit a quantitative pay-for-performance misalignment. Drastic changes to long-term incentive programs would not be expected for award cycles beginning in 2020 unless the underlying business strategy has fundamentally changed. Modest alterations to an incentive program could be viewed as reasonable. More drastic changes, such as shifts to predominately time-vesting equity or short-term measurement periods, would be viewed negatively. In any event, companies should clearly explain any changes to the program.

Retention/other one-time awards. As with one-time awards granted outside the context of the pandemic, companies that grant one-time awards should clearly disclose the rationale for the award, including magnitude and structure, as well as describe how the award furthers investors' interests. Boilerplate language regarding "retention concerns" will not be viewed as sufficient rationale. The awards should be reasonable in magnitude and an isolated practice, and the vesting conditions should be strongly performance-based and clearly linked to the underlying concerns the award aims to address. In addition, the award should contain shareholder-friendly guardrails to avoid windfall scenarios, including limitations on termination-related vesting. To the extent one-time awards are granted in the year (or following year) in which incentives are forfeited, companies will be expected to explain the specific issues driving the decision to grant the awards and how the awards further investors' interests.

ISS' responsiveness policy. When a company receives less than 70% support on its say-on-pay proposal, the ISS' responsiveness policy reviews three factors: (i) the disclosure of the board's shareholder engagement efforts; (ii) the disclosure of the specific feedback received from dissenting investors; and (iii) any actions or changes made to pay programs and practices to address investors' concerns. With respect to the third factor, if a company is unable to implement changes due to the pandemic, the proxy statement should disclose specifically how the pandemic has impeded the company's ability to address shareholders' concerns and the company's longer-term plan on how it intends to address investors' concerns.

Perks

Item 402(c)(2)(ix)(A) of Regulation S-K requires companies to disclose in the Summary Compensation Table and include in the total compensation calculation the value of any perquisites and other personal benefits (perks) provided to a NEO if the aggregate value of the perks received by the NEO is more than $10,000. Technology, transportation, and other accommodations provided to a company's executive officer in connection with remote working arrangements established this year in response to COVID-19 will require careful analysis to determine whether the value of such items should be included in the calculation of the executive officer's total compensation and disclosed in the summary compensation table. Failure to properly disclosure perks provided to a company's executive officers has been the subject of several settled SEC enforcement proceedings in 2020, and we expect perks disclosure to continue to be an enforcement and investor focus going forward.

The SEC has traditionally applied a two-factor test to determine whether a particular item is a perk and therefore subject to the disclosure requirements of Regulation S-K:

- 1. An item is not a perk if it is integrally and directly related to the performance of the executive's duties.
- 2. An item is a perk if it confers a direct or indirect benefit that has a personal aspect, without regard to whether it may be provided for some business reason or for the convenience of the company unless it is generally available on a non-discriminatory basis to all employees.

In September 2020, the Staff provided additional guidance specific to items provided to executive officers in response to COVID-19. Published as Question 219.05 to the Regulation S-K C&DIs, the guidance confirmed the continued applicability of the traditional two-factor analysis and also provided illustrative examples of benefits provided in light of COVID-19. Under these examples, enhanced technology provided to make an executive officer's home better suited to remote work would not be a perk when local stay-at-home orders required the executive officer's home to be used as his or her primary workplace. In contrast, enhanced or new health or personal transportation benefits provided to address new risks associated with COVID-19 likely would be considered a perk unless they were made available generally to all employees because these types of benefits have a personal aspect and are not generally likely to be "integrally and directly related" (i.e., necessary) to the performance of the executive's duties.

Companies should evaluate all benefits and resources provided to executive officers using the two-factor analysis to determine whether any of those items may require disclosure in the 2021 proxy statement and should retain documentation of that analysis to support the decisions made with respect to the disclosure implications of such items.

Pay ratio disclosure

Item 402(u) of Regulation S-K requires companies subject to the rule to disclose in their proxy statements the ratio of the annual total compensation of the CEO to that of its median employee. This pay ratio rule, first effective for proxy statements filed in 2018, allows a company to use the same median employee for up to three years, unless there has been a change in the company's employee population or employee compensation arrangements that the company reasonably believes would result in a significant change in the pay ratio disclosure. After the third year, a new median employee determination is required.

We expect that many companies have concluded or will conclude that a new median employee needs to be identified for pay ratio disclosures in 2021 proxy statements. Any company that used the same median employee for proxy statements filed in 2018, 2019, and 2020 will be required under the pay ratio rule to identify a new median employee, as will any company that experienced a significant change in its employee population or employee compensation arrangements. Even if not required to under the rule, a company may also voluntarily identify a new median employee for purposes of proxy statements filed in 2021.

In preparing for 2021 pay ratio disclosures and determining whether identification of a new median employee is necessary or desirable, companies will want to carefully consider the impacts of employee furloughs, reductions in force, or pay reductions implemented in response to the effects of COVID-19 and how these and similar actions will be reflected in the compensation and headcount calculations underlying the calculation of the pay ratio itself. These underlying calculations may prove to be more complex than in prior years due to COVID-19-related actions.

For example, the treatment of furloughed employees is not directly addressed by SEC rules. Instead, Staff guidance in the Regulation S-K C&DIs acknowledges that the rules do not address furloughed employees and that companies instead will need to determine whether furloughed workers should be included as employees based on their specific facts and circumstances.

Board risk oversight

Item 407(h) of Regulation S-K requires companies to describe in their proxy statements the board's role in the risk oversight of the company, such as how the board administers its oversight function. Additionally, SEC guidance has emphasized that companies should also discuss how their boards oversee the management of material risks. The effects of COVID-19 may have amplified certain existing risks, such as cybersecurity-related risks arising from a transition to remote working arrangements, and introduced new risks not previously surfaced at the board level. Companies should update their 2021 board risk oversight discussions to clearly describe to investors how the board is approaching and fulfilling its oversight responsibilities for risk management in the COVID-19 environment.

Hedging disclosure

In December 2018, the SEC adopted a hedging policy disclosure rule under Item 407(i) of Regulation S-K. Item 402(b) of Regulation S-K already requires companies to disclose in their CD&A any policies permitting named executive officers to hedge the economic risk of company securities ownership, to the extent material. Item 407(i) expands this requirement to describe any practices or policies a company has adopted regarding the ability of its employees, including officers or directors (or any of their designees), to purchase securities or other financial instruments or otherwise engage in transactions that hedge or offset, or are designed to hedge or offset, any decrease in the market value of "registrant equity securities" granted as compensation, or held directly or indirectly by the employee or director.

Reporting companies, other than emerging growth companies (EGCs) and smaller reporting companies (SRCs), were required to comply with the new rule in 2020 by disclosing their hedging policies, or that there are no such policies in their proxy statements. EGCs and SRCs will have to make such disclosures in proxy and information statements for the election of directors for fiscal years beginning on or after July 1, 2020.

Board diversity

In 2020, pressure from large institutional investors, proxy advisors, and advocacy organizations for increased diversity on public company boards of directors continued to intensify, as did calls for increased disclosure regarding diversity and inclusion at the board and senior management level from a variety of stakeholders. State legislatures in a number of states (for example, California, Washington, Illinois, and Maryland) have also taken or are considering taking action to impose diversity requirements or diversity-related reporting requirements on public companies domiciled there. Additionally, the focus of these efforts has expanded beyond gender diversity to encompass racial, ethnic, and sexual orientation diversity as well. On December 1, 2020, Nasdaq filed a proposed rule with the SEC to adopt new listing rules that would require most Nasdaq-listed companies to disclose, in a specified format, certain Nasdaq-defined diversity statistics at the board level, based on director self-identification. Additionally, boards of Nasdaq-listed companies would be required under the proposed rules to have at least two diverse directors, including at least one director who self-identifies as female and at least one who self-identifies as a member of an underrepresented minority group or LGBTQ+.

Currently, Item 407(c)(2)(vi) of Regulation S-K requires companies to disclose in their proxy statements whether, and, if so, how, the nominating committee considers diversity in identifying director nominees. Additionally, if the nominating committee (or the board) has a policy with regard to the consideration of diversity in identifying director nominees, companies are required to describe how that policy is implemented and how the nominating committee (or the board) assesses the effectiveness of that policy. SEC rules do not define diversity and instead permit each company to define it as it considers appropriate.

Beyond the disclosures required by SEC rules, practices with respect to additional diversity disclosures vary widely across sectors and companies. Companies should critically review their proxy statement diversity disclosures in light of recent developments in, and the current focus on, this area to assess whether additional or enhanced disclosures addressing the company's policies and practices in respect of diversity and inclusion should be provided in their 2021 proxy statements. Companies will also want to be aware of voting policies adopted by their institutional investors and the positions of proxy advisory firms on these matters. Recent updates to ISS and Glass Lewis benchmark policies are discussed below under "*Shareholder Meetings- ISS and Glass Lewis – Revision to benchmark policies*."

D&O questionnaires

In general, we are not recommending changes to D&O questionnaires for the 2021 proxy season. We highlight below a few items, however, for companies to be aware of with regard to their D&O questionnaires.

In February 2020, the SEC approved a proposed Nasdaq amendment to change the definition of "Family Member" for purposes of determining whether a director is independent under the bright-line tests of Nasdaq Rule 5605(a)(2). As amended, "Family Member" means a person's spouse, parents, children, siblings, mothers- and fathers-in-law, sons- and daughters-in-law, brothers- and sisters-in-law, and anyone (other than domestic employees) who shares such person's home. The definition—which was specifically amended to exclude stepchildren who do not share the director's home and domestic employees who share the director's home from the types of relationships that always preclude a finding that a director is independent under Nasdaq listing rules—now mirrors the definition of "immediate family member" in the corresponding corporate governance rules of the New York Stock Exchange. Nasdaq-listed companies, however, will continue to need to make an affirmative determination, based on the specific facts and circumstances, that any stepchild or domestic employee relationship of a director would not interfere with that director's exercise of independent judgment in carrying out his or her responsibilities. Additionally, the amended definition does not affect the additional independence criteria for audit committee members set forth in Nasdaq Rule 5605(c)(2). Given the continued potential relevance of these relationships to independence determinations, we recommend that companies continue to elicit information regarding these relationships in their D&O questionnaires.

As discussed earlier in this alert, SEC rules regarding perks disclosure have not changed in recent years, and long-standing Staff guidance in this area has in fact been recently reaffirmed. Nonetheless, companies are encouraged to review their form of D&O questionnaire in light of any COVID-19-related perks that may have been provided to executive officers to ensure that disclosure of those items is elicited, and should also review responses against internal records to identify any potential reporting implications. Companies may also want to remind respondents of the importance of these questions in light of recent enforcement proceedings involving perks disclosure.

Should a company desire to request that directors self-identify gender, race, ethnicity, or sexual orientation information for proxy statement diversity disclosure purposes, D&O questionnaires are one possible vehicle to use to obtain that information. However, we recommend that companies carefully consider the sensitivity of this personal information and how and by whom it may be accessed before including self-identification questions in the company's D&O questionnaires. A separate, more private means of obtaining this information may instead emerge as a best practice.

Say-on-frequency

Rule 14a-21(b) requires an advisory say-on-pay frequency vote of shareholders every six years. Companies should note when the last annual meeting of shareholders included a say-on-frequency advisory vote to determine when the next vote is required.

Shareholder meetings

Virtual shareholder meetings

Before this year, many public companies examined the feasibility of virtual-only shareholder meetings (VSMs). The relevant technology has existed for years, and the cost savings are attractive, especially for companies whose annual meetings are large and costly events. Thirty-three states, including Delaware, permit VSMs and even more permit hybrid in-person and virtual meetings. However, the practice had not taken hold due to concerns from companies, shareholders, institutional investors, and proxy advisory firms that it was inherently harmful to shareholder involvement. Accordingly, as recently as 2019, fewer than 300 of more than 4,000 public companies had adopted VSMs.

The extraordinary public health considerations associated with COVID-19 and corresponding restrictions on large gatherings have finally driven the widespread adoption of videoconferencing and fully remote meetings across the business world, including for annual meetings, where VSMs have taken on new importance. Public companies held over 2,500 VSMs in 2020. They may remain the norm after the pandemic subsides.

For the 2021 proxy season, it seems likely that VSMs will continue to be a popular choice and perhaps mandatory as the pandemic is far from over. A survey of recent experience with VSMs suggests that public companies considering their use in 2021 should focus on a few key areas, summarized below.

Rationale

The company should clearly explain the rationale for a VSM beyond the pandemic. If the company believes, especially post-pandemic, that a VSM furthers shareholder access, it should explain this in the proxy materials. For example, many public companies cited improvements in shareholder questions since questions at VSMs could often be submitted in advance, resulting in management and the board addressing questions of general interest, as opposed to just those questions submitted by a relatively small number of shareholders who choose to attend a traditional meeting in person. Without such an explanation, VSMs may face renewed resistance as they may be perceived as a means of stifling shareholder participation.

Shareholder participation

The company should provide its shareholders with clear and complete information on how to participate in its VSM, including voting at the VSM or prior to it. Despite recent improvements in tracking who has the ability to vote shares held in street name (beneficially owned), shareholders should be made aware of the differences in voting procedures, and the corresponding meeting attendance requirements, for shares held of record versus those held beneficially. Finally, the process for shareholder questions (such as the procedure for submission, the time allotted, who may speak, and so on) should be clearly communicated well in advance of the meeting to ensure that matters of importance are addressed in a manner similar to how they would be addressed at a live meeting.

Preparation

The company should ensure that the technical and logistical requirements of the VSM are well-rehearsed. While a number of companies experienced technical glitches holding a VSM for the first time in 2020, shareholders may have less tolerance for a repeat of such issues in 2021.

Shareholder proposals

VSMs, like live meetings, present challenges for shareholder proposals. Clear ground rules only go so far in ensuring that proponents do not attempt to dominate a meeting by exceeding the allotted time, introducing extraneous matters, or causing disruption. Some companies have found success in inviting the submission of prerecorded statements that meet time limits (either as a primary form of submission or a backup in case of technical difficulties), using a dedicated connection with a proponent that can be cut off or silenced if rules are violated, and similar measures.

Audiovisual format

Even in 2020, the vast majority of VSMs were audio-only, making participation look and feel very different from in-person attendance at an annual meeting. Companies should strongly consider adopting videoconferencing for VSMs, to better replicate the in-person experience and reduce the feeling of an overly-scripted event in which shareholders have little ability to fully participate. Companies should also consider whether it is appropriate (or required) to include closed captioning and whether live interpretation will be helpful to shareholders whose primary language is not English.

Voting

The VSM should employ technology that makes it simple for a participating shareholder to vote (including changing a vote previously submitted via proxy) and provides a solid audit trail in the event of questions regarding the integrity of the vote.

Proxy advisors

The most-influential proxy advisors, ISS and Glass Lewis were generally supportive of VSMs during 2020, given the exigencies of the pandemic, and they have both indicated that they remain supportive of VSMs as an option where adequate procedures are in place for meaningful shareholder participation. That said, public companies should carefully follow updates from ISS and Glass Lewis and their institutional investor clients in this area.

ISS and Glass Lewis — Revisions to benchmark policies

On November 12, 2020, ISS released updates to its proxy voting guidelines for shareholder meetings to be held on or after February 1, 2021 (ISS Updates). Similarly, on November 24, 2020, Glass Lewis released updates to its proxy voting guidelines for 2021 shareholder meetings (Glass Lewis Updates). A complete review of the updates is beyond the scope of this Client Alert, but we summarize below several key policies that are of general application to most public companies.

Board diversity

The ISS Updates note that recent social unrest has placed racial and ethnic injustices and inequalities top-of-mind for boards of directors and institutional investors, resulting in renewed focus on board diversity. For 2021, ISS will report on companies included in the Russell 3000 and/or S&P 1500 indexes that lack racial or ethnic diversity (or lack disclosure in this area), with a view to assisting investors in engaging with these companies. Starting in 2022, ISS will also recommend voting against or withholding a vote from the chairperson of the nominating committee, and possibly other directors, of these companies, subject to exceptions where the company is endeavoring to appoint at least one racially or ethnically diverse director within the next year.

The Glass Lewis Updates feature expanded focus on board gender diversity. Glass Lewis already recommends voting against the chairperson of the nominating committee of a board with no women. For 2021, Glass Lewis will note as a concern a board with fewer than two women. And in 2022, it will recommend voting against the chairperson of the nominating committee of such a board, absent sufficient rationale or plan to address board diversity. The firm has also noted that it will generally recommend voting in accordance with board composition requirements included in applicable state law, such as recent California legislation imposing requirements regarding board participation by women and underrepresented groups.

Public companies often find it difficult to locate and secure the talents of qualified directors, so it seems apparent that waiting until the 2022 proxy season to address the revised ISS and Glass Lewis policies and the underlying investor concerns is not an option.

Shareholder litigation: Exclusive forum proposals

Many public companies have implemented or considered implementing exclusive forum provisions in their charters or bylaws, limiting (or purporting to limit) the locations in which certain shareholder litigation may be filed. A Delaware Supreme Court decision decided in early 2020 cleared the way for exclusive forum provisions making federal courts the exclusive forum for limitation under the federal securities laws, which a number of companies have since implemented. This follows years of debate regarding exclusive forum provisions generally, which often provide that shareholder litigation may be brought only in the state of incorporation (i.e., Delaware for most public companies).

The ISS Updates clarify that, with respect to federal securities litigation, ISS will generally support proposals to select federal courts as the exclusive forum, so long as the proposals do not limit such actions to a particular district court. They also clarify that ISS will generally support proposals to select Delaware courts as the exclusive forum for the resolution of state law claims, given their reputation for efficient resolution of corporate law cases.

Public companies that have previously considered enacting exclusive forum provisions but that have hesitated to do so (or eliminated them) may wish to examine whether to implement them, in light of these developments, as a means of reducing at least a few of the unknowns inherent in shareholder litigation.

Upcoming changes; voluntary compliance

Selected financial data — Item 301

On November 19, 2020, the SEC adopted amendments intended to modernize and enhance MD&A and other financial disclosure requirements. A company may voluntarily comply with the amended rules any time after 30 days after their publication in the *Federal Register*, as long as it complies with the amended item in its entirety.

The amendments eliminate Item 301 of Regulation S-K, which requires companies to furnish selected financial data in comparative tabular form for each of the company's last five fiscal years and any additional fiscal years necessary to keep the information from being misleading. The SEC noted that eliminating this requirement will reduce duplicative disclosures because such historical financial information is readily available through prior filings on EDGAR. However, where a company determines that inclusion of historical financial information for periods preceding those included in the financial statements of a particular filing is advisable or would be useful to investors, it will want to consider presenting such information in tabular format in the introductory or overview section of MD&A.

Supplementary financial information — Item 302

As part of its November 19, 2020 release adopting amendments intended to modernize and enhance MD&A and other financial disclosure requirements, the SEC amended Item 302 of Regulation S-K. A company may voluntarily comply with the amended rules any time after 30 days after their publication in the *Federal Register* as long as it complies with the amended item in its entirety.

Current Item 302(a) of Regulation S-K requires certain companies to disclose (i) selected financial data for each quarter of the last two completed fiscal years and any subsequent interim period and (ii) variances of those results from amounts previously reported on Form 10-Q. Instead of eliminating Item 302(a) as proposed, the amendments adopt a principles-based approach and streamline Item 302(a)'s requirements to require disclosure only when there are one or more retrospective changes (such as correction of an error, disposition of a business that is accounted for as a discontinued operation, reorganization of entities under common control, or change in an accounting principle) that pertain to a company's statements of comprehensive income for any of the quarters within the two most recent fiscal years and any subsequent interim period for which financial statements are included or required to be included by Article 3 of Regulation S-X and that, individually or in the aggregate, are material. Amended Item 302(a) also requires disclosures of an explanation of the reasons for the material retrospective changes and provides certain summarized financial information for each affected quarterly period and the fourth quarter in the affected year.

The affected quarters may include, depending on the facts and circumstances, a single quarter in which the material retrospective change applies or may flow through to subsequent quarters during the relevant look-back period. The amended Item 302(a) will refer to amended Rule 1-02(bb)(ii) of Regulation S-X for summarized financial information related to the statements of comprehensive income, providing companies flexibility in the line items presented.

The amendments retain Item 302(b) of Regulation S-K (disclosure of oil-and-gas–producing activities), but the SEC may reconsider its elimination in the future if the Financial Accounting Standards Board (FASB) finalizes amendments to U.S. GAAP that would require the incremental disclosure called for by Item 302(b).

MD&A — Item 303

On November 19, 2020, the SEC adopted amendments intended to modernize and enhance MD&A and other financial disclosure requirements. A company may voluntarily comply with the amended rules any time after 30 days after their publication in the *Federal Register* as long as it complies with the amended item in its entirety.

Item 303 of Regulation S-K requires disclosure of information relevant to assessing a company's financial condition, changes in financial condition, and results of operations. The amendments to Item 303 include these updates:

Objectives of MD&A

New Item 303(a) provides a broad statement of the SEC's views of the purpose of MD&A and calls for the following disclosure to better allow investors to view the company from management's perspective:

- Material information relevant to assessing the financial condition and results of operations of the company, including an evaluation of the amounts and certainty of cash flows from operations and outside sources;
- Material events and uncertainties known to management that are reasonably likely to cause reported financial information not to be indicative of future operating results or of future financial condition, including descriptions and amounts of matters that have had a material impact on reported operations, as well as matters that are reasonably likely to be based on management's assessment to have a material impact on future operations; and
- Material financial and statistical data that the company believes will enhance a reader's understanding of the company's financial condition, cash flows, and other changes in financial condition and results of operations.

These objectives, which "emphasize a registrant's future prospects and highlight the importance of materiality and trend disclosures to a thoughtful MD&A," apply throughout amended Item 303. The SEC encouraged companies to revisit these objectives regularly to provide enhanced analysis in MD&A disclosure that encompasses short-term results, as well as future prospects, as seen from the eyes of management.

Reasons underlying material changes; segment information

In light of the addition of the objective statement in new Item 303(a), current Item 303(a) becomes new Item 303(b) and is amended to clarify that MD&A requires a narrative discussion of the "reasons underlying," rather than "causes for," material changes, even when material changes within a line item offset each other. These underlying reasons for material changes must be in quantitative and qualitative terms. The SEC noted that despite specific instructions in the current rules, the MD&A discussion should not merely repeat numerical data contained in the consolidated financial statements; many companies simply recite the amounts of changes from year to year that are readily available from their financial statements. The intent of amended Item 303(b) is to encourage companies to provide a more meaningful discussion of the underlying reasons that may be contributing to material changes in line items.

Current Item 303(a) also requires companies to focus on each relevant "reportable" segment and/or other subdivision when a discussion of segment information and/or other subdivision is appropriate to an understanding of such business, in the company's judgment. The amendments require companies to focus the discussion and analysis on each reportable segment and/or other subdivision (such as geographic areas and product lines), as well as on the company as a whole.

Additionally, consistent with a materiality focused, principles-based approach to disclosure, amended Item 303(a) updates disclosure requirements for liquidity and capital resources, results of operations, off-balance sheet arrangements, and contractual obligations, as further discussed below.

Liquidity and capital resources

Codifying the SEC's 2003 MD&A Interpretive Release, the amendments to current Item 303(a)(2), renumbered as Item 303(b)(1), specify that a company should describe its material cash requirements, including but not limited to commitments for capital expenditures as of the end of the latest fiscal period, the anticipated source of funds needed to satisfy such cash requirements, and the general purpose of such requirements. The SEC does not expect that companies would have to deviate substantially from current practices of assessing material cash requirements because the amendments reflect current SEC guidance and resulting disclosure practices.

Results of operations — Known trends or uncertainties

The amendments provide that when a company knows of events that are reasonably likely to cause (as opposed to will cause) a material change in the relationship between costs and revenues, such as known or reasonably likely future increase in costs of labor or materials or price increases or inventory adjustments, the reasonably likely change must be disclosed.

The SEC emphasizes in the adopting release that the forward-looking threshold of "reasonably likely" applies throughout Item 303, and whether a matter is "reasonably likely" to have a material impact on future operations is based on "management's assessment," consistent with the MD&A objectives in the new Item 303(a).

This "reasonably likely" threshold requires a thoughtful analysis that applies an objective assessment of the likelihood that an event will occur balanced with materiality analysis regarding the need for disclosure regarding such an event. When applying this standard to known trends, demands, commitments, events, or uncertainties that management considers likely to come to fruition, companies should provide disclosure if that likely occurrence would reasonably be likely to have a material effect on the company's future results or financial condition. In cases of known trends, demands, commitments, events, or uncertainties where management cannot make an assessment as to the likelihood that they will come to fruition, and their occurrence would be reasonably likely to have a material effect on the company's future results or financial condition were they to come to fruition, companies should provide disclosure if a reasonable investor would consider omission of the information as significantly altering the mix of information made available in the company's disclosures. Disclosure of immaterial or remote future events is not required.

Results of operations — Net sales and revenue

Codifying previous guidance, amended Item 303(a)(3)(iii), renumbered as Item 303(b)(2)(iii), clarifies that the results of operations discussion should describe not only the underlying reasons for material "increases" but also decreases in net sales or revenues attributable to changes in prices, the volume or amount of goods or services being sold, or the introduction of new products or services.

Results of operations — Inflation and price changes

Current Item 303(a)(3)(iv) requires companies to discuss the impact of inflation and price changes on their net sales, revenues, and income from continuing operations for the three most recent fiscal years. The amendments eliminate this requirement and the corresponding instructions to encourage a focus on disclosure of material information in MD&A that is tailored to a company's facts and circumstances and to avoid duplicative disclosure. However, under amended Item 303, companies will be required to discuss the impact of inflation or changing prices if these are part of a known trend or uncertainty that had or is reasonably likely to have a material impact on net sales, revenue, or income from continuing operations.

Off-balance sheet arrangements

To avoid duplicative disclosure and promote the principles-based nature of MD&A, the amendments replace the current prescriptive off-balance sheet arrangements disclosure requirement in Item 303(a)(4) with a new Instruction to Item 303(b) that requires companies to discuss commitments or obligations arising from arrangements with unconsolidated entities or persons that have or are reasonably likely to have, a material current or future effect on the company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, cash requirements, or capital resources. No longer required in a separately captioned section, the off-balance sheet arrangements disclosure is expected to be presented as a part of the capital resources discussion required by Item 303(b)(1), which specifically calls for consideration of off-balance sheet financing arrangements. Companies may continue to provide a separate discussion of off-balance sheet arrangements to the extent warranted to facilitate investors' understanding of such arrangements.

Contractual obligations

The amendments eliminate current Item 303(a)(5), which requires companies to provide a table of contractual obligations arranged by type of obligation, overall payments due, and four prescribed periods. The SEC notes that this elimination will not result in a loss of material information to investors in light of the expansion of the liquidity and capital resources disclosure requirements, which include disclosure of material cash requirements from known contractual and other obligations.

Critical accounting estimates

Currently, the 2003 MD&A Interpretive Release requires companies to consider whether accounting estimates and judgments could materially affect reported financial information and disclose critical accounting estimates. The amendments add a new Item 303(b)(3), which is intended to codify and clarify the disclosure required under that guidance, eliminate disclosure that duplicates the financial statement discussion of significant accounting policies, and promote enhanced analysis of measurement uncertainties.

Focusing the definition of critical accounting estimates on estimation uncertainties, companies will be required under new Item 303(b)(3) to disclose for each critical accounting estimate, to the extent material, why the estimate is subject to uncertainty; how much each estimate or assumptions has changed during a relevant period; and the sensitivity of the reported amounts to the methods, assumptions, and estimates underlying the estimate's calculation. The discussion of critical accounting estimates should provide quantitative as well as qualitative information, to the extent such information is reasonably available and will provide material information to investors.

Smaller reporting companies

The amendments also eliminate current Item 303(d), which modifies the application to smaller reporting companies of the current inflation and changing price and contractual obligations disclosure obligations, since the underlying Regulation S-K items addressing these requirements are eliminated by the amendments. The SEC notes that smaller reporting companies are required to provide disclosure addressing liquidity and capital resources under the amended requirements, including disclosure of material cash requirements from known contractual and other obligations.

Shareholder proposals

In September 2020, the SEC amended Rule 14a-8 governing shareholder proposals. The amendments revised certain procedural requirements and the provision relating to resubmitted proposals. The minimum share ownership thresholds for eligibility to submit a shareholder proposal were revised as follows:

- Holders of at least $2,000 worth of company securities must have held those securities for an extended period of three years rather than the current one-year period;
- Holders of at least $15,000 worth of company securities must have held those securities for at least two years; and
- Holders of at least $25,000 worth of company securities must have held those securities for at least one year.

The SEC added a new rule requiring shareholders that use a representative to submit a proposal for inclusion in a company's proxy statement to provide documentation that:

- Identifies the company to which the proposal is directed;
- Identifies the annual or special meeting for which the proposal is submitted;
- Identifies the shareholder submitting the proposal and the shareholder's designated representative;
- Includes the shareholder's statement authorizing the designated representative to submit the proposal and otherwise act on the shareholder's behalf;
- Identifies the specific topic of the proposal to be submitted;
- Includes the shareholder's statement supporting the proposal; and
- Is signed and dated by the shareholder.

In addition, under the amendments, shareholder-proponents will be required to provide the company with a written statement that they are able to meet with the company in person or via teleconference at specified dates and times that are no less than ten calendar days, nor more than 30 calendar days, after submission of the proposal. Shareholder-proponents will also be required to provide their contact information and identify specific business days and times (i.e., more than one date and time) that they are available to discuss the proposal. Companies will not be required to engage with a shareholder-proponent or state that they attempted to engage with the shareholder-proponent prior to submitting a no-action request.

The amendments to the resubmission thresholds revise the levels of shareholder support a proposal must receive to be eligible for resubmission at the same company's future shareholder's meetings. Under the amended rules, a shareholder proposal will be excludable from a company's proxy materials if it addresses substantially the same subject matter as a proposal, or proposals, previously included in the company's proxy materials within the preceding five calendar years, if the most recent vote occurred within the preceding three calendar years and the most recent vote was less than:

- 5% of the votes cast if previously voted on once;
- 15% of the votes cast if previously voted on twice; or
- 25% of the votes cast if previously voted on three or more times.

The amendments will be effective January 4, 2021, and will apply to any proposal submitted for an annual or special meeting to be held on or after January 1, 2022. However, a shareholder that has continuously held at least $2,000 of a company's securities entitled to vote on the proposal for at least one year as of January 4, 2021, and continuously maintains at least $2,000 of such securities from January 4, 2021, through the date he or she submits a proposal, will be eligible to submit a proposal to such company, and need not satisfy the amended share ownership thresholds for an annual or special meeting to be held prior to January 1, 2023.

Statistical data for banks

On September 11, 2020, the SEC adopted rules to update and expand the statistical disclosure requirements for banks and savings and loans, and the holding companies of such registrants (banking registrants). The new rules were effective November 16, 2020, and will apply to fiscal years ending on or after December 15, 2021. However, voluntary compliance with the new rules in advance of the mandatory compliance date is permitted, provided that the final rules are applied in their entirety.

The SEC updated and codified certain disclosure items from Industry Guide 3, Statistical Disclosure by Bank Holding Companies (Guide 3), and eliminated other Guide 3 disclosure items that overlap with SEC rules, U.S. GAAP, or International Financial Reporting Standards (IFRS). The codified disclosure requirements have been relocated to the new subpart 1400 of Regulation S-K. In addition; the SEC also amended Rule 9-01 of Regulation S-X to include savings and loan associations and savings and loan holding companies within the scope of Article 9 of Regulation S-X.

The update and codification of Guide 3 reflect the significant financial reporting changes that have taken place for banking registrants since Guide 3 was last updated. While currently, the Guide 3 guidelines represent staff policies and practices, this codification elevates them to SEC rules.

Subpart 1400 reduces the "reporting period" required by Guide 3. As opposed to the three- and five-year requirements of Guide 3, the Subpart 1400 "reporting period" is each annual period for which SEC rules require a registrant to provide financial statements and for any interim period when there is a material change in the information or the trend evidenced by the information.

The codified updated Guide 3 requirements call for disclosure of the following areas:

Distribution of assets, liabilities, and stockholders' equity; interest rates, and interest differential

New Item 1402 of Regulation S-K codified all of the average balance sheet, interest and yield/rate analysis, and rate/volume analysis disclosure items currently in Item I of Guide 3, including the disaggregation of all major categories of interest-earning assets and interest-bearing liabilities. New Item 1402 requires banking registrants to further disaggregate the categories of interest-earning assets and interest-bearing liabilities required to be disclosed, if material, by separating (i) federal funds sold from securities purchased with agreements to resell and (ii) federal funds purchased from securities sold under agreements to repurchase and to disaggregate commercial paper.

Investment portfolio

New Item 1403 of Regulation S-K requires a banking registrant to disclose the weighted average yield of each category of debt securities not carried at fair value through earnings for which disclosure is required in the financial statements, presented for a specified range of maturities (i.e., due one year or less, within five years, within five to ten years, and after ten years). In this regard, the new SEC rules use the categories required by U.S. GAAP and IFRS rather than those categories currently called for by Item II.B of Guide 3.

New Item 1403 does not require the following existing disclosure items in Item II of Guide 3: (i) book value information, (ii) the maturity analysis of book value information, and (iii) the disclosures related to investments exceeding 10% of stockholders' equity.

Loan portfolio

New Item 1404(a) of Regulation S-K codifies the maturity by loan category disclosure currently called for by Item III.B of Guide 3, but the loan categories are based on the loan categories required in the registrant's U.S. GAAP or IFRS financial statements. New Item 1404(a) also requires additional maturity categories of (i) after five years through 15 years and (ii) after 15 years.

Item 1404(b) codifies the disclosure items in Item III.B of the Guide 3 regarding the total amount of loans due after one year that have (i) predetermined interest rates or (ii) floating or adjustable interest rates, and specifies that this disclosure should also be disaggregated by the loan categories disclosed in the registrant's U.S. GAAP or IFRS financial statements.

The final rules do not codify the following Guide 3 disclosure items because of their overlap with SEC rules, U.S. GAAP, or IFRS: (i) the loan category disclosures called for by Item III.A of Guide 3, (ii) the loan portfolio risk elements disclosure called for by Item III.C, and (iii) the other interest-bearing assets disclosure called for by Item III.D.

Allowance for credit losses

New Item 1405 of Regulation S-K requires the disclosure of the ratio of net charge-offs during the period to average loans outstanding based on the loan categories required to be disclosed in the registrant's U.S. GAAP or IFRS financial statements, instead of on a consolidated basis as called for by Guide 3. Item 1405 also requires registrants to provide the tabular allocation of the allowance disclosure called for by Item IV.B of Guide 3, except that the allocation would be based on the loan categories presented in the U.S. GAAP financial statements instead of the loan categories specified in Item IV.B of Guide 3.

New Item 1405 also requires a registrant to disclose, for each reported period, the following new credit ratios on a consolidated basis, along with each of the components used in their calculations: (i) allowance for credit losses to total loans, (ii) nonaccrual loans to total loans, and (iii) allowance for credit losses to nonaccrual loans. Registrants will also be required to discuss the factors that drove material changes in the ratios or related components during the periods presented.

Deposits

New Item 1406 of Regulation S-K codifies the majority of the disclosure items in Item V of Guide 3, with some revisions. Instead of requiring disclosure of time deposits of a certain dollar threshold, Item 1406 requires a registrant to disclose the amount of uninsured deposits. It requires separate presentation of U.S. time deposits in amounts in excess of the FDIC insurance limit and time deposits that are otherwise uninsured, by time remaining until maturity of (i) three months or less (ii) over three through six months, (iii) over six through 12 months, and (iv) over 12 months.

The new rules also permit a registrant to disclose uninsured deposits at the reported date based on an estimate of uninsured deposits if it is not reasonably practicable to provide a precise measure of uninsured deposits, provided that the estimates are based on the same methodologies and assumptions used for the bank or savings and loan registrant's regulatory reporting requirements, such as the FDIC rules.

Items from Guide 3 eliminated

The SEC decided not to codify Item VI of Guide 3 that calls for disclosure of four specific ratios for each reported period, including return on assets, return on equity, a dividend payout ratio, and an equity-to-assets ratio. The SEC also did not codify the existing disclosure items in Item VII with respect to short-term borrowings. New Item 1402 of Regulation S-K, however, requires disaggregation of the major categories of interest-bearing liabilities to include those referenced in Item VII of Guide 3. The other disclosure items in Item VII were not codified because those are substantially covered by existing SEC rules and the financial statement requirements.

For more information on the content of this alert, or on securities law issues we've covered this year, please contact your Nixon Peabody attorney or:

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