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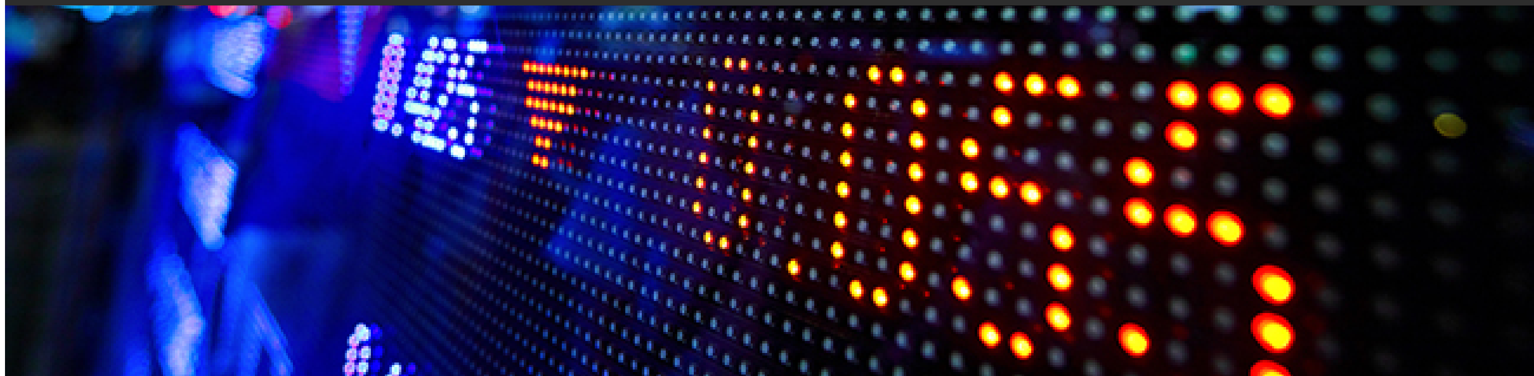

March 7, 2018

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SEC Regulation

SEC Issues Guidance on Cybersecurity Disclosure and Investigations

On Feb. 21, 2018, the SEC issued interpretive guidance to public companies relating to disclosure of cybersecurity risks and incidents. The new release reinforces and expands the guidance provided by the SEC in 2011.

The guidance covers three key areas: disclosure of cybersecurity risks and incidents in periodic reports and registration statements; implementation and maintenance of disclosure controls and procedures relating to cybersecurity risks and incidents; and implementation of insider trading policies when cybersecurity events occur.

The new guidance continues to address disclosure of known incidents in a similar manner as the 2011 guidance and now also better addresses the need for disclosure on cybersecurity threats and the potential consequences. If cybersecurity risks are material, the SEC believes disclosure in the proxy statement about a board's involvement in risk oversight should include a discussion of cybersecurity threats and how the board engages with management on cybersecurity issues. The SEC states that companies are required to establish and maintain effective disclosure controls and procedures to help them make accurate and timely disclosures of material cybersecurity events.

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In addition, the guidance states that company directors, officers, and corporate insiders must not trade a company's securities while possessing material nonpublic information on cybersecurity attacks. The SEC encourages companies to consider adopting specific policies that would restrict executive trading in shares while a cybersecurity incident is under investigation and before it is disclosed.

The SEC Speaks: Here's What They Said

The SEC Speaks 2018 conference was held from Feb. 23-24, 2018. Below are highlights from the conference.

- ***Priorities in 2018***. SEC Chair Jay Clayton laid out his priorities for the SEC for 2018. These included:
    - finding the right regulatory balance on initial coin offerings (ICOs) and regulation of blockchain technology companies;
    - focusing on protecting "main street" investors and the impact that the activities of large institutions have on those investors; and
    - harmonizing various standards of conduct for broker-dealers.
- ***Extension of Nonpublic Review of Registration Statements***. The Staff of the Division of Corporation Finance highlighted the popularity of the new nonpublic review procedure that the Staff instituted in June 2017, noting that since then:
    - more than 20 companies who did not otherwise qualify as an emerging growth company took advantage of the procedure for IPO registration statements;
    - more than 40 companies have used the procedure for registration statements for follow-on offerings; and
    - a handful of companies have used the procedure for Exchange Act registration statements.

  The Staff also clarified that the nonpublic review procedure is available in other circumstances, including reviews of:
    - spinoff entities, even where their parent companies do not qualify to use it;
    - Form S-4s in connection with business combinations, even if the Form S-4 serves as a proxy or information statement or is filed by a SPAC;
    - Form S-11s for REITs; and
    - Reg. A issuers in certain circumstances.

  In addition, the Staff reiterated that companies may omit interim financial statements that a company reasonably believes will not be required to be included in the registration statement at the time it is publicly filed.
- ***Update on Non-GAAP Financial Measures***. The Staff gave an update on compliance with non-GAAP requirements in the wake of its May 2016 guidance, noting that it continues to find compliance issues in the following areas:

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- improper use of tailored accounting principles;
- non-GAAP measures with titles similar to GAAP measures; and
- equal or greater prominence of GAAP measures.

- ***Rulemaking Agenda***. The Staff discussed a few of the near-term rulemaking goals it hopes to accomplish, including:
  - streamlining financial statement requirements for acquired businesses and registered debt offerings;
  - increasing the thresholds in the "smaller reporting company" definition;
  - streamlining disclosure in the MD&A to eliminate discussion of the oldest period if not material; and
  - providing greater flexibility with respect to redacting or omitting information in exhibits and their schedules and attachments.

The SEC Speaks: Shareholder Proposals

At SEC Speaks, the Staff discussed Staff Legal Bulletin 14I, which provides guidance to companies on two existing grounds for excluding a shareholder proposal:

- To exclude a shareholder proposal based on its economic relevance, the Staff is looking for an analysis as to the relationship of the proposal to the particular company, and that the company's board of directors is in the best position to perform this analysis (particularly if the issue is not apparent to the Staff).
- The Staff reiterated the challenge it faces in deciding whether or not an issue rises above the ordinary business of the company.

Although the Staff reiterated that the board's analysis is not a requirement for either of these grounds for exclusion, it did highlight the importance of the analysis to its decision whether to agree to provide relief to companies seeking to exclude a proposal, and it provided a few tips:

- The analysis should describe specific factors the board considered.
- Did the board consider shareholder engagement on the issue, and has it otherwise been approached on the issue?
- If a prior vote was held on an issue, why was the vote not significant to merit change? How has the board already addressed the issue (if at all) and how is it different than the approach suggested by the proposal?
- Quantitative data might be helpful in some cases.
- An analysis is not helpful where it lays out the steps the board took but then, without detail of the specific factors it considered, concludes that the board has deemed the proposal not significant.

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Executive Compensation Disclosure after the Tax Cuts and Jobs Act

The recent Tax Cuts and Jobs Act included substantial changes to executive compensation deduction rules under Section 162(m) of the Internal Revenue Code. Significantly, under Section 162(m), as revised, the exceptions for qualified performance-based compensation and commissions from the $1 million deduction limit have been eliminated. As a result, all performance-based compensation paid to a covered employee, including annual bonuses, performance stock units, and stock options, will now be subject to the $1 million annual deduction limitation.

The term "covered employee" has been expanded to include the Chief Financial Officer (in addition to the Chief Executive Officer and the three next most highly compensated officers). Any person who is a covered employee after 2016 continues to be a covered employee in future years.

For purposes of the revised rules, the term "publicly held corporation" has been revised to cover a corporation that is required to register any securities (as opposed to just shares of stock as was the case under prior law), including not only domestic publicly traded companies and all publicly traded foreign companies, including those traded through ADRs, as well as certain large private companies required to file reports with the SEC.

The changes apply with respect to taxable years beginning after Dec. 31, 2017. Under a transition rule, however, the new rules do not apply to compensation provided pursuant to a written binding contract that was in effect on Nov. 2, 2017 and that was not modified in any material respect after that date.

Any awards made to covered employees in 2018 that are not subject to the transition rule will no longer qualify for the performance-based exceptions to Section 162(m). Accordingly, when drafting this year's proxy disclosure or proposals, disclosure of Section 162(m) as a justification for approval of compensation or stock plans may be inaccurate, except to the extent it applies to compensation subject to the transition rule. If an executive has a legally binding right to receive an award in the future that would qualify for the transition rule, but the award would be granted more than 5 years after the last Section 162(m) shareholder approval, it may be prudent to have the plan reapproved by shareholders before the award is granted to preserve the transition rule.

Companies should aim to balance the fact that performance-based compensation will now be subject to the Section 162(m) deduction limitations with the knowledge that proxy advisory firms may still review performance-based compensation to covered employees as a metric of sound corporate compensation governance. Companies should also consider discussing the impact of the loss of the tax deduction in the Compensation Discussion and Analysis.

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Exchanges

Nasdaq Proposes Changes to Shareholder Approval Requirements

On Jan. 30, 2018, Nasdaq proposed amendments to its shareholder approval requirements for issuances of common stock in private placements. The current Nasdaq rule, which has remained substantively the same for 28 years, requires a company to obtain shareholder approval of issuances of common stock at a price that is less than the greater of book or market value (other than in a public offering) if either:

- the issuance equals 20 percent of the outstanding stock or voting power; or
- if a smaller issuance coupled with sales by the officers, directors, or substantial security holders meets the 20 percent threshold.

Nasdaq proposes updating this rule to:

- change the definition of market value; and
- eliminate the requirement for shareholder approval of issuances at a price less than book value, but greater than market value.

Market Value

The current Nasdaq rule defines market value as the stock's closing bid price. However, Nasdaq found that bid price may not be a transparent number to companies and investors, and it may not reflect the actual trading price of a stock. To provide companies with a more reliable price, Nasdaq has proposed to define market value as the lower of:

- the closing price of the common stock on Nasdaq.com; or
- the average closing price of the common stock on Nasdaq.com for the five trading days before the signing of the binding agreement.

Book Value

The proposed rule eliminates the book value test for shareholder approval. Nasdaq noted that book value is an accounting measure based on the historic cost of assets, rather than the current value, and as a result, is not an appropriate measure of whether a transaction is dilutive or should require shareholder approval. In situations where book value may be lower than market value, Nasdaq found that companies become frustrated as it is difficult to raise capital on terms that are favorable to market price.

All comments should be submitted to the SEC on or before March 13, 2018.

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New NYSE Rules Facilitate Listing Without An IPO

On Feb. 2, 2018, the SEC approved amendments to the NYSE listing standards to facilitate the direct listing of private companies on the NYSE without conducting a firm commitment underwritten IPO.

Typically, a company lists on a national securities exchange as part of an underwritten IPO, upon transfer from another market or as a result of a spinoff. Before the rule change, a company that had not previously registered its shares under the Exchange Act could list upon the effectiveness of a selling shareholder registration statement, at the NYSE's discretion, if the market value of its publicly-held shares was at least $100 million, based on the lesser of (1) an independent third-party valuation of the company and (2) the most recent trading price for the company's common stock in a private placement market. The amendments provide that where there is no recent trading in a private placement market, a company can meet the market value of publicly-held shares requirement if an independent third party with "significant experience and demonstrable competence" provides a valuation of at least $250 million in market value of publicly held shares. The amendments identify several criteria to determine the third party's independence.

The amendments eliminated a provision that would have allowed a company to list solely upon the effectiveness of an Exchange Act registration statement. Under the amended rules, in order to make a direct listing, a company must file a resale registration statement to cover the resale of securities previously sold by the company in private placements. This registration statement will be subject to traditional SEC review and comment. As is the case with any registered public offering, companies will need to consider the application of the gun-jumping and liability provisions of the Securities Act.

By eliminating the market price provision, the amendments facilitate direct listings for companies that are large enough to be suitable for listing but do not have their shares traded on a private placement market before going public, or the private placement market trading is too limited to provide a reasonable basis for reaching conclusions about their qualification.

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Litigation

SCOTUS Rules Dodd-Frank Does Not Protect Internal Whistleblowing

On Feb. 21, 2018, the U.S. Supreme Court held that the anti-retaliation provision of the Dodd-Frank Act protects only employees who complain to the SEC and not those who make only internal complaints.

In a unanimous decision, the justices found that employees who bring securities law complaints against their employers must first take their allegations to the SEC to be protected by the Dodd-Frank Act anti-retaliation provisions.

The decision resolves a long-standing circuit split, discussed in a prior GT Alert, between the Fifth Circuit Court of Appeals which held internal reporting was not protected by the Dodd-Frank Act, and the Second and Ninth Circuits which held that internal reporting was protected.

For more information, read the *GT Alert*, "SCOTUS Rules Dodd-Frank Does Not Protect Internal Whistleblowing," prepared by Terence P. McCourt, Todd D. Wozniak, and Jack S. Gearan.

Delaware Chancery Court Finds Unaffected Market Price is Fair Value in Appraisal Case

On Feb. 15, 2018, the Delaware Court of Chancery held in *Veriton Partners Master Fund Ltd. v. Aruba Networks, Inc.*, that an acquired company's unaffected thirty-day average market price (the market price before publicly announcing the transaction), provided the best evidence of its fair value in an appraisal action involving the sale of a publicly-traded company in an arm's-length transaction. The decision noted that it was decided in the wake of two recent decisions where the Delaware Supreme Court endorsed the use of the market price of widely traded firms as evidence of fair value.

In its analysis, the Court of Chancery considered three alternatives – (1) discounted cash flow; (2) the merger price; and (3) the unaffected market price. The Court opined that while a discounted cash flow analysis can be a useful tool when there is little compelling market evidence, a court should be cautious in estimating fair value when market evidence is available. The Court further explained that while the merger price is a probative indication of value, reductions to the merger price would be needed to adjust for any synergies or value arising from the deal itself, which may be difficult for a court to accurately determine. The Court concluded that the market for the acquired company's stock was efficient because, among other things, the company did not have a controlling shareholder, the company made public filings in compliance with securities laws, thirty-three securities analysts covered the company and the company was widely traded. Since the market was deemed efficient, the Court determined that utilizing the acquired company's unaffected market price was the right approach for determining its fair value even though it resulted in a value that was lower than the merger price.

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