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GT Insights for Public Companies

June 1, 2018

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SEC

SEC Staff Issues 45 New Proxy C&DIs

The Staff recently provided updated guidance relating to the proxy rules and disclosure requirements for the first time in more than a decade with the release of 45 new Compliance and Disclosure Interpretations (C&DIs) that replace its previously issued telephone interpretations.

Six of the new C&DIs reflect substantive changes to certain disclosure requirements in the context of proxy solicitations. The key takeaways from these C&DIs are summarized below:

- C&DI 124.01 – Rule 14a-4(b)(1) states that a proxy may confer discretionary authority with respect to matters as to which a choice has not been specified by the security holder, so long as the form of proxy states in bold-faced type how the proxy holder will vote where no choice is specified. The new C&DI clarifies that for election of directors, the Staff will permit companies to cumulate votes among director nominees if the company indicates this in bold-faced type on the proxy card itself, and if relevant state law permits.
- C&DI 124.07 – The SEC has permitted companies to avoid filing proxy materials in preliminary form despite receipt of adequate advance notification of a non-Rule 14a-8 matter as long as the company disclosed in its proxy statement the nature of the matter and how the company intends

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to exercise discretionary authority if the matter was actually presented for a vote at the meeting. The new C&DI clarifies that, to the extent a company cannot properly exercise discretionary authority in the context of a non-Rule 14a-8 shareholder proposal matter, the company should file preliminary proxy materials and a preliminary form of proxy with the SEC.

- C&DI 126.02 – The Staff provided guidance that approval of a corporate name change, in and of itself, will not require a company to file a preliminary proxy statement.
- C&DI 151.01 – The Staff advised that Note A of Schedule 14A (requiring Items 11, 13 and 14 information) is triggered if an acquisition will be funded by a "material portion" of the proceeds of the issuance of additional stock pursuant to security holder authorization. If, on the other hand, the proceeds from the sale of common stock is not an integral part of the acquisition transaction because the company has other means of fully financing the acquisition, the proposal to authorize additional common stock will not "involve" the acquisition and, therefore, Note A of Schedule 14A will not be triggered.
- C&DI 161.03 – The Staff clarified that a company may include narrative disclosure to the New Plan Benefits Table to state that no individuals or groups received amounts under the new plan. Previously, companies were required to provide quantitative disclosure in the New Plan Benefits Table even when individuals or groups received no benefit.
- C&DI 163.01 – The Staff affirmed that elimination of preemptive rights from a security is a modification of that security for purposes of Item 12 of Schedule 14A. Accordingly, financial and other information would be required in the proxy statement to the extent required by Item 13 of Schedule 14A.

Accounting

SEC Chief Accountant Delivers a Speech at the 2018 Baruch College Financial Reporting Conference

On May 3rd, SEC Chief Accountant Wesley Bricker addressed the 2018 Baruch College Financial Reporting Conference. Mr. Bricker discussed the objective of financial reporting and commented on new accounting standards, the effects of income tax reform, non-GAAP measures, and the importance of independent, diverse thinking on audit committees. He also offered guidance on areas where audit committees and management can have a positive effect on the quality of disclosure.

Mr. Bricker discussed the importance of successfully implementing several new accounting standards: (i) revenue recognition (in 2018), (ii) leases (in 2019), and (iii) credit losses (in 2020). He also noted that companies and auditors have been responding to the recent income tax reforms, and that "[t]he Staff expects companies to act in good faith to complete the accounting." Referencing the Staff's guidance in Staff Accounting Bulletin No. 118, Mr. Bricker stated that "the staff would not object to a company, when accounting for the effects of the tax reform, utilizing a measurement period that ends when an entity has obtained, prepared and analyzed the information necessary…to complete the accounting, which is not to exceed 12-months."

Mr. Bricker highlighted how audit committees can review the presentation of non-GAAP financial measures and support management's enterprise risk oversight. In discussing how companies are planning their communication strategies with investors regarding changes in equity investment accounting requirements, Mr. Bricker emphasized that while the FASB standard can be supplemented with additional disclosures or non-GAAP information, non-GAAP reporting cannot supplant GAAP reporting. He stressed how audit committees "that clearly understand non-GAAP measures presented to the public – and who take the time and effort in their financial reporting oversight role to review with management the preparation, presentation, and integrity of those metrics – are an indicator of a strong compliance and reporting culture." Mr. Bricker suggested that these committees can (and should) consider engaging

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policies that increase disclosure quality, especially with regards to changes in market risk that can, for example be triggered by rising interest rates.

Mr. Bricker also described how the largest audit firms communicate meaningful information about firm culture in the context of governance as an aspect of firm-wide risk management. In discussing such communication, he specifically identified "the design of the firm's board, its membership, the particular responsibilities assigned to the members, why a member of a board or advisory council or other structure is determined to be 'independent' of the firm, and related information that would inform an audit committee's consideration of the audit firm's commitment to factors that impact audit quality." Mr. Bricker stated that these governance and culture considerations can assist audit committees as they oversee the company's external auditors.

SEC Proposes Amendment to Auditor Independence Rules

On May 2, the SEC proposed amendments to its auditor independence rules. The SEC's current auditor independence standard is set forth in Rule 2-01 of Regulation S-X, which establishes that the SEC will not recognize an accountant as independent with respect to an audit client if the accountant is not capable of exercising objective and impartial judgments on all issues within the accountant's engagement. Specifically, Rule 2-01(c)(1)(ii)(A) (the "Loan Provision") currently provides that an auditor is not independent when the audit firm, any covered person in the audit firm, or any of the covered person's immediate family members has a loan to or from (i) an audit client, or (ii) an audit client's officers, directors, or (iii) record or beneficial owners of more than 10 percent of the audit client's equity securities.

The proposed amendments are designed to limit the Loan Provision to those relationships that could reasonably be viewed as endangering the auditor's impartiality and objectivity. The proposed amendments would:

- limit the loan prohibitions to beneficial owners and not to record owners;
- replace the existing 10 percent bright-line shareholder ownership test with a "significant influence" test;
- add a reasonable inquiry standard with respect to identifying beneficial owners; and
- amend the definition of "audit client" for a fund under audit to exclude from the provision funds that otherwise would be considered "affiliates of the audit client."

This proposed addition of the significant influence test would require an audit firm and its audit client to assess whether a borrower/lender that is also a beneficial owner of the audit client's equity securities "has the ability to exert significant influence over the audit client's operating and financial policies." The SEC intends the term "significant influence" to refer to the principles in the Financial Accounting Standards Board's ASC Topic 323. In determining significant influence,

- a rebuttable presumption of significant influence would be established where a borrower/lender beneficially owns 20 percent or more of an audit client's voting securities;
- based on the factors set forth in ASC 323, a shareholder that owns 20 percent or more of the audit client's voting securities may be able to rebut the presumption of significant influence; and
- if the beneficial ownership percentage is less than 20 percent, there would be a rebuttable presumption that the borrower/lender does not have significant influence over the audit client.

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Mergers & Acquisitions

The Ninth Circuit Splits with Five Circuits on Liability Standard under Section 14(e) in a Tender Offer

On April 20, the Ninth Circuit in Varjabedian v. Emulex, held that claims under Section 14(e) of the Securities Exchange Act only require proof of negligence, not the heightened standard of scienter. Section 14(e) is the anti-fraud provision applicable to tender offers. Specifically, Section 14(e) states that it shall be unlawful for any person:

- to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or

- to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer…

In deciding the case, the Ninth Circuit determined that the first clause of Section 14(e) is devoid of any suggestion that scienter is required. The case arose in connection with a tender offer where the target corporation issued a statement to its shareholders in its Schedule 14D-9 recommending that they accept the tender offer, based on financial analyses by a financial advisory firm. The financial analysis concluded that the premium offered was within the normal range of similar transactions, but below average. The financial advisory firm ultimately opined that the merger was fair. The target corporation did not summarize this specific analysis in its Schedule 14D-9.

The target corporation's shareholders brought suit against the bidder, the target company and the target's board of directors claiming that the defendants violated Section 14(e) by failing to summarize the premium analysis in the Schedule 14D-9, which would have disclosed that the premium was below average compared to similar mergers.

Although five circuits have ruled that Section 14(e) requires scienter, the Ninth Circuit disagreed. In its analysis, the Ninth Circuit rejected scienter analogies between Section 14(e) and Rule 10b-5, noting that the five other circuits improperly interpreted Supreme Court precedent in relying on the similarities between Rule 10b-5 and Section 14(e) and that 14(e) regulates a broader array of conduct than Rule 10b-5.

Corporate Governance

New DOL Guidance Takes Aim at ESG Engagement by ERISA Fiduciaries

In 2015 and 2016, the US Department of Labor (DOL) issued interpretive bulletins that suggested ERISA fiduciaries could (1) consider environmental, social and corporate governance (ESG) issues in making investment decisions without violating their fiduciary duties if the ESG-related factors had a "direct relationship to the economic value of the plan's investment," and (2) include ESG considerations in their investment policies. Under prior guidance, ESG issues were viewed as "collateral considerations" or to be used as "tie-breakers" when choosing between two equal investment alternatives.

In an April 23, 2018 Field Assistance Bulletin, the DOL cautioned that ERISA fiduciaries should not too readily treat ESG issues as economically relevant in making investment decisions or decide that investments that promote such issues are necessarily prudent choices for investors. Rather, it noted that the economic interests of the plan in providing retirement benefits are paramount to making investment decisions. The Bulletin further warned that ERISA fiduciaries should not routinely incur significant plan expenses to fund shareholder campaigns, call special meetings or sponsor proxy fights on ESG issues.

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The Bulletin may cause ERISA fiduciaries to forgo outreach or engagement on ESG issues or place a heavier burden on non-ERISA fiduciaries, such as managers of mutual funds and government pension funds, to take the lead on ESG issues at public companies.

SEC Enforcement

SEC Enforcement Concerning Cybersecurity Disclosure

On April 24, 2018, the SEC brought its first action against a public company for a cybersecurity disclosure violation. According to the Order, the company in question which is a multi-billion-dollar public company, delayed its disclosure of substantial data breaches into its customer accounts for nearly two years. The SEC noted that the company's senior management and legal staff did not properly assess the impact of the breach and whether the breach would render any public filings misleading. The Order noted that the company failed to maintain disclosure controls and procedures designed to ensure that such breaches were properly and timely assessed to determine how and where such breaches should be disclosed in the company's public filings. Relatedly, the SEC noted that senior management and legal staff had failed to share information regarding the breaches to the company's auditors and outside counsel.

Among other disclosure omissions, the SEC found that the company's risk factor disclosures were "materially misleading" because they stated only that the company faced the risk of "potential" future data breaches, despite the company's knowledge of the major historical beaches. In addition, the company failed to address the breach in its MD&A disclosures as a known trend and uncertainty.

The company agreed to settle the SEC's action by consenting to a Cease-and-Desist Order and payment of a $35 million civil penalty. The company neither admitted nor denied the findings in the Order.

SEC Charges over $143 million for FCPA and Accounting Fraud Violations

A leading multinational hi-tech corporation agreed to pay more than $143 million to resolve charges of Foreign Corrupt Practices Act (FCPA) and accounting fraud violations perpetrated by its global avionics business.

The SEC said the subsidiary offered a consulting contract "to a government official at a state-owned airline to induce the official to help" the subsidiary obtain and retain business from the airline. The subsidiary paid the official approximately $875,000 for a position that required little to no work and concealed the payments using an unrelated third-party vendor.

In addition, the corporation fraudulently overstated its pre-tax and net income when its subsidiary backdated an agreement with the airline. As a result, the subsidiary prematurely recognized more than $82 million in revenue.

The SEC also found that the corporation lacked sufficient internal accounting controls and failed to make and keep accurate books and records with respect to its subsidiary's consultants and sales agents. The SEC stated, "issuers must implement effective controls for the selection and engagement of consultants and agents to ensure compliance with anti-bribery statutes," and further cautioned, "it is not enough for a company merely to set up policies and procedures that are not enforced or are easily circumvented by employees."

The subsidiary also entered into a deferred prosecution agreement with the DOJ pursuant to which it will pay a criminal penalty in a related matter of more than $137 million.

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