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# *GT Insights* for Public Companies

**March 20, 2018**

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## SEC Regulation

### Early Trends in Pay Ratio Disclosure

In accordance with the final rules issued by the Securities and Exchange Commission (SEC) under Section 953(b) of the Dodd-Frank Act, reporting companies are required to disclose the ratio of the total annual compensation of its principal executive officer to that of its median employee. The new SEC rules, contained in Item 402(u) of Regulation S-K, became effective for Form 10-Ks for the 2017 fiscal year or in Proxy Statements for the 2018 annual meeting.

In calculating the ratio, companies may use various methodologies and assumptions, apply certain exclusions, and make reasonable estimates that reflect their individual compensation practices and employee populations. Accordingly, the pay ratio reported by one company may not be comparable with that of another.

Based on a review of the first one hundred proxy filings that included pay ratio disclosures:

- Well over a majority of the companies made annualizing adjustments;
- 10 companies provided supplemental ratios;
- 19 companies used the "*de minimis*" exemption;
- No companies used the data privacy exemption;

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- No companies used cost of living adjustments;
- One company used statistical sampling;
- 22 companies included language that cautions readers against comparing pay ratios;
- 11 companies discussed their philosophy that pay should be fair and equitable for its employees; and
- Many companies used subtitles to assist readers in following their methodology.

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## SEC Issues Comment Letters on Revenue Recognition Disclosure

The FASB's new revenue recognition accounting standard is effective Jan. 1, 2018 with most public companies being required to disclose the newly implemented standard in their Form 10-Q for the first quarter of 2018. A review of recent comment letters issued by the SEC's Division of Corporation Finance to early adopters provide some insight on the Staff's focus in this area.

The comment letters request additional information in the following areas and at times referred the company to more detailed or inconsistent disclosures made elsewhere in the issuer's public filings:

**Contract Specifics**. The Staff requested additional detail related to the specific nature and terms of the company's contracts, including pricing and nature and number of transactions.

**Accounting Treatment.** The Staff requested that companies explain the methods, assumptions, and estimates they used, including:

- in determining when revenue is recognized such as assumptions regarding transfer and control;
- details surrounding the decision to report revenue on a gross basis; and
- considerations for determining when revenue will be recognized in the future.

**Categories of Aggregated or Disaggregated Revenues.** The Staff requested information regarding:

- the selection of appropriate categories to use to disaggregate revenue;
- why aggregation of certain revenue is appropriate, in light of differing characteristics; and
- why current disclosures meet the objective of depicting how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors.

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## Trends in Shareholder Proposals

ISS released a summary of shareholder proposals submitted to date for the 2018 proxy season, based on 450 proposals made to Russell 3000 companies. Of the 450 proposals reviewed, more than two-thirds related to social or environmental issues, continuing the trend of such issues overshadowing governance- and compensation-related proposals.

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The top proposals on social issues related to lobbying and political contributions (74), “other” social issues (65) and board and workplace diversity and parity (62). The leading proposals on environmental proposals related to climate change (70), other environmental issues (22) and sustainability (20). For governance issues, the top proposals related to board matters (49), shareholder rights (46), and other governance matters (11). ISS noted that the increase in public awareness and concern about transparency in the political process, workplace harassment and equity, and climate change risks may be one reason for the substantial growth in proposals related to social and environmental issues.

Of the 450 shareholder proposals analyzed, 50 were omitted and 43 were withdrawn. In addition, more than 40 percent of the 2018 shareholder proposals included in the ISS database have been challenged at the SEC, in comparison to about 30 percent of proposals for all of 2017. The ISS article does not discuss why companies are increasingly challenging shareholder proposals and does not give any insight into how such challenges will ultimately be resolved. It is likely, though, that the recent guidance from the SEC’s Division of Corporation Finance included in Staff Legal Bulletin No. 14I, relating to the exclusion of shareholder proposals on the basis of the ordinary business exception, and recent no-action letters such as the one issued on February 21, 2018, which excluded a shareholder proposal relating to the calling of a shareholder meeting on the basis that it conflicted with a proposal the company planned to submit at its annual meeting, are providing companies with more opportunities to successfully argue for exclusion of certain proposals.

## Views Expressed Regarding Mandatory Arbitration of Shareholder Claims

In prior years, the SEC had not looked favorably upon provisions in a company’s bylaws that require shareholders to submit to binding arbitration for securities actions against the company rather than bringing the action in court. In recent speeches, the SEC and others have expressed mixed views on these provisions.

In a July 2017 speech at the Heritage Foundation, SEC Commissioner Michael Piwowar said that he would encourage companies to discuss mandatory arbitration provisions with the Staff and to “ask for relief to put in mandatory arbitration into their charters.”

The Treasury Department has also recently weighed in on the topic. In an October 2017 report, it recommended that the SEC investigate ways to reduce the cost to companies of securities litigation, “including by allowing companies and shareholders to settle disputes through arbitration.”

On Feb. 24, 2018, at the 2018 SEC Speaks conference, Rick Fleming, Investor Advocate at the SEC, stated that “…stripping away the right of shareholders to bring a class action lawsuit seems to be draconian and, with respect to promoting capital formation, counterproductive.” He stressed “…the importance of private suits in helping to protect investors and deter wrongdoing” and noted that to deprive shareholders with a class-wide remedy to bring claims against a company in court would deny recourse to investors with smaller holdings.

On Feb. 26, 2018, newly appointed SEC Commissioner Robert J. Jackson, Jr. also expressed concerns about mandatory arbitration provisions. He noted that due to the private nature of arbitration proceedings, they do not create the “positive externalities” that public proceedings facilitate, and that the provisions could lead to a potential increase in the cost and burden of SEC investigations. He also noted, however, that due to budget constraints, there are limits to what the SEC can do in this area.

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On March 8, 2018, in remarks to the SEC Investor Advisory Committee, Chairman Clayton reiterated that he is not anxious to see the issue of mandatory arbitration come before the SEC. He clarified that this did not mean the topic was not worthwhile for discussion, and that he had not formed a definitive view as to whether the provisions are appropriate in any particular circumstance.

## Exchanges

### Reduced NYSE Proxy Delivery Requirements

On March 1, 2018, the SEC approved a modification to the NYSE's rules regarding physical delivery of proxy materials. The modified rule now states:

- Listed companies are no longer required to provide proxy materials to the NYSE in physical form provided the proxy materials are included in a Schedule 14A available on the SEC's EDGAR filing system;
- If a listed company's proxy materials are available on EDGAR but are not filed pursuant to Schedule 14A (for example, if they are included in an S-4 registration statement), it must provide the NYSE information sufficient to identify such filing by designated means no later than the date on which such material is sent, or given, to any security holders; and
- If a listed company's proxy materials are not included in their entirety (together with proxy card) in an SEC filing available on EDGAR, it will continue to be required to provide three physical copies of any proxy material not available on EDGAR to the NYSE no later than the date on which such material is sent, or given, to any security holders.

## Litigation

### Delaware Court Interprets Stockholders' Agreements

The Delaware Court of Chancery recently issued two important decisions relating to the interpretation of stockholders' agreements that each serves as reminders of their limitations and power and highlights the importance of carefully drafting these agreements.

#### Stockholders' Agreement Cannot Limit Board's Authority to Remove CEO

In the first case, certain stockholders (who together held a majority interest) delivered a written consent that attempted to remove and replace the company's CEO from both his executive position and his seat on the company's board of directors. The company rejected this attempt and brought an action pursuant to Section 225 of the Delaware General Corporation Law ("DGCL"), seeking a declaratory judgment that the written consent was ineffective.

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With respect to attempted removal/replacement of the CEO as an officer of the company, the Court of Chancery concluded that Section 142 of the DGCL and the bylaws of the company exclusively vested such power in the board—rendering the stockholders' written consent ineffective. With respect to the attempted removal/replacement of the CEO as a director of the company, the Court concluded that the language of the applicable stockholders agreement controlled.

After considering the competing interpretations of that language–which stated that the stockholders agreed to vote their shares "to cause and maintain the election to the Board of…three (3) representatives designated by the holders of a majority of the Common Stock, one of whom shall be the Chief Executive Officer of the Company"–the Court held that the company's reading was correct and required the common stockholders to nominate the CEO to serve as a director. According to the Court of Chancery, this reading "harmonizes [the bylaws of the company and the stockholders agreement] by recognizing that the Board selects the CEO, who need not be a director at the time of selection, but then the common stockholders must nominate the CEO to serve as a director." Accordingly, the written consent's attempt to remove and replace the director of the company who was also the CEO was ineffective.

## Stock Issuance in Violation of Stockholders' Agreement is "Void" and not "Voidable"

In the second case, a stockholder group that previously owned 48.8 percent of the company acquired a majority stake in the company. Immediately thereafter, the board adopted a new employee equity compensation plan and issued enough restricted stock under the plan to dilute this stockholder group back down to a minority position. After the issuance of the restricted stock, the stockholder group acted by written consent to remove and replace two directors. In reliance on the shares issued pursuant to the restricted stock award agreement, the company refused to recognize the validity of the consent.

The diluted stockholder, again in an action under Section 225 of the DGCL, contended that the dilutive issuances were invalid because the company failed to obtain joinder documents from each recipient before the issuance, as required by the stockholders' agreement. That agreement barred the company from issuing stock to any person who did not sign the joinder agreement. It further provided that any issuance of shares in violation of the joinder requirement was "null and void ab initio." The relevant restricted stock award agreements provided only that the shares would be "subject to" the stockholders' agreement and that the recipients agreed to execute the required instruments, but the recipients never executed the required joinders.

In determining the proper composition of the board and therefore the validity of the restrictive stock issuances, the court relied on the "express" terms of the stockholders' agreement and the penalty it imposed, citing prior case law that it is the "court's job to enforce the clear terms of contract." Because the stockholders' agreement expressly provided that failure to comply with the joinder requirement would cause the issuance to be void ab initio, the Court of Chancery found that the restricted stock issuance was void.

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