

SIXTH EDITION

THE PUBLIC COMPANY HANDBOOK

A Corporate **Governance and Disclosure**
Guide for Directors and Executives

Jens M. Fischer
Stewart M. Landefeld
Andrew B. Moore
Jason Day
John R. Thomas
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with additional contributing authors from
Perkins Coie LLP

**ANCHORAGE • AUSTIN • BEIJING • BELLEVUE • BOISE • CHICAGO •
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Sixth Edition
October 2021

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About this Handbook

Perkins Coie is pleased to share with you this Sixth Edition of The Public Company Handbook: A Corporate Governance and Disclosure Guide for Directors and Executives.

We have designed this practical and easy to digest guide for directors and executives of public companies. Directors and officers can face a bewildering task in understanding the myriad SEC, NYSE, Nasdaq and state law issues that apply to their organizations, as well as situations that arise with investors and other stakeholders. The first step in fulfilling the duties of being a director or officer is getting a “lay of the land,” and that is what this slim volume seeks to provide. We’ve written this guide in a “plain English” style to discuss topics such as:

- The best “In the Board Room” corporate governance practices
- NYSE and Nasdaq requirements and guidelines
- Investor and other stakeholder engagements
- Insider reporting obligations and trading restrictions for directors and officers
- Public disclosure obligations, including those under Regulations FD and G
- How to think about Rule 10b5-1 Trading Plans
- How to establish an Annual Meeting/Proxy Calendar

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Dedication

We dedicate this to our families. Susanne Wagner-Fischer, Maximilian and Sebastian Fischer, Margaret Breen, Hackett, James and Owen Landefeld, Cori Gordon Moore, Toby and Margaret Moore, Jessica and Ellery Day, Jennifer, Jack and Ned Thomas, and Jim, Payton and Nick Handy gave us patient support throughout the drafting and editing process.

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PLEASE READ THIS DISCLAIMER: This Handbook is intended to provide an informational overview to nonlawyers and is not intended to provide legal advice as to any particular situation. The laws and regulations applicable to public companies are complex and subject to frequent change. Experienced corporate and securities counsel should be consulted regarding the information covered in this Handbook. The views expressed in this Handbook are those of the authors only and do not necessarily reflect the views of Perkins Coie LLP.

Table of Contents

Chapter 1

You're a Public Company? What Does It Mean?	1
1934 Act Registration	1
Listing on an Exchange	1
Meeting Size Thresholds	2
Concurrent Registration Under the 1933 and 1934 Acts ...	2
1934 Act Periodic Reporting Requirements	3
Additional 1934 Act Regulation	4

Chapter 2

Corporate Governance: Best Practices in the Boardroom ...	7
Director Responsibilities	9
Duty of Care	10
Duty of Loyalty	12
Duty of Candor	14
Judicial Review: Business Judgment Rule	15
Enhanced Scrutiny: The Unocal and Revlon Standards	15
Entire Fairness	17
Board Composition	18
Independence	21
Board Size	21
Board Structure and Director Terms	22
Board Leadership and Structure	24
Overboarding	26
Board Meetings and Process	27
Regular Meetings of Board	29
Special Meetings of Board	31
Board Committees	31
Types of Committees	31
Audit Committee	31
Compensation Committee	38
Nominating & Governance Committee	45
Other Committees	49
Board Compensation	51
Cash Compensation	52
Equity Compensation	52
Liabilities and Indemnification	54
Limiting Director Liability	54
Indemnifying Directors and Officers	55
Indemnification Agreements	56
D&O Insurance	57

Chapter 3	
Investor and Other Stakeholder Engagement	61
Shareholder Engagement in the Ordinary Course	61
Proxy Statements and Sustainability Reports	62
Investor Meetings on ESG Topics	65
Engagement with Other Stakeholders	65
Shareholder Activism	66
Chapter 4	
Nuts & Bolts: The Basics of Public Company Periodic Reporting Obligations	71
CEO and CFO Certifications and Disclosure Practices	72
Certifications by CEO and CFO	72
Disclosure Controls and Procedures	74
Internal Control Assessment	74
Forms 10-K and 10-Q Filing Deadlines	79
Integrated Disclosure Under Regulations S-K and S-X	81
Scaled Disclosure for Smaller Reporting Companies	81
Interactive Data	83
Hyperlinks for Documents Incorporated by Reference and Exhibits	84
Annual Report on Form 10-K	85
Information Included in Form 10-K	85
Signatures and Certifications	87
MD&A	87
Through Your Eyes: The Purpose of MD&A	87
Overall Presentation	88
Focus and Content	88
Substantive Guidance	88
Incorporation by Reference	93
Risk Factors and the Safe Harbor	93
Form 10-K Exhibits	95
Quarterly Reports on Form 10-Q	96
Information Included in Form 10-Q	96
Signatures and Certifications	97
Form 10-Q Exhibits	97
Missed Form 8-K Filings	97
Current Reports on Form 8-K	97
Mandatory Filing	98
Optional Filing	99
Regulation FD Disclosure	99
Form 8-K Exhibits	99
Timing	100

Confidential Information: Redaction and Confidential	
Treatment Requests	105
Personally Sensitive Information	105
Material Contracts and Plans of Acquisition, Reorganiza-	
tion, Liquidation or Succession	105
All Other Information	106
SEC Review of 1934 Act Reports	107
Amending 1934 Act Reports	109
Applying Plain English Rules to 1934 Act Disclosure	109
Drafting in Plain English	110
The EDGAR Filing System	110
Signatures for Electronically Submitted SEC Filings	111
Liabilities Relating to Periodic Reporting	112

Chapter 5

Finding Your Voice: Disclosure Practices for Non-GAAP	
Mandatory Measures and Regulations FD and M-A	115
Mandatory and Voluntary Disclosures	115
“Mind the GAAP” – Presenting Non-GAAP	
Information	117
Public Disclosures	118
SEC-Filed Documents	119
Regulation FD’s Mandate: Share and Share Alike	122
“Curing” Unintentional Disclosures	124
What Is Material? Is It Just “Market Moving”?	125
Website and Social Media Disclosure Can Satisfy Regula-	
tion FD	130
Exemptions from Regulation FD	133
Rating Agencies	134
Liability for Selective Disclosure	134
Corporate Disclosure Policy: Forward-Looking Statements	
and the Safe Harbor	135
Written Forward-Looking Statements	135
Oral Forward-Looking Statements	136
Regulation M-A: Merger and Acquisition Communica-	
tions	137

Chapter 6

Insider Reporting Obligations and Insider Trading	
Restrictions; Rule 10b5-1 Trading Plans	141
Section 16 Reporting Obligations of Directors, Executive	
Officers and 10% Beneficial Shareholders	141
Who Is an Insider?	141

What Is the Scope of Section 16?	142
What Do Section 16(a) Insiders Report?	142
How Does an Insider Report Beneficial Ownership?	144
Consequences of Late Filing: Embarrassment, Publicity and Fines	147
Mandatory Electronic Filing and Website Posting of Beneficial Ownership Reports	148
Section 16(b) – Short-Swing Profit Liability	150
Transactions Exempt from Section 16(b) Liability	152
Calculating Profit Realized in a Short-Swing Transaction	152
Schedules 13D and 13G Reporting Requirements for 5% Shareholders	154
Initial Schedule 13G Report	154
Schedule 13D or 13G Filings Once the Company Is Pub- lic	155
Rule 144 Restrictions on Trading Restricted Stock and Stock Held by Directors, Executive Officers and Other Affiliates	157
Securities Subject to Rule 144	157
Who Are Affiliates?	158
Rule 144 Requirements	159
Rule 144 and Shell Companies	161
Rule 144 Compliance Chart for Reporting Companies ..	162
Insider Trading and Rule 10b-5	163
Penalties	163
Company Insider Trading Policy	164
Rule 10b5-1 Trading Plans	165
Insider Trading During Pension Plan Blackout Periods Prohibited	165
Get with the Program: Rule 10b5-1 Trading Plans	169
Benefits to the Company and Its Insiders on Adopting Rule 10b5-1 Trading Plans	170
The Three “Legs” of a Rule 10b5-1 Trading Plan	171
Drafting a Rule 10b5-1 Trading Plan	172
Review by the Company	173
Public Disclosure; Filing the Right Forms	174
Chapter 7	
Proxy Statements and Proxy Solicitation	177
The Proxy Statement	177
The Annual Meeting of Shareholders	177

Special Shareholders' Meetings	178
Regulations Governing the Proxy Statement	178
The Proxy Statement as a Solicitation Tool	178
Information Included in the Proxy Statement	179
Dodd-Frank Act's Impact on Proxy Voting and Proxy Statement Disclosures	180
Executive Compensation	181
Analysis of Risk Related to Compensation for All Employees	183
Say-on-Pay and Say-on-Frequency	184
Pay Ratio Disclosure	186
Hedging Policy Disclosure	187
Board and Corporate Governance	190
Audit Committee Report & Auditor Fees	194
Filing and Distributing Proxy Materials	195
E-Proxy Rules: No Cookies!	195
Filing the Notice of Internet Availability	195
Filing Preliminary Proxy Statements	196
Distributing the Proxy Statement to Shareholders	196
The Proxy Card	197
Shareholder Proposals Submitted for Inclusion in Proxy Materials	198
Procedural Requirements	200
Substantive Requirements	202
No-Action Letter Requests	203
Statement in Opposition to Qualifying Proposal	204
Identification of Proponent	204
Shareholder Proposals Not Submitted for Inclusion in Proxy Materials	205
The Proxy Contest: Election Contests and Takeover Trans- actions; Proxy Access	205
Directors' and Officers' (D&O) Questionnaire	206
Annual Report to Shareholders	206
Content Requirements of the Annual Report to Share- holders	207
Format Requirements of the Annual Report to Share- holders	208
Timing of the Annual Report to Shareholders	209
Chapter 8	
Annual Meeting of Shareholders	211
Pre-Meeting Planning	212

Setting the Annual Meeting Date	212
Determining the Annual Meeting Location	213
Setting the Record Date	216
Notifying Shareholders and Exchanges	217
Reaching Past “Street Name” to Contact Beneficial Owners	217
Who Attends the Annual Meeting?	218
Board Meeting or Board Consent to Address Matters Pertaining to the Annual Meeting	221
Script, Agenda and Rules of Conduct	222
Materials to Bring to the Annual Meeting	224
Voting and Quorum Requirements	225
Voting in Person or by Proxy	225
Quorum	225
Broker Non-Votes	225
Abstentions	226
The Effect of Abstentions and Broker Non-Votes	226
Shareholder Actions by Written Consent in Lieu of an Annual Meeting	229

Chapter 9

NYSE Listing Standards: Governance on the “Big Board”	231
NYSE Continued Listing Standards	232
NYSE Corporate Governance Standards	232
A Majority of Directors Must Be Independent	232
What Is Independence? The NYSE Describes What It Is Not	234
Executive Sessions	236
Audit Committee	237
Compensation Committee	240
Nominating & Governance Committee	242
Corporate Governance Guidelines	242
Code of Business Conduct and Ethics	243
CEO’s Certification of Compliance with Corporate Gov- ernance Standards and Company’s Annual Written Affirmation Regarding Ongoing NYSE Obligations ..	244
NYSE May Issue Public Reprimand Letters	244
Website Requirements	244
Shareholder Approval	245
Equity Compensation Plans	245

20% Stock Issuance	247
Issuances with Related Parties	247
Issuances in Change-of-Control Transactions	248
Prior Approval of Related Party Transactions	248
Additional NYSE Standards	249
Communicate! NYSE Notices and Forms	250
Disclosure of Material News	251
Exceptions to Required Public Disclosure	252
Procedures for Public Disclosure of Material News	253
Trading Halts or Delays	254
Consequences of Noncompliance	255
Chapter 10	
Nasdaq Listing Standards: To Market, to Market	257
Continued Nasdaq Listing Standards	257
Nasdaq Corporate Governance Standards	259
A Majority of Independent Directors	259
Mandatory Executive Sessions of Independent Directors	262
Audit Committee	265
Audit Committee Review and Oversight of Related Party Transactions	269
Compensation Committee	269
Exceptional and Limited Circumstances Exception to Compensation Committee	271
Nominating & Governance Committee (or Nominations by Independent Directors)	273
Code of Conduct	274
Notification of Noncompliance with Nasdaq Corporate Governance Standards	274
Shareholder Approval	274
Equity Compensation Plans	274
20% Stock Issuance (5% to Affiliates in an Acquisition)	275
Change-of-Control Transactions	276
Additional Corporate Governance Standards	277
Keep Nasdaq Informed! Notices and Forms	278
Disclosure of Material News	280
Exceptions to Nasdaq's Disclosure Requirements	281
Procedures for Public Disclosure	283
Trading Halts	283
Consequences of Noncompliance	284

Chapter 11

Corporate Structural Defenses to Takeovers	289
Why Adopt Corporate Structural Defenses?	290
Why Not Adopt Corporate Structural Defenses?	291
Dual-Class Common Stock Structure with Super-Voting Shares	292
Staggered Boards	293
Supermajority Removal Provisions	293
Shareholder Rights (Poison Pill) Plans	295
Developments in Shareholder Rights Plan	
Implementation	296
Net Operating Loss Poison Pills	296
Two-Tiered Poison Pill to Address Creeping or Nega- tive Control by Activists	297
State Antitakeover Statutes	298
Delaware Section 203: A Business Combination Statute	299
Authorized Common and Blank Check Preferred Stock ...	301
Common Stock	301
Blank Check Preferred Stock	301
Limitations on Shareholders' Meetings and Voting	
Requirements	302
Limitations on the Right to Call Special Shareholders' Meetings	302
Advance Notice Bylaw Provisions	303
Elimination of Shareholder Action by Written Consent	305
Supermajority Vote on Merger or Sale of Assets	305
Supermajority Vote on Amendments to Certificate of Incorporation and Bylaws	306
Other Actions: Change-of-Control or Golden Parachute	
Agreements	307
Best Protections	308

Chapter 12

Follow-On Offerings and Shelf Registrations	311
Primary Offerings and Secondary Offerings – What Is the Difference?	312
Shelf Registrations	313
Common Types of Shelf Registrations	313
Registration Statements on Form S-1	319
Registration Statements on Form S-3	319

Eligibility Restrictions on Use of Form S-3	320
Unique Flexibility for WKSIs	322
Use of Form S-3 by Small Public Companies	324
Form S-4: The M&A Registration Statement	325
Acquisition Shelf	327
Registration Statements on Form S-8	329
Registrant Requirements	330
Transaction Requirements	330
Definition of Employee	331
Transferable Options	331
Filings Relating to Employee Benefit Plan Amendments	332

Chapter 13

Securities and Corporate Governance Litigation	333
Liability Under the 1934 Act - Section 10(b) and Rule 10b-5	333
Liability Under the 1933 Act - Sections 11 and 12(a)(2)	335
Section 11 - Liability for Misrepresentations in a Regis- tration Statement	336
Section 12(a)(2) - Seller's Liability	337
Special Situations Under the 1933 and 1934 Acts	338
Forward-Looking Statements	338
Liability for Endorsing Third-Party Statements	338
Duty to Correct and Duty to Update	339
Shareholder Class Actions	340
CEO/CFO Certifications	342
Retention and Destruction of Documents	342
Whistleblower Incentives and Protection	344
ERISA Claims	344
Corporate Governance Litigation	346
Change-of-Control Transactions	346
Shareholder Derivative Lawsuits	348
Shareholder Access to Corporate Books and Records	350
Foreign Corrupt Practices Act	351
Regulatory Investigations and Enforcement	352
SEC	352
Market Regulations	353
Department of Justice and State Securities Regulators	354
The Important Role of D&O Insurance	355

Chapter 14

Tiring of the Public Eye? Delisting, Deregistration and Going Private	359
Delisting and Deregistration	359

Exchange Delisting (Section 12(b))	359
Size Criteria Delisting (Section 12(g))	359
Suspension After Filing 1933 Act Registration (Section 15(d))	360
Going Private Transactions: Flying Below the Radar	361
Process of Going Private	363
Rule 13e-3	364
Chapter 15	
Foreign Private Issuers	367
What Is a Foreign Private Issuer?	368
Benefits of Being a Foreign Private Issuer: The Notable Nine	368
Rule 12g3-2(b) Exemption	370
SEC 1934 Act Reporting and Disclosure Requirements	371
Annual Report: Form 40-F (for Canadians) or 20-F (for All Others)	371
Reports on Form 6-K	371
Other Ongoing SEC Filing and Disclosure Requirements	372
The NYSE and Nasdaq Exchange Requirements	372
Corporate Governance Standards	372
Appendix 1	
Annual 1934 Act Reporting Calendar (SEC Reporting and Annual Shareholders' Meeting)	375
Appendix 2	
Form 8-K Reportable Events and Filing Deadlines	401
Appendix 3	
Directors' and Officers' Liability Insurance: A Visual Guide	413
Appendix 4	
NYSE Listing Standards	415
Appendix 5	
The Nasdaq Global Select Market and The Nasdaq Global Market	417
The Nasdaq Capital Market	418

Chapter 1

You're a Public Company? What Does It Mean?

The Public Company Handbook is a practical guide for directors and executives of public companies.

A *public company* is a corporation, limited liability company or partnership subject to the regulations and disclosure requirements of the Securities Exchange Act of 1934 (1934 Act). Usually, this applies to entities that have completed an initial public offering (IPO) registered with the Securities and Exchange Commission (SEC) under the Securities Act of 1933 (1933 Act).

1934 Act Registration

The 1934 Act requires companies with a widely traded class of equity securities to register those securities with the SEC. Registration under the 1934 Act is a one-time registration of an entire class of securities. By contrast, registration under the 1933 Act, such as an IPO, registers a certain number of securities for a particular public distribution. Two events trigger 1934 Act registration: listing on a national securities exchange or meeting certain size thresholds.

Listing on an Exchange

To list any securities for trading on a national securities exchange, a company must register the class of securities with the

SEC under Section 12(b) of the 1934 Act. The company will also have to file a listing application and other materials with the exchange.

Meeting Size Thresholds

Alternatively, a company may trigger 1934 Act registration requirements simply by reaching a certain size. A company with total assets in excess of \$10 million and a class of equity securities *held of record* by 2,000 or more persons – or 500 or more persons who are not accredited investors – must register the class of securities under Section 12(g) of the 1934 Act. A shareholder qualifies as an accredited investor by meeting criteria specified in rules under the 1933 Act, which generally involve individuals with high levels of income or net worth or entities with significant total assets. Securities issued pursuant to employee compensation plans are excluded from the definition of securities *held of record* for purposes of calculating the Section 12(g) threshold. This exemption generally covers stock options and other equity awards, as well as shares issued under these awards, held by employees and former employees of the company. A company must register within 120 days after the last day of the fiscal year in which it meets both the shareholder and total asset size thresholds.

Concurrent Registration Under the 1933 and 1934 Acts

Typically, a company will register its securities under the 1934 Act simultaneously with its IPO. This allows the company to list the securities offered in the IPO on a national securities exchange. Form 8-A makes 1934 Act registration relatively simple for a company concurrently registering an IPO. Form 8-A is a shortened registration statement that requires disclosure of general characteristics of the company's securities, including dividend rights, voting rights and any antitakeover provisions in the company's certificate or articles of incorporation and bylaws. This information is typically incorporated by reference from the company's IPO registration statement.

**Breaking News:
The Rise of SPACs:
An Alternative Path to Becoming a Public Company**



Among other things, 2020 will be remembered as a year that saw a boom in the use of special purpose acquisition companies (SPACs) as a robust alternative to a traditional IPO. A SPAC is a company formed to raise capital in an IPO, with the offering proceeds serving as a blind pool of funds held in trust to finance the acquisition of one or several unidentified targets. As SPAC IPOs surged in 2020 and 2021, many companies and investors evaluated and undertook transactions with SPACs – referred to as “de-SPAC” transactions – as an alternative to traditional IPOs or merger and acquisition liquidity events. A de-SPAC transaction consists of a merger between a private operating company and a publicly traded SPAC, with the shareholders of the private company receiving shares of the SPAC and/or cash as consideration. The SPAC is already a public company, having completed an IPO and a simultaneous 1934 Act registration to list its shares on a national securities exchange. As a result of the de-SPAC transaction, the private company becomes a public company, with a shareholder base comprising the rollover private company shareholders, the SPAC sponsor, the SPAC’s public investors, and any private investors that participate in the deal through private investment in public equity.

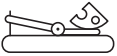
1934 Act Periodic Reporting Requirements

A company with securities registered under Section 12(b) (exchange listing) or 12(g) (companies of a certain size) of the 1934 Act must file periodic reports with the SEC. As we describe in this Handbook, a public company files annual, quarterly and current reports with the SEC.

Additional 1934 Act Regulation

In addition to periodic reporting, 1934 Act registrants and their directors, executive officers and significant shareholders are subject to the following requirements:

- The proxy rules;
- The tender offer rules;
- Section 16 reporting obligations and short-swing profit liability;
- Beneficial ownership reporting on Schedules 13D and 13G; and
- The listing standards of The Nasdaq Stock Market (Nasdaq), the New York Stock Exchange (NYSE) or other exchanges or listing services.



Trap for the Unwary: 1934 Act Registration Alone Triggers 1934 Act Periodic Reporting

A company that has issued equity or debt securities to the public in an offering registered under the 1933 Act must file annual, quarterly and current reports with the SEC under Section 15(d) of the 1934 Act. This reporting requirement applies even though the company does not list the securities on a national securities exchange or market and the company has not crossed the size thresholds triggering 1934 Act registration. Companies subject to periodic reporting only by reason of Section 15(d) are free from a host of other 1934 Act requirements, including regulation of proxy solicitations and third-party tender offers, beneficial ownership reporting and short-swing profit liability.

**Practical Tip:
Consider the Evolving View of Corporate Purpose
and Responsibility as You Navigate Public Company Life**



In recent years, an array of public company stakeholders have pushed corporations to reevaluate their traditional focus on maximizing monetary returns for shareholders in favor of a more holistic approach that considers the interests of all stakeholders. Rising consumer, employee and government scrutiny and engagement have encouraged companies to change their business practices and policies. Consumers expect ethical and eco-friendly behavior; employees seek equitable pay, good working conditions and a diverse and inclusive workforce; and governments incentivize companies that invest in the communities where they operate.

In addition, a growing number of shareholders consider social and environmental factors in their investment strategies. In fact, U.S. assets held by institutional investors and money managers applying sustainable investing criteria accounted for \$12 trillion in 2018 – about 25% of all professionally managed U.S. assets. Socially conscious investors look to environmental, social and governance (ESG) factors in making investment decisions, with some of the largest institutional investors leading the way. For example, massive worldwide fund manager BlackRock has developed a focus on sustainable investment offerings and plans to exit investments with high environmental risks. Investor attitudes toward ESG issues are also reflected by trends in shareholder activism. A large number of public company shareholder resolutions – a tool used by shareholders to drive change – concern political spending, climate change, pay equity, diversity, human rights and other ESG matters.



Practical Tip:
**Consider the Evolving View of Corporate Purpose
and Responsibility as You Navigate Public Company Life
(Cont'd)**

This evolving and more expansive view of the role and responsibility of corporations in society is an important backdrop against which your company will engage in public company life, crafting required and mandatory SEC disclosure and reporting obligations, guiding directors and senior management through the proxy statement and annual meeting processes, and striving to comply with the myriad corporate governance and fiduciary requirements of securities exchanges and state corporate laws. Through all this, your company will need to understand and address ESG and other matters at the forefront in the minds of stakeholders to ensure continued support, investment and opportunities for growth in the future.

Chapter 2

Corporate Governance: Best Practices in the Boardroom

The Board of Directors bears ultimate responsibility for the oversight of a company's business and affairs. The Board establishes significant policies; makes fundamental decisions about strategic focus and direction of the company, including evaluation of key opportunities and risks; and approves the hiring, firing, succession planning and compensation of the executive officers who manage the company's day-to-day business operations. Directors oversee risk management, including internal controls and compliance with laws, and monitor financial reporting and public disclosure. The Board also manages shareholder relations and engagement and sets the tone for ethical business conduct. This chapter describes how members of a Board, and its Audit, Compensation and Nominating & Governance Committees, can best fulfill these duties.

Although our discussion uses concepts from Delaware law, similar principles apply in other states.



Practical Tip:
**Best Practices and Better Still: The Evolving
Standards of Corporate Governance**

Directors face a sometimes bewildering array of corporate governance requirements. Where do they come from?

- *State Law.* The corporate statutes and court decisions of a company's state of incorporation provide the basic "rule book" for a Board. State corporate law controls all aspects of corporate life, from the very simple (such as shareholder notice and voting requirements) to the complex (such as fiduciary duties and liability).
- *Federal Law.* Federal law, primarily created by Congress and the SEC, regulates the governance of public companies, mandating, for example, entirely independent Audit and Compensation Committees and codes of ethics for CEOs and senior financial officers.
- *NYSE and Nasdaq.* The NYSE, Nasdaq and other exchanges impose governance standards on their listed companies. Subject to limited exceptions we discuss in Chapters 9 and 10, requirements include independent Audit, Compensation and Nominating & Governance Committees, a majority of independent directors and executive sessions of non-management directors. All public companies will have an Audit Committee and all listed companies will have a Compensation Committee, both made up of independent directors. The NYSE requires, and Nasdaq suggests, an independent director Compensation Committee. The NYSE requires a Nominating & Governance Committee, while Nasdaq requires either a Nominating & Governance Committee or that independent directors meet in executive session to deal with director nominations. (Chapters 9 and 10 discuss committee requirements of the NYSE and Nasdaq in detail.)

Practical Tip:
**Best Practices and Better Still: The Evolving
Standards of Corporate Governance (Cont'd)**



- *Institutional Investors.* Institutional investors, as well as shareholder activists and proxy advisory firms, have applied increasing pressure on public companies to adopt corporate governance practices, many of which are now commonplace, that the investors believe are in the best interests of shareholders. Those practices include eliminating staggered Boards, giving shareholders the right to call special meetings, having shareholders approve shareholder rights plans (a takeover defense commonly referred to as a “poison pill,” which we discuss further in Chapter 11), requiring independent chairs and adopting “majority vote” procedures for annual shareholders’ meetings.

In short, many of yesterday’s “best practices” have become today’s baseline requirements. New best practices continue to evolve as companies, regulators, institutional investors and corporate governance commentators debate the many new governance rules and standards that apply to public companies.

This chapter reviews best practices of corporate governance at the time this Handbook went to press in 2021. In Chapters 9 and 10, we describe in detail the governance standards of the NYSE and Nasdaq. We also make suggestions that may help your Board stay abreast of best practices of corporate governance that are sure to evolve in the years to come.

Director Responsibilities

State statutes, court decisions and, increasingly, federal laws and regulations define the duties of directors. Yet even after the implementation of many new regulations, the basic duties of directors remain unchanged. Although there are nuances in the

duties imposed by various states, most hold directors to general fiduciary duties of care and loyalty. Some courts have imposed the additional duty of candor.

Duty of Care

Directors owe the company and its shareholders a duty to exercise the care that an ordinarily prudent person in a comparable position would exercise under similar circumstances. A director is not presumed to have special management skills, but is expected to exercise common sense and apply the skills he or she possesses. The time needed to fulfill the duty of care will increase with the importance and complexity of the proposed corporate action. The following decisions, for example, require substantial investigation and consideration:

- Merging or selling the company;
- Establishing or waiving antitakeover defenses;
- Hiring, terminating or setting compensation for management;
- Approving debt or equity offerings, or other material financings;
- Entering into new lines of business; and
- Approving an annual budget or strategic business plan.

Due care requires directors to apprise themselves of all reasonably available material information prior to making a business decision. Directors can best assess each proposal's strengths and weaknesses by taking these steps:

- Ask for sufficient notice of each Board meeting to allow for adequate preparation;
- Require – and review – written background documentation describing the rationale and key terms of any proposed transaction prior to the meeting;
- Discuss the proposed issue with the company's management and legal and financial advisors;

- Attend meetings in person or by telephone in a way that allows each director to participate and to learn all the information available to the Board; and
- Make sufficient inquiry – ask questions prior to and at the Board and committee meetings – in order to discuss and understand as fully as possible all the relevant issues, including the risks of executing the business decision.

**Practical Tip:
No Speeding!**



You may want to use this image to illustrate the duty of care for your Board:

“Directors get in trouble for speeding, not for running the car off the road!”

In other words, the Board should act in good faith to make its best thoughtful, considered and informed decisions. If no conflicts of interest exist and the Board follows an appropriate process, courts usually will not second-guess the directors even when, in *hindsight*, the Board makes a wrong choice, takes a wrong turn or causes the company to suffer a loss.

In making decisions, a director may generally rely on information and reports from the company’s officers and employees; legal, financial and other advisors; and Board committees. Reliance, however, must be “eyes open” and prudent. Each director should assess the qualifications of the parties providing information and advice, and then examine the work product. A director may not rely on information or advice if the director has knowledge that would make reliance unreasonable. In reviewing material, the three best rules of thumb are simply:

- Ask;
- Ask; and
- Ask.

Duty of Loyalty

A director owes the company and its shareholders a duty of loyalty to give higher priority to corporate interests than to his or her personal interests in making business decisions. If a director has a personal interest in a matter, he or she must fully disclose the interest to the Board and will often abstain from voting on or participating in discussion of the matter. Similarly, directors should not pursue, other than through the company, business opportunities that relate to the company's existing or contemplated business unless disinterested members of the Board, after full disclosure, have decided that the company will pass on the opportunity.

Conflicts of Interest. Conflicts of interest and corporate opportunities arise regularly in the day-to-day conduct of a Board's business.

A director may, for example, have a corporate opportunity or conflict of interest as a result of:

- An inside director's employment or severance arrangement;
- An issue that is material to the director's employer; or
- An interest in the potential purchaser in a change-of-control transaction.

The frequency of conflicts of interest has given rise to a host of mechanisms for conflict management. Using them should permit a Board to act responsibly. Ways to manage conflicts of interest include:

- *A Majority of Disinterested Directors Approve, and Interested Directors Abstain.* If only one director, or a small number of directors on a larger Board, has a conflict of interest, a majority of the disinterested directors may approve the transaction. In this situation, a director with a conflict should fully disclose it, including all facts that would be relevant to the Board's decision, remove himself or herself from discussion at appropriate times, and abstain from voting.

- *A Wholly Independent Committee Approves.* The Board may establish an independent committee of disinterested, independent directors to approve a particular transaction. Either the Board chair or disinterested directors will take the lead in establishing the committee. The Board may either delegate the final decision to the committee or ask the committee to make a formal recommendation to the Board for approval. The committee should act independently, with an adequate budget to seek assistance from independent legal counsel and other advisors, as the committee deems appropriate.
- *Shareholders Approve.* If all or nearly all directors have a conflict of interest, the Board may ask for shareholder approval of a particular transaction. The proxy statement disclosure to shareholders should describe the transaction and fully disclose all conflicts of interest and other relevant information. The Board may either recommend the transaction to the shareholders or call for a shareholder vote without a Board recommendation.

In unusual situations, such as where all or virtually all directors have a conflict, and where shareholder approval is impractical or the shareholders themselves have conflicts of interest, the Board may take an action that it believes to be “entirely fair” to the company. Public companies rarely act on this basis. Shareholders have the right to challenge a transaction in which the directors have a conflict and the transaction is nonetheless approved by the Board. A court will uphold the action if it establishes that the action was fair to the company at the time the Board approved it.

Duties to Other Stakeholders. The interests of the company and its shareholders, while primary, are not the sole consideration of the Board. Some states have adopted constituency statutes that permit directors to consider the interests of other constituents, including employees, customers, suppliers and communities, when making business decisions. Even in a state without a permissive constituency statute, such as Delaware, directors may take into account – in the absence of a sale of control transaction –

various stakeholder interests in a manner consistent with their fiduciary duties as they consider long-term value creation for the company and its shareholders. The Business Roundtable's 2019 Statement on the Purpose of a Corporation, highlighting the corporate signatories' commitment to all their stakeholders, garnered significant attention. The Statement has led to conversations among governance professionals and in the boardroom about balancing the interests of various constituents while fulfilling the Board's duties in a manner consistent with application of the business judgment rule. Chapter 3 discusses company engagement with shareholders and other stakeholders.

In addition, other statutory provisions may mandate the consideration of stakeholders other than a company's shareholders. When a company becomes or is likely to become insolvent, for example, a director's duty of loyalty may shift to include the company's creditors.

Delaware and several other states have adopted laws permitting the creation of public benefit corporations. These hybrid corporations balance shareholders' financial interest with the best interests of other stakeholders materially affected by the company's business activities, while creating an overall public benefit. Few companies have adopted the public benefit corporation model, and we would not expect many public companies to utilize this hybrid approach.

Duty of Candor

Delaware judicial decisions have articulated a duty of candor or disclosure. This additional responsibility derives from both the duty of care and the duty of loyalty. The duty of candor calls on directors to disclose to their fellow directors and the company's shareholders all material information known to them that is relevant to the decision under consideration. In judging whether a director has satisfied his or her duty of candor, courts will examine the materiality of all undisclosed or underdisclosed information.

Judicial Review: Business Judgment Rule

Courts apply the business judgment rule in reviewing most decisions made by directors. Under the business judgment rule, courts defer to the decisions of disinterested directors absent evidence that the directors did not act in good faith or were not reasonably informed about the decision or that there is no rational business purpose for the decision that promotes the interests of the company or its shareholders.

Enhanced Scrutiny: The Unocal and Revlon Standards

Courts in Delaware and other states apply a more stringent *enhanced scrutiny* standard when examining transactions involving the adoption of antitakeover measures, implementation of deal-protection mechanisms such as lock-up options, a change of control or a breakup of the company.

When applied in assessing the appropriateness of antitakeover or deal-protection measures, this standard is known as the *Unocal* standard. In defending its adoption of company deal-protection measures, a Board must show that:

- The Board had reasonable grounds for believing that a threat to company policy and effectiveness existed; and
- The measures adopted were proportional in relation to the threat posed.

If a Board can establish both elements, the action should receive the protection of the business judgment rule.

When a Board elects to pursue a change of control or breakup of the company, the Board has a separate enhanced responsibility: to obtain the highest value reasonably available for shareholders. This standard is commonly referred to as the *Revlon* standard. A “change of control” in the *Revlon* context involves a cash merger, a merger in which more than 50% of the consideration is cash or a merger in which a controlling shareholder will result. If, however, a proposed merger will not result

in a sale of control, such as in a stock-for-stock merger between two noncontrolled companies, the ordinary business judgment rule applies to the Board's decision to enter into a merger agreement, as held by the Delaware Supreme Court in *Paramount Communications, Inc. v. Time Inc.* (commonly known as the *Time-Warner* case).



**Practical Tip:
Obtain a Fairness Opinion**

Courts give special deference to Boards that seek truly independent third-party advice, such as that of an investment bank, valuation consultant or law firm, to assist disinterested directors in assessing a transaction. An opinion from a reputable third-party financial advisor that a transaction is fair to the company and its shareholders from a financial point of view may substantially reduce the risk of a successful challenge to the Board's decision under any standard of review. A fairness opinion can also help independent directors make an informed decision.

Without a fairness opinion, you may find yourself in the same unfortunate position as the directors of Trans Union Corporation. In the 1980s, Trans Union's Board approved a sale of the company. In the case *Smith v. Van Gorkom*, a Delaware court held that the Board breached its fiduciary duties by acting without adequate information or independent third-party advice. The court concluded that the Board's decision to accept a market premium without first determining the intrinsic value of Trans Union's shares left the directors vulnerable to personal liability to the company's shareholders to the extent a fair price exceeded the sale price.

By contrast, in the 2005 *Disney* case, a Delaware court placed weight on the Disney Compensation Committee's reliance on an independent compensation expert.



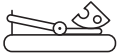
**Practical Tip:
Obtain a Fairness Opinion (Cont'd)**

The Committee was entitled to rely on the expert even though his analysis may have been incomplete or flawed. The Committee had selected the expert with reasonable care, the analysis was within his professional competence, and the directors had no reason to question his conclusions. (See “Trap for the Unwary: The Compensation Committee After *Disney*” later in this chapter.)

Directors should remember, however, that a fairness opinion is only one item in a Board’s toolbox for satisfying directors’ fiduciary duties in a sale-of-the-company transaction, and is not an automatic defense to a fiduciary duty claim. Directors should closely review the supporting analyses for the fairness opinion and make sure they understand the various inputs. In any case, the Board’s reliance upon a fairness opinion must be reasonable.

Entire Fairness

Entire fairness, the most demanding judicial standard of review, applies when independent directors have not approved or cannot approve a transaction, and the approving directors have a financial interest in, or other conflict with respect to, a transaction. Transactions are also reviewed for entire fairness when a court finds that a breach of the duty of care occurred or that the Board failed to meet an enhanced scrutiny standard. Under the entire fairness standard, courts conduct a broad substantive inquiry into whether the transaction is fair to the company and its shareholders in light of all the relevant facts and circumstances that existed at the time of the transaction.



**Trap for the Unwary:
Reliance on Experts Is NOT a Safe Harbor –
Keep Your Eyes Open!**

As *Smith v. Van Gorkom* and *Disney* show, a director has traditionally been able to demonstrate good faith and due care by relying on reports prepared by expert advisors to the company, such as bankers and accountants, regardless of the director's personal qualifications. There are limits, however, to the safe harbor for a director who "should have known better."

In the 2004 *Emerging Communications* case, a Delaware court determined that an outside director who, as an investment banker, possessed special expertise had no right to rely on a fairness opinion of the company's independent investment banker. The court found that the director violated his duties of loyalty and/or good faith in approving a transaction because, given his background, he should have known that the transaction was unfair to minority shareholders.

The key takeaway: Although as a director you may generally rely on a report prepared by a third-party advisor, if you possess special knowledge or skill, you may not "leave it at the door" of the Boardroom! In your area of expertise, you may be held to a higher standard than your peers.

Board Composition

The composition, size and structure of a public company Board varies considerably with each company's circumstances. The Board of an established Fortune 500 company differs from that of a younger, founder-led technology company. And both of these Boards differ from that of a family-dominated company. Board composition is a strategic asset and should be reviewed in light of a company's strategic direction.

A well-assembled Board is diverse. It includes individuals who bring complementary skills relevant to the company's business and objectives. In selecting director nominees, the Nominating & Governance Committee (or the independent directors responsible for nominations) should consider the candidates' financial and business understanding, their industry backgrounds, public company experience, leadership skills and reputation. The Committee should also monitor and consider diversity in geography, race, gender, age and skills.

Recently, some states and other regulatory bodies have sought to address diversity on public company Boards. Legislative efforts in the last several years have ranged from aspirational, to specified minimums (requiring either compliance or explanation), to mandatory minimums (establishing penalties for noncompliance). California, for example, passed a law in 2018 requiring public companies with securities listed on a major U.S. stock exchange and headquartered in California to have women on their Boards, and a subsequent law enacted in 2020 requires the same companies to have at least one director from an underrepresented community on the Board, in each case with specific targets based on Board size and passage of time. A 2020 Washington corporate law requires gender diversity on the Boards of public companies incorporated in Washington, while a 2019 Illinois law requires public companies headquartered in Illinois to disclose certain information about racial, ethnic and gender diversity of their Boards in state filings. Numerous other states have passed similar legislation and we anticipate additional states will consider such legislation in the coming years. Even The Nasdaq Stock Market received SEC approval of a listing rule effective 2022 that generally requires Nasdaq-listed companies to provide statistical information relating to directors' self-identified gender, race and LGBTQ+ status and satisfy an objective to include diverse directors on the Board, or explain why they have not. The new Nasdaq listing rule is discussed in greater detail in Chapter 10.

Every year, a Nominating & Governance Committee (or other independent body) assesses the existing Board's effectiveness in light of evolving company needs and recommends appropriate nominees to address new circumstances. "Board refreshment" has increasingly been in the spotlight as institutional investors and other

constituents put pressure on Boards to critically assess director independence, including a focus on director tenure, and to satisfy gender and other diversity goals or legal requirements.

Each annual proxy statement describes which experience, qualifications, attributes or skills of each director led the Board to nominate that person as a director for the company. The proxy statement also describes how the Board or the Nominating & Governance Committee considered diversity. If the Board has a diversity policy, the proxy statement describes how the Board implements the policy and includes an assessment of the policy's effectiveness.



Practical Tip:
What Makes a Good Director?
“Noses in, Fingers Out”

Set expectations for your Board members from the outset. Candidates should be ready to devote ample time to learn and give guidance to company officers, while knowing when to stop short of usurping management. An effective director will:

- Learn about the company. Stay informed by visiting physical locations. Ask questions of management. Learn from informal communication with others.
- Review (or, as chair or lead director, develop) agendas and related materials in preparation for Board and committee meetings.
- Attend and actively participate in Board and committee meetings.
- Respond promptly in crisis situations.
- Ask tough, probing questions. Come to each meeting armed with a short list of questions and expect answers.
- Insist on clear and responsive answers.

In short, “noses in, fingers out.”

Independence

Most public company Boards include both inside and outside (or independent) directors. An *independent director* is an individual who can exercise judgment as a director independent of the influence of company management. An independent director will be free from business, family or personal relationships that might interfere with the director's independence. The NYSE and Nasdaq each require that a majority of directors be independent. Each exchange has its own definition of an independent director, and we discuss these definitions in Chapters 9 and 10. Many institutional investors expect that a "substantial" majority of a company's directors will be independent.

The three core committees – Audit, Compensation and Nominating & Governance – generally consist exclusively of independent directors. Independence standards for Audit and Compensation Committee members are more stringent than those for membership on a Board or other Board committees. The Dodd-Frank Act and the Sarbanes-Oxley Act generally delegate to the NYSE and Nasdaq the rules defining *independence*. (We provide more information about the Dodd-Frank Act and the Sarbanes-Oxley Act in Chapter 4.) And the NYSE and Nasdaq largely leave to Boards the responsibility to determine whether a director is independent under NYSE and Nasdaq standards.

Board Size

The size of a public company's Board averages 11 directors but may range from as few as 5 directors to as many as 15 or more, depending on the size and complexity of the company. A company's charter documents may set the size of the Board or allow the Board to set the size, usually within a permitted range.

Larger Boards can provide increased diversity, better continuity and greater flexibility in staffing Board committees with independent directors. But larger Boards have a cost. A group larger than 10 or 12 can prove administratively unwieldy and may reduce each director's opportunity for active and meaning-

ful involvement. Board committees can bridge this gap and increase the effectiveness of a larger Board.

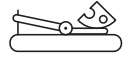
Board Structure and Director Terms

The corporate laws of most states permit Boards to be divided into two or more classes of directors. Directors serving on an unclassified Board serve for one-year terms and stand for election at each annual shareholders' meeting. Directors serving on a classified or staggered Board – one with multiple classes of directors – serve term lengths equal in years to the number of classes of directors.

A company with a staggered Board will divide the number of directors assigned to each class as equally as possible. Staggered Boards typically are composed of three classes (the maximum permitted by the NYSE rules and most state corporate statutes), with shareholders annually electing directors of one of the classes to serve three-year terms. This results in staggered termination dates for the director classes, enhancing Board continuity.

Institutional investors generally dislike staggered Boards. Classes reduce flexibility in changing Board membership annually because directors on a staggered Board typically may be removed only for cause and stand for election only every two or three years. Yet reviewing each class of directors with care every two or three years is a reasonable approach and, as we discuss in Chapter 11, staggered Boards may provide some protection against a hostile proxy contest. More than 90% of the S&P 500 companies now have unclassified Boards.

**Trap for the Unwary:
Shareholder Groups Campaign to Abolish Staggered
Boards, Adopt “Majority Voting” and Eliminate
Discretionary Broker Voting in Director Election**



Institutional investors and their advisors, like the proxy advisory firm Institutional Shareholder Services, have encouraged companies to vote to elect all directors annually, and to require *majority* rather than *plurality* voting for directors. Critics contend that annual elections for all directors, together with majority voting, hold directors more accountable every year. In addition, some investors and shareholder activists argue that staggered Boards can limit a target company’s stock value in the takeover bidding process. Largely as a result of this pressure, staggered Boards at large public companies have nearly disappeared, and shareholder activists have expanded their efforts to target staggered Boards at mid- and small-cap companies. In addition, approximately 90% of the S&P 500 companies have either adopted majority voting for director elections or adopted corporate governance guidelines that implement a *plurality plus* policy requiring a nominee to tender his or her resignation if the nominee fails to receive a majority vote. Although Boards do, from time to time, choose not to accept resignations offered by directors who fail to receive a majority vote, this is a controversial decision that a Board should make only after careful thought.

The NYSE has not historically allowed discretionary voting by NYSE member brokers in contested elections of directors. Since 2010, the NYSE has also prohibited discretionary voting by brokers in *uncontested* director elections at shareholders’ meetings. Now, NYSE member brokers may vote only those shares with instructions from the beneficial owner of the shares at any company, *regardless of the exchange* on which the company’s stock is listed. Brokers have typically voted in favor of incumbent directors. The prohibition on discretionary voting in uncontested director elections increases the risk that director nominees at companies that have adopted majority voting and plurality plus policies will not receive the needed votes for election.

Some companies have adopted term limits or age restrictions for their directors. Term or age limits can serve as a simple mechanism to bring greater age diversity to a Board and, at times, to remove a noncontributing director. Age limits, however, can cause a qualified director who is making valuable contributions to “age out” just when he or she has the time to devote to serving on the Board and its core committees. Implementing term or age restrictions as nonbinding guidelines, rather than as charter document provisions, can provide greater flexibility. Despite the recent focus by shareholder activists on director term limits, only 5% of S&P 500 companies have adopted them, although more than 70% of S&P 500 companies have established a mandatory retirement age for directors.

Board Leadership and Structure

Board leadership rests primarily with the chair and a lead independent director. Increasingly, Boards designate an independent director as chair, or ask an independent director to share Board leadership with an internal chair, usually the CEO. This shared role may be titled *lead director* or *presiding director* (presiding over meetings and executive sessions of independent directors). In recent years, both the number of companies separating the roles of CEO and chair and the number of companies appointing independent chairs have increased. In 2019, approximately 75% of S&P 500 companies had a lead or presiding director, and nearly 35% had an independent chair.

Under the SEC’s proxy rules, a company describes its Board leadership structure in its proxy statement and explains why it believes its structure is appropriate given the company’s specific characteristics or circumstances. Issuers must describe whether and why the company combines or separates the Board chair and CEO positions. If the Board chair and CEO positions are combined, then the proxy statement explains whether and, if so, why the company has a lead independent director and the specific role the lead independent director plays in the company’s leadership. The proxy also explains why the company believes its structure is the most appropriate.

Typical duties of a chair include:

- Developing agendas in consultation with management and other directors and presiding over Board meetings;
- Interviewing potential director candidates and coordinating with the Nominating & Governance Committee on director, committee and chair appointments;
- Conducting shareholders' meetings; and
- Subject to any independence limitations, sitting as an ex officio member on Board committees of which the chair is not otherwise a member.

An independent chair's role also includes:

- Chairing regular meetings and executive sessions of independent directors;
- Serving as a liaison between the independent directors and management on sensitive issues, including compensation; and
- Taking the lead in setting short- and long-term goals for management and evaluating progress in meeting expectations.

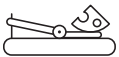
When the CEO or an inside director serves as the Board chair, many companies designate an independent lead (or presiding) director to coordinate the activities of the independent directors and to:

- Work with the chair to develop Board agendas;
- Work closely with the chair and the Nominating & Governance Committee to identify new director candidates;
- Coordinate with the chair regarding information to be provided to the independent directors in performing their duties;
- Chair the regular meetings and executive sessions of independent directors;

- Act as a liaison between the independent directors and the chair; and
- Take the lead in setting short- and long-term goals for the CEO and in evaluating the CEO's performance.

Overboarding

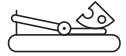
It takes a director many hours to adequately prepare for and attend just one company's Board and committee meetings. Even talented directors can find themselves overboarded if they sit on more Boards than they can properly serve at one time. Nearly a quarter of S&P 500 companies have adopted policies limiting the number of outside Boards on which their CEOs may serve, often setting a limit of one or two public Boards. Even without formal policies, however, an increasing number of S&P 500 CEOs serve on no outside Boards – nearly 60% in 2019, up from 51% 10 years ago. Also, nearly 65% of S&P 500 companies place some restriction on other corporate directorships for their directors, often limiting the number of outside Boards on which their directors may serve to three or four public Boards. Although approximately 10% of directors serve on four or more Boards, the average S&P 500 independent director has two outside corporate Board affiliations, which number has remained relatively constant in recent years.



Trap for the Unwary: Governance Changes Pave the Way for Increased Shareholder Engagement and Activism

In prior years, institutional investors and shareholder activists focused much of their reform efforts on corporate governance matters – staggered Boards, majority voting and poison pills, among others. As the “best practices” of yesterday have become today's standard practices, the corporate governance focus of shareholder activists is shifting to more nuanced debates, such as Board diversity and “refreshment” and the Board's role in overseeing risk management. Given the current governance climate,

**Trap for the Unwary:
Governance Changes Pave the Way for Increased
Shareholder Engagement and Activism (Cont'd)**



shareholder activists are also more likely to engage with management and the Board on matters of economic significance to drive financial gains, such as share buybacks, spin-offs, divestitures and corporate transactions.

In addition, activists' focus has expanded in recent years to matters beyond the traditional governance and economic focus, with growing attention to environmental and social policies. To minimize vulnerability to unwelcome engagement, Boards should remain focused on overseeing the strategic direction of the company and proactively communicating that direction and company initiatives to shareholders. See Chapter 3 for a discussion of how shareholder activism is increasing and evolving, as well as how companies are engaging with investors and other stakeholders.

With these shifts has come an evolution in Board-shareholder engagement. Today, management, Boards, institutional investors and other shareholder activists are engaging in a more regular and direct dialogue than in prior years. Directors are being asked to devote time and attention to engagement with shareholders regarding corporate governance and other matters. Chapter 3 further discusses shareholder activists and how they may seek to engage a company or its Board, including in the company's proxy process.

Board Meetings and Process

Directors may meet in person or, when appropriate, by telephone or videoconference. When no further material discussion is required, a Board may also act by unanimous written consent in lieu of a meeting. A director's failure to attend at least 75% of the Board meetings (and meetings of any committee on which

the director serves) held within a fiscal year will trigger annual proxy statement disclosure – and often, negative votes.

Directors can learn some of their most important information in less formal Board gatherings, such as site visits, retreats with senior management to review company strategy, or other efforts to familiarize themselves with the company, its management and corporate governance practices.

The format and frequency of Board meetings depends on the nature of the company and the powers and duties that the Board delegates to Board committees.



Practical Tip:
Understand “Group” Decision-Making to Improve Board Behavior

By and large, people will make better decisions as part of a group – so convening a group of intelligent individuals to address tough issues should be an asset of corporate Boards. However, the failures in Board decision-making in Enron, WorldCom and other corporate governance scandals appeared to arise, in significant part, through flawed group decision-making.

Boards can help decision-making by understanding that each director will make decisions differently when serving as part of a group than when acting individually. For example, studies show that responsible and capable people take less responsibility in group settings, in effect becoming “bystanders,” than they would individually. Stress from time constraints or the importance of a decision can accentuate human factors that lead to flawed group decision-making. Here are some practical steps Boards can take to avoid the potential pitfalls of group decision-making:

- Keep the Board small or use Board committees and executive sessions to discuss decisions in smaller groups, minimizing “bystanders”;

**Practical Tip:
Understand “Group” Decision-Making to Improve
Board Behavior (Cont’d)**



- Assign a “devil’s advocate” role to a director or group of directors to analyze the downside of critical decisions;
- Create a nonconfrontational way for newer or more junior members of the Board to make suggestions, raise questions and give their opinions – especially in the critical first year;
- Assign each director an area of focus, on committees or on a task force, regarding a subject of specific concern for the company; and
- Identify anomalies or issues as they emerge, before they become crises.

Regular Meetings of Board

Most Boards schedule 4 to 12 regular meetings a year to review and discuss company activities and to consider various proposals made by Board committees and management. At regular meetings, a Board may:

- Review financial and operating results and business developments;
- Approve fundamental company plans, strategies and objectives;
- Review management performance and approve senior officer compensation packages;
- Meet with auditors and review accounting policies and internal controls;
- Review and approve SEC filings; and
- Evaluate the company’s corporate governance practices and the effectiveness of the Board.



**Practical Tip:
Executive Sessions – The Best Things in
(Governance) Life Are Free**

Unlike some more costly aspects of Sarbanes-Oxley (which we discuss in Chapter 4), executive sessions of independent directors, as a group or as a committee, serve a vital governance function at virtually no cost. In light of the NYSE and Nasdaq mandates requiring executive sessions of non-management and independent directors, companies should adopt a practice of routinely holding executive sessions of independent directors at each Board meeting. The NYSE and Nasdaq have few specific requirements as to the timing, format and substance of executive sessions of non-management directors. An ideal format is to schedule an executive session as the final agenda item at each regularly scheduled Board meeting. Some Boards, however, prefer to break out executive sessions as separate meetings entirely.

The lead director and fellow non-management directors set the tone for these meetings. Before each session, the lead director will develop an agenda based on matters up for consideration at the regular Board meeting or current pressing concerns. While directors usually do not have authority to make decisions while in executive session, they can reach a consensus and carry the discussion back into the formal Board meeting. A good chair or lead director will work with both management and fellow directors to use executive sessions to address critical Board issues over the course of the year.

Executive session proceedings can be informal, sometimes without an agenda. Minutes, if taken at all, generally reflect only the attendees and time of the meeting.

Special Meetings of Board

A Board will also call special meetings to act on important matters such as possible mergers, acquisitions or divestitures, joint ventures or securities offerings, or other significant financings.

Board Committees

A strong committee system will allow a Board to function effectively. Sarbanes-Oxley, the NYSE and Nasdaq standards, and SEC rules prescribe the existence, composition and many of the activities of the three core committees.

Types of Committees

The three core committees are Audit, Compensation, and the committee variously known as Nominating, Corporate Governance or Nominating & Governance. All public companies will have an Audit Committee. The NYSE requires, and Nasdaq suggests, an independent director Compensation Committee. The NYSE requires a Nominating & Governance Committee, while Nasdaq requires either a Nominating & Governance Committee or that independent directors meet in executive session to deal with director nominations. (We discuss committee requirements of the NYSE and Nasdaq in detail in Chapters 9 and 10.) Many Boards have more than the three core committees – commonly, an additional committee may be an executive committee, finance committee or risk management committee.

Audit Committee

Purpose and Authority. The Audit Committee fulfills the Board's oversight responsibilities related to the company's internal controls, financial reporting and audit functions. The Committee is directly responsible for the appointment, compensation and oversight of the company's outside auditor and may engage independent counsel and other advisors as it deems necessary.

Duties. An Audit Committee has six areas of responsibility:

- *Assessment of the Independent Auditor.* The Committee selects, determines the compensation for, monitors the performance of and, when necessary, replaces the outside auditor. Responsibilities include reviewing the outside auditor's independence, including objectivity and lack of bias. One critical task for the Committee is to preapprove all audit and any nonaudit services (including tax services) that SEC regulations permit the independent auditor to provide.
- *Review of Financial Statements.* The Committee reviews annual and quarterly financial statements and financial disclosures. The Committee discusses with management and/or the outside auditor:
 - Earnings releases and guidance;
 - The section of the company's periodic reports setting out management's discussion and analysis of the company's financial condition and results of operations (MD&A), including descriptions of critical accounting principles and policies (we discuss MD&A further in Chapter 4);
 - Management judgments and accounting estimates;
 - Alternative treatments under generally accepted accounting principles (GAAP) that the outside auditor has discussed with management;
 - Off-balance sheet structures; and
 - Material communications between the outside auditor and management, including management letters or disagreements between management and the outside auditor.
- *Internal Controls and Disclosure Practices.* The Committee has oversight responsibility for internal controls and financial disclosure practices, including overseeing the company's internal audit function. The Committee reviews reports from management and the outside audi-

tor about the company's internal controls, and meets with the company's internal auditors and its Disclosure Practices Committee to evaluate the effectiveness of the company's internal control over financial reporting and disclosure controls and procedures. The Committee should inquire into and be comfortable with the basis for the certifications of the company's CEO and CFO included in periodic reports filed with the SEC. The Committee may also be responsible for oversight of enterprise-wide compliance with the law.

- *Whistleblower Process.* The Committee is the “buck stops here” reviewer for accounting and audit-related whistleblower complaints. The Committee sets procedures for, and receives, retains and treats:
 - Internal and external complaints about accounting, internal accounting controls or auditing matters; and
 - Confidential submissions by employees of accounting and auditing concerns.
- *Risk Oversight.* Boards differ in how much risk oversight the Audit Committee will assume. NYSE company Audit Committees need to discuss the guidelines or policies that the company uses to govern the process of risk assessment and risk management. But even under the NYSE requirements, an Audit Committee need not oversee all risk. Instead, an NYSE company may have a separate risk oversight committee, or another committee or subcommittee, perform the risk oversight function. In that situation, the Audit Committee performs a general review of the risk oversight processes as well as risk assessment and risk management policies.
- *Compliance with Legal, Ethical and Regulatory Requirements.* In addition to its risk oversight function, the Audit Committee should be actively engaged in setting the proper tone – maintaining a culture of honesty and high ethical standards – and providing strong oversight in the areas of legal and regulatory compliance. As part of this responsibility, the Audit Committee coordinates with the Board's

Nominating & Governance Committee, or a majority of the Board's independent directors, to monitor compliance with the company's code of ethics for the CEO and senior financial officers (a Sarbanes-Oxley and SEC requirement) and the company's code of business conduct and ethics for employees, officers and directors (a mandate of both the NYSE and Nasdaq).

Other responsibilities of the Audit Committee include an annual self-evaluation and preparation of an annual report for the company's proxy statement.

Charter. The Audit Committee defines its duties in a publicly available charter. The Board should approve the charter, and the Committee should annually review and reassess it. The company then files a copy of its Audit Committee charter with its annual proxy statement at least every three years or makes the charter available on its website.

Composition. The NYSE and Nasdaq require that Audit Committees consist of at least three members. With a few exceptions, all members of the Committee must be independent and financially literate. At least one member should qualify as an *Audit Committee financial expert*. (We discuss the Audit Committee financial expert later in this chapter.)

Independence. Audit Committee members must meet two overlapping independence standards, one established by Sarbanes-Oxley, the other by the NYSE or Nasdaq. The overlapping standards have one critical requirement: no Audit Committee member may be a party to any relationship that would interfere with the exercise of his or her independent judgment in carrying out the responsibilities of a director. (We discuss the NYSE and Nasdaq Audit Committee independence requirements in Chapters 9 and 10.)

Sarbanes-Oxley and implementing SEC rules have only two criteria for Audit Committee independence:

- *No Compensation Other Than for Board Service.* Committee members may not accept consulting, advisory or other

compensation from the company or an affiliate of the company, except in the director's role as a member of the Board or a Board committee. This prohibits such indirect payments as payments to spouses or other close family members, or payments to an accounting, consulting, legal, investment banking or financial advisor affiliated with the director.

- *No Affiliate or Affiliated Person.* Committee members may not be affiliates or affiliated persons of the company. An affiliate is any person that directly or indirectly controls, is controlled by, or is under common control with the company. An *affiliated person* is a director, executive officer or principal of an affiliate, or anyone the affiliate places on the Board to serve as the affiliate's alter ego. The SEC provides a safe harbor to allow a person who owns, directly or indirectly, up to 10% of the company's outstanding shares to serve on the Committee. Anything above 10% ownership will be tested on a facts-and-circumstances analysis under which the company must answer affirmatively the critical question: "Is he or she a party to any relationship that would interfere with the exercise of independent judgment in carrying out the responsibilities of a director?"

Financial Literacy. Audit Committee members must be able to read and understand fundamental financial statements, including balance sheets and income and cash flow statements.

Audit Committee Financial Expert. SEC rules implementing Sarbanes-Oxley require that companies disclose in their Form 10-Ks (or in a proxy statement incorporated by reference into Form 10-K) the names of one or more members of the Audit Committee who qualify as Audit Committee financial experts. If the Committee does not have at least one Audit Committee financial expert, the company must explain why in the Form 10-K or the proxy statement incorporated by reference.



**Practical Tip:
Audit Committee Financial Expert Casts a Wide Net**

The SEC has adopted a pragmatic definition of *Audit Committee financial expert*. Investment bankers, venture capital investors, stock analysts and others may qualify, along with finance professionals. An Audit Committee financial expert is a person who has all five of the following attributes:

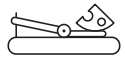
- Understands GAAP and financial statements;
- Has the ability to assess the application of GAAP to accounting for estimates, accruals and reserves;
- Has experience:
 - Preparing, auditing, analyzing or evaluating financial statements with accounting issues comparable in breadth and complexity to those that can reasonably be expected to be raised in the company's financial statements; or
 - Actively supervising someone engaged in those activities;
- Understands internal control over financial reporting; and
- Understands Audit Committee functions.

The Board must determine that an Audit Committee financial expert has developed the five attributes through any combination of:

- Education and experience as a CFO, principal accounting officer, controller, public accountant or auditor performing similar functions;
- Experience actively supervising a person in those positions;
- Experience overseeing or assessing the performance of companies or public accountants regarding the preparation, auditing or evaluation of financial statements; or
- Other relevant experience that the Board determines to be adequate (and which it must publicly disclose).

Limitation on Multiple Audit Committee Service. NYSE rules generally encourage Boards to limit their directors to serving on an aggregate of three public company Audit Committees – that is, the company’s plus two others. If an NYSE company does not limit Audit Committee members to serving on three or fewer Audit Committees, the Board must make an annual determination that the simultaneous service will not impair the director’s ability to serve effectively on the Audit Committee. Although Nasdaq imposes no similar limitation, as a practical matter, a limit of three is an excellent rule of thumb.

**Trap for the Unwary:
NYSE and Nasdaq Financial Expertise Requirements**



Sarbanes-Oxley and SEC rules allow a company, if it chooses, to disclose that its Audit Committee does not have an Audit Committee financial expert. However, NYSE and Nasdaq rules *require* that the Committee have a member with accounting and financial management expertise (NYSE) or employment experience or other comparable experience resulting in financial sophistication (Nasdaq). A director who meets the Audit Committee financial expert requirements under SEC rules is presumed to satisfy the NYSE and Nasdaq requirements.

Meetings. Many Audit Committees will meet eight or more times per year. For example, a Committee may schedule one in-person meeting every quarter to review the company’s proposed earnings release and draft financial statements. The Committee may then follow with a second telephonic meeting in the same quarter to review and comment on the Form 10-Q prior to its filing. Many Committees hold another longer meeting or retreat at least once per year, at a time when there is no pressure to review financial statements, to consider:

- Critical accounting policies and practices;
- Internal financial controls; and
- Disclosure practices and procedures.

The Audit Committee's own "annual meeting" is the one at which the Committee approves the Audit Committee's report for the proxy statement and the audited financial statements that will be part of the Form 10-K. At the meeting, the Committee will consider:

- The auditor's report;
- Auditor independence;
- Procedures and other issues related to financial statements and disclosure;
- Management's internal controls report;
- The draft Audit Committee Report to be included in the proxy statement stating the Committee's approval of the financial statements; and
- The appointment of the outside auditor for the new year.



Practical Tip:
Use Your Audit Committee in Conflict-of-Interest Situations

Often, a Board will face a situation requiring action by its independent directors. For example, only disinterested directors should approve a transaction between the company and a director. In fact, both Nasdaq and the NYSE require that the Audit Committee or another committee of independent directors approve related party transactions. Rather than form a Special Committee of disinterested directors for each situation, the Board may ask the Audit Committee (or another existing independent committee) to review interested director transactions.

Compensation Committee

Purpose and Authority. A company's Compensation Committee develops criteria and goals for, and then reviews and approves the compensation of, the company's senior management. The Com-

mittee also develops and establishes equity and other benefit plans, and may review and establish director compensation. Its charter should provide the Committee sole authority to retain, compensate and terminate consultants and advisors to assist the Committee in fulfilling its responsibilities.

Duties. The Compensation Committee will:

- *Set Goals and Objectives.*
 - Review, approve and evaluate achievement of performance goals and objectives by the CEO and other executive officers in connection with their cash and equity compensation;
 - Set compensation levels to motivate management to achieve stated objectives; and
 - Align the executive officers' interests with the long-term interests of the company and shareholders.
- *Establish and Oversee Equity and Benefit Plans.*
 - Establish, administer and review compensatory benefit plans for executive officers and directors and, to a lesser extent, employees generally;
 - Grant or delegate power to grant stock options and restricted stock awards; and
 - Ensure that the plans yield benefits based on performance.
- *Recommend Stock Plan Approval.*
 - Recommend Board or shareholder approval of incentive compensation and equity-based plans.
- *Monitor Compliance with Law.*
 - Monitor the regulatory compliance of benefit plans.
- *Approve Public Disclosure.*
 - Review and approve public disclosure, including the annual Compensation Committee report to be included in the proxy statement and Form 10-K.

Charter. The Compensation Committee should adopt and periodically review a charter that describes its duties.

Independence. The Compensation Committee should consist of independent directors. The NYSE requires a committee of all independent directors (at least three), and Nasdaq requires either a committee composed exclusively of independent directors (with a limited exception) or that a majority of independent directors on the Board meet in executive session to perform Committee duties. Pursuant to the Dodd-Frank Act, NYSE and Nasdaq have their own rules defining *independence* for Compensation Committee members. These standards, like those for the Audit Committee, are more stringent than those for membership on the Board or other Board committees. (We discuss the NYSE and Nasdaq Compensation Committee independence requirements in Chapters 9 and 10.) To preserve independence, companies will want to avoid interlocking Compensation Committee memberships. An *interlock* occurs when an executive officer of one company:

- Serves on the Compensation Committee of a second company, one of whose executive officers served on the Compensation Committee of the first company; or
- Serves as a director of a second company, one of whose executive officers served on the Compensation Committee of the first company; or
- Serves on the Compensation Committee of a second company, one of whose executive officers served as a director of the first company.

Interlocks can create an appearance of inappropriate influence and must be disclosed in a company's proxy statement and Form 10-K.

Independence of Compensation Committee members plays a critical role in federal income tax deductibility as well. Although 2018 amendments to Internal Revenue Code Section 162(m) mean that companies can generally no longer deduct executive compensation over \$1 million per year, transition relief provides

that certain compensation paid pursuant to a written binding contract in effect on November 2, 2017, will be grandfathered and not subject to the amended rules (so long as the contract is not materially modified on or after that date). For a company seeking to take advantage of the grandfathering relief, the Compensation Committee must consist entirely of two or more “outside” directors to allow the company to maintain deductibility of executive compensation under Section 162(m). An all-independent Compensation Committee of “nonemployee” directors also allows the Committee’s approval of option grants to executive officers and directors to qualify as exempt purchases under Rule 16b-3 under the 1934 Act.

Compensation Discussion and Analysis (CD&A). In the company’s annual proxy statement and Form 10-K, the Compensation Committee submits an annual discussion that analyzes and describes the bases for the compensation paid to the CEO and other executive officers. Developing the CD&A is an annual part of the Committee’s duties. (We discuss practical tips for drafting the CD&A in Chapter 7.) Smaller reporting companies are not required to provide a CD&A.

Compensation Committee Report. In the company’s annual proxy statement and Form 10-K, the Compensation Committee submits an “annual report.” In it, the Committee confirms that it has reviewed and discussed the CD&A with management. Based on that, it recommends that the Board include the CD&A in the company’s proxy statement and Form 10-K.

Risk Management and Compensation Policies and Practices. The SEC’s proxy rules require companies to assess whether their compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company. If so, then the proxy statement will need to discuss the relationship between risk management and the compensation policies and practices for all employees, including non-executive officers. (This requirement does not apply to smaller reporting companies.)

Meetings. The Compensation Committee will generally meet at least quarterly. Its “annual” meeting will be held when fiscal

year-end results are available to assess how the company's executive officers performed against corporate and personal goals and objectives for that year and to set new goals and objectives for the new year. The Committee will also meet as needed to establish or recommend changes to compensation plans.

Compensation Consultants: Disclosing Fees and Conflicts.

A prudent Compensation Committee will retain outside compensation consultants to evaluate compensation for executive officers. The proxy statement will disclose fees paid to compensation consultants, including if a compensation consultant engaged by the Board or Committee provides other services to the company (e.g., benefits or human resources consulting), if the fees for those additional services exceed \$120,000 during the company's fiscal year.

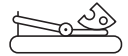
The proxy statement will not need this disclosure, however, if the Board or Committee used different compensation consultants, or when the other services performed by the consultant are limited to providing certain survey data or consulting on broad-based plans for all salaried employees that do not discriminate in favor of executive officers or directors.

The NYSE and Nasdaq provide that a Compensation Committee must consider specified independence-related criteria when selecting a compensation advisor, as discussed in Chapters 9 and 10. The Dodd-Frank Act requires Compensation Committees selecting advisors to consider factors that may affect the advisors' independence, including:

- Does the advisor provide other services to the company?
- What percentage of the advisor's total revenue derives from the company?
- Has the advisor implemented conflict-of-interest policies?
- Is there a business or personal relationship between the advisor and a member of the Committee?
- Does the advisor own any company stock?

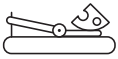
As long as the Board takes the appropriate factors into consideration, the Board may choose to engage non-independent advisors. Companies, however, will disclose in their annual proxy statements when the Compensation Committee receives advice from a compensation consultant, whether the work of the compensation consultant raised any conflict of interest and, if so, the nature of the conflict and how it was resolved. The NYSE and Nasdaq exempt smaller reporting companies from these provisions.

**Trap for the Unwary:
The Compensation Committee After *Disney***



In 2005, the Delaware Court of Chancery absolved directors of liability for the 1995-96 hiring and firing of former Disney president Michael Ovitz. The Board had approved a severance package for Mr. Ovitz of approximately \$140 million for his 14-month tenure. While not finding Disney's directors personally liable, the court sharply criticized their action (and inaction) as falling short of best corporate governance practices. Many lessons of what not to do, wrote the court, could be learned from the Disney Board's conduct.

- *Engage Your Independent Directors at an Early Stage.* Do not deliver decisions on a silver platter! In *Disney*, half of the Compensation Committee was active in negotiations and the other half came in "very late in the game." Engage your entire Compensation Committee in the "many" early stages of critical employment negotiations.
- *Seek Expert Advice.* In *Disney*, the court allowed the Compensation Committee to rely on an expert, even though the expert's analysis may have been incomplete or flawed, because the Committee selected him with reasonable care, his analysis was within his professional competence, and the directors had no reason to

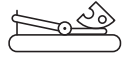


Trap for the Unwary: The Compensation Committee After *Disney* (Cont'd)

question his conclusions. So make sure your Committee has the authority to solicit advice, and does, from independent employment compensation experts.

- *Provide Directors with Sufficient Notice and Materials Prior to the Meeting.* Provide notice and materials well in advance of any meeting at which an executive employment agreement is to be discussed, including:
 - A plain English term sheet summarizing the key provisions of the arrangements (and, when appropriate, a full draft of the proposed agreement).
 - An analysis of the cost to the company of termination of employment, change of control, etc., including information relating to reasonableness of terms. Compensation Committee members should expect a spreadsheet making different, alternative assumptions and showing the range of potential payments in the most reasonably foreseeable alternative scenarios that could arise. The court noted that an analysis for the Ovitz employment agreement should have shown the cost to Disney if Mr. Ovitz's employment terminated during each of the five years of the agreement's initial term. Show your Board each possible bottom line!
- *Allow Sufficient Time for Discussion, and Document the Process.* The *Disney* court focused on the length of Board discussions, noting how helpful it would have been had the Committee minutes shown that the discussion relating to Mr. Ovitz was longer than discussion of other issues. Insist that your Compensation Committee spend sufficient time on discussion, and document it!

**Trap for the Unwary:
The Compensation Committee After *Disney* (Cont'd)**



- *Establish Succession Planning.* Mr. Ovitz came to Disney as the result of a too-rapid search precipitated by the unexpected death of Disney's president and the discovery of the then-CEO's heart ailment. The Compensation Committee can take the lead in implementing a robust succession-planning process so that your company does not find itself in the position of being forced to hire a CEO without having conducted a proper search or made appropriate preparations.

Nominating & Governance Committee

The Nominating & Governance Committee, third in the triumvirate of "core" Board committees, monitors the Board itself.

Purpose and Authority. The Nominating & Governance Committee takes the lead in selecting directors, committee members and chairs or lead directors. The Committee may also develop corporate governance principles and policies and recommend them to the Board. The Committee should have the ability to retain, compensate and terminate its own advisors, including any search firm used to identify director candidates.

Duties. The Nominating & Governance Committee will:

- *Select the Director Slate.* Identify, evaluate and recommend nominees for directors, and recommend committee members, chairs and lead directors.
- *Oversee Board Governance.* Develop, review and evaluate the effectiveness of corporate governance principles, including director and committee member selection guidelines and procedures and director performance criteria.
- *Develop Meeting Procedures.* Assist the chair or lead director in developing Board meeting practices and procedures.

- *Evaluate the Board.* Periodically evaluate the effectiveness of the Board and coordinate periodic evaluations of Board committees with committee chairs.

Either the Compensation Committee or the Nominating & Governance Committee will:

- Establish director compensation practices; and
- Determine procedures for the selection, review, development and succession of executive officers.

The Nominating & Governance Committee may assist the Audit Committee in monitoring ethical codes. Sarbanes-Oxley provides for a code of ethics for the CEO and senior financial officers, and both the NYSE and Nasdaq mandate a code of business conduct for employees, officers and directors.

Charter. The Board should approve, and the Nominating & Governance Committee should annually review, a written charter describing the Committee's duties.

Composition. Like the Audit and Compensation Committees, the Nominating & Governance Committee should be composed of independent directors. The NYSE requires a Committee of all independent directors (at least three). Nasdaq mandates either a Committee composed exclusively of independent directors (with a limited exception) or that a majority of independent directors on the Board make director nominations.

Director Qualifications and Board Diversity. Companies must disclose in their annual proxy statements a description of each director's or nominee's experience, qualifications or skills that qualify that person to serve as a director. These qualifications may include any specific past experience that would be useful to the company, the director's or nominee's particular area of expertise, and why the director's or nominee's service as director would benefit the company. Diversity policies are also part of proxy statement disclosures, if the Nominating & Governance Committee (or Board) has a policy to consider diversity when identifying nominees. The proxy statement will disclose how the Board implements the diver-

sity policy, and how the Nominating & Governance Committee (or Board) assesses the effectiveness of its policy.

As described in “Board Composition” earlier in this chapter, numerous state statutes establish diversity goals or mandatory minimums for the Boards of public companies incorporated and/or headquartered in those states. Nasdaq has a listing rule related to Board diversity, and Board diversity is an area of increasing focus for institutional investors, shareholder activists and proxy advisory firms. Even investment banks are weighing in on the topic, as shown by the recent Goldman Sachs policy decision to underwrite IPOs in the United States and Europe only if the issuer has at least two (as of 2021) diverse directors on its Board.

Meetings. The Nominating & Governance Committee will meet periodically to discuss and set governance procedures, to evaluate or select the nominees for election as directors at the annual shareholders’ meeting, and to recommend members to the Board. There is no set recommended number of meetings for the Committee.

Practical Tip:
**Mirror, Mirror on the Wall: Does Your Board
Conduct a Self-Evaluation?**



Evaluating the Board and its core committees (Audit, Compensation and Nominating & Governance) on an annual basis has rapidly become a “best practice” for public companies. The NYSE’s listing standards require annual self-evaluations in corporate governance guidelines and committee charters, and many Nasdaq companies conduct evaluations as part of a healthy corporate regimen. No single method has emerged as the “best” evaluation practice, yet these five practical tips have emerged as consistent guidelines:

- *Choosing a Leader to “Own” the Process.* For the Board, this should generally be the chair (if independent), the



Practical Tip:
**Mirror, Mirror on the Wall: Does Your Board
Conduct a Self-Evaluation? (Cont'd)**

lead director or the chair of the Nominating & Governance Committee. For evaluating a committee, it will be that committee's chair. The director responsible for the evaluation process has a number of decisions to make, the discussions are sensitive, and the evaluation needs to get done – all good reasons to entrust the process to one person.

- *Deciding on Written or Oral – or Both?* The director responsible for the evaluation process should make a threshold decision as to whether the inquiry and the results should be written or oral. Talk to the CEO, Board chair and general counsel, as there are many opinions – and no perfect answers. Often, the questions are written, the evaluation itself is a live interview and a summary of the results – including how your Board will address any shortfalls – is in writing. Alternative formats include written questionnaires and a single Board or committee meeting focused on self-evaluation.
- *Assessing the Board as a Whole.* Ask your fellow directors: How is the Board performing its responsibilities of strategic planning, financial and risk oversight, succession planning, executive evaluation and compensation?
- *Assessing Individual Director Performance: Independence and Suitability Annually and Overall Performance Periodically.* The most difficult part of any Board self-evaluation is assessing individual director performance. On an annual basis, the Board needs to make independence assessments and determine suitability of the directors for service on its core committees. A Board could assess individual directors' performance annually, but it is probably sufficient to make these assess-

Practical Tip:
**Mirror, Mirror on the Wall: Does Your Board
Conduct a Self-Evaluation? (Cont'd)**



ments every second or third year (which could be part of a regular renomination process for companies with staggered Boards).

- *Shortcomings? Address Them – Promptly.* Self-evaluation will almost certainly reveal some shortcomings. Before completing the evaluation process, develop proposed solutions. And ask the director who “owns” the process to report back to the Board at an appropriate time on success in addressing any issues.

Other Committees

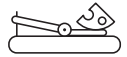
More than 70% of S&P 500 companies have more than the three core committees. Other common Board committees include:

- *Finance Committee.* A finance committee usually reviews the company’s financing policies and procedures and recommends potential debt or equity financings and similar activities. The Board may also delegate to a finance committee the authority to approve certain kinds of transactions when approval is required between regularly scheduled Board meetings.
- *Executive Committee.* An executive committee can make decisions for the company regarding administrative situations or in an emergency, when the full Board is not readily available to act.
- *Risk Oversight Committee.* Because NYSE rules require an Audit Committee to discuss “guidelines and policies to govern the process” by which an NYSE company undertakes risk assessment and management, Audit Committees historically have overseen the company’s risk management function. Companies need not adopt one approach to risk oversight and management, however.

Exchange rules allow companies to establish separate committees or subcommittees to perform the risk oversight function, as long as the processes undertaken by the committee are overseen by the Audit Committee. Boards should put in place a risk management system that brings to the Board's attention the most significant risks faced by the company and that allows the Board to understand and evaluate those risks, the relationship among the risks, and the ways in which the company's and management's ability to handle the risks is affected by the risks themselves. The system can consist of a review by a separate risk oversight committee or subcommittee, or a regular review by the Audit Committee, combined with a periodic review by the full Board. Many companies allocate risk management responsibilities among several committees. This is appropriate so long as the committees coordinate efforts and relay information to one another and to the full Board. The company's proxy statement will describe the Board's role in the risk oversight of the company, how the Board administers its oversight function (the Board as a whole? a risk committee? the Audit Committee?), and the effect this has on the Board's leadership structure. The proxy statement will also describe whether the individuals who supervise day-to-day risk management report directly to the Board or provide their input to the Board or committee through another means.

- *Special Committee of Independent Directors.* The Board may establish a Special Committee of disinterested directors to evaluate litigation, transactions or other special situations that require arm's-length review. These situations may include a change of control or assessment of strategic alternatives, shareholder litigation, contracts with or special compensation to a director or a director affiliate, allegations of wrongdoing by a director or an officer, or any other situation in which management or other directors have a conflict of interest.

Trap for the Unwary: Cybersecurity (or the *Risk du Jour*)



In recent years, high-profile breaches have catapulted the issue of cybersecurity, as well as victim companies and their Boards, into the spotlight. The Board's critical roles in overseeing both risk management and crisis management mean that the full Board should be informed and engaged on cybersecurity-risk issues, even if a committee is primarily responsible for risk oversight.

The Board should make sure that the company is regularly assessing cybersecurity vulnerabilities, which could include an outside consultant's cybersecurity-risk audit, and directors should be educated about the possible consequences of a breach. Management and the Board may work together to create an incident response plan. The Board should consider the SEC's disclosure guidance specific to cybersecurity and should carefully review the company's existing disclosures regarding cybersecurity risk, updating them as necessary.

Board Compensation

Public companies compensate independent directors for Board and committee service with a combination of cash and securities. Some companies also permit their nonemployee directors to participate in company-deferred compensation or other benefit plans. Outside director compensation varies considerably from company to company. Employee directors generally receive limited or no additional compensation for Board service.

In the current environment, with directors serving on fewer Boards and dedicating more time and care to each Board on which they serve, companies have continued to increase director compensation. Directors who assume the highest levels of responsibility, including independent chairs or lead directors,

committee chairs and committee members, earn more in proportion to their responsibilities. The Board or the Nominating & Governance Committee should periodically evaluate the company's director compensation package against peer companies to ask: "Are we competitive? Do we appropriately match rewards to Board effort, risk and results?"

Cash Compensation

Most companies pay their directors an annual cash retainer for Board and committee service. Cash retainers for Board service generally range from about \$50,000 to \$200,000 or more per year. Directors may receive additional compensation for committee service, service as a committee chair or lead director and, sometimes, for meetings. In recent years, the annual cash retainer amount for Board service has increased while the number of companies compensating Board members for meeting attendance has declined.

Equity Compensation

Most public companies make initial stock grants to directors upon commencement of Board service. Directors then often earn additional grants as part of an annual compensation package. Many public companies pay annual retainers exclusively with equity grants, rather than cash. It is common for initial restricted stock grants to be larger and have longer vesting periods (e.g., two to four years), and for annual grants to be smaller and have shorter vesting periods (e.g., one year or immediate vesting). Although some companies continue to grant options to directors, the composition of equity awards for Board service has largely shifted to restricted stock awards.



Practical Tip: Stock Ownership Goals

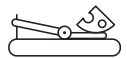
Does equity or cash compensation provide better incentive to directors without encouraging excessive risk?

While some companies believe equity-based compensation may encourage directors to act in ways that could increase the short-term value of their equity stakes at the expense of the company's long-term interest, most companies believe that equity can better align the interests of directors with those of shareholders.

These companies may:

- Establish minimum goals (based on a number of shares or dollar amount) for stock ownership by directors;
- Integrate these goals with a compensation plan that allows directors to elect to receive a portion of their annual compensation in stock; and
- Give each director two to five years to achieve the stock ownership goal.

Trap for the Unwary: Hart-Scott-Rodino Filing Requirements



Directors who exercise options for or otherwise purchase large amounts of company stock (in 2020, stock with a value in excess of \$94 million) should be aware of individual filing obligations created by the Hart-Scott-Rodino Antitrust Improvements Act of 1976. Fluctuations in the trading price of a company's common stock could cause the value of a director's holdings to surpass thresholds obligating the director to make a filing with the Department of Justice and the Federal Trade Commission. Failure to make required filings could result in substantial monetary penalties for the individual director and company disclosure obligations.

Liabilities and Indemnification

A public company's directors and officers may be subject to personal liability under statutes relating to employee benefits, tax, antitrust, foreign trade, environmental and securities matters. As discussed previously, directors are also liable for breaches of their duties of care, loyalty and candor. To encourage individuals to serve as directors and officers, state laws permit companies to limit director liability and indemnify their directors and officers against some of this exposure.

Limiting Director Liability

Delaware and states that follow the Model Business Corporation Act permit charter documents to include *exculpation* or *raincoat* provisions that eliminate the personal liability of a director to the company or its shareholders for monetary damages for some breaches of director duties. However, corporations cannot limit directors' liability in situations that involve:

- Breach of the duty of loyalty;
- Intentional misconduct or a knowing violation of law;
- Unlawful payment of dividends;
- Transactions from which the director derived an improper personal benefit; or
- Breach of the duty of good faith. (Although Delaware does not grant this permission, most Model Business Corporation Act states allow a corporation to limit director liability in situations that involve a breach of the duty of good faith.)

**Practical Tip:
The Best Way to Limit Liability?
Keep Informed**



Even the most robust charter provisions limiting director liability are subject to limitations, particularly in today's dynamic legal and business environment. The most effective ways for you as a director to reduce your exposure to fiduciary claims are to:

- Adopt effective corporate governance and compliance procedures;
- Monitor your Board's compliance with those procedures; and
- Actively oversee the business and operations of the company.

Actively inquire into and be informed about the corporate decisions that the Board will consider. Use the questions that we suggest in this Handbook. Comply with the duty of loyalty to the company. Create a robust record that demonstrates that you and your fellow directors have met your respective duties of care and loyalty. Do these things, and the business judgment rule will generally protect you from personal liability.

Indemnifying Directors and Officers

The corporate laws of nearly all states provide for both mandatory and permissive indemnification of directors and officers, and related rights.

Mandatory Indemnification. A company typically must indemnify every director or officer who successfully on the merits defends an action or claim brought as a result of his or her status as a director or officer. Some states require the director or officer to be wholly successful on the merits, while other states,

including Delaware, provide for mandatory partial indemnification to the extent of the individual's successful defense.

Permissive Indemnification. The corporate laws of most states permit a company to indemnify its directors and officers against expenses incurred in specified actions if they acted in good faith and in a manner that they reasonably believed to be in, or not opposed to, the company's best interests. Directors and officers may receive indemnification in a criminal action or proceeding if they had no reasonable basis to believe that their conduct was unlawful. However, indemnification usually is not available for actions by the company for amounts paid in settling derivative actions or when the directors or officers are found to be liable to the company.

Advancement of Expenses. Most states also permit a company to advance defense costs to its directors and officers. State law typically provides that the company may require the director or officer to sign an agreement (an undertaking) to repay any advanced amounts if it is ultimately determined that the individual's conduct did not meet the applicable standard of conduct to entitle the individual to indemnification.

Protection Against Subsequent Amendment to Rights. A Delaware corporation may not eliminate or impair a right to indemnification or to advancement of expenses arising under a provision of its certificate of incorporation or its bylaws by amending the provision after the act or omission occurs. The one exception to this is that the provision in effect at the time of the act or omission may explicitly authorize the elimination or impairment after the action or omission has occurred.

Indemnification Agreements

It is becoming increasingly common for companies to enter into indemnification agreements with their directors and, less frequently, their officers. To the extent a company's charter documents provide for broad indemnification rights and specifically state that these rights are contractual, indemnification agreements may not seem to provide substantial additional protection.

But in reality, an agreement may provide great comfort to directors and officers. It adds clarity and provides protection against future alterations of charter documents. If any contractual rights are broader than those provided by statute, courts may subject the contract rights to review on public policy or reasonableness grounds.

D&O Insurance

Most public companies purchase insurance to cover liabilities arising from their directors' and officers' actions on behalf of the company, known as D&O insurance. This insurance provides a potential source of reimbursement to the company for indemnification payments it makes to its directors and officers. D&O insurance may also motivate individuals to serve as directors and officers by reducing their exposure to personal liability from potential gaps in the availability of indemnification and, in situations such as insolvency, where the company cannot adequately indemnify its directors and officers. Most D&O insurance policies include entity coverage, which also insures the company directly for its liability on certain defined claims without diluting available coverage for directors and officers.

Practical Tip: Know Your Coverage



D&O insurance coverage is subject to exclusions similar to those that apply under state law to corporate indemnification obligations, including:

- Claims arising out of personal benefits to which the director or officer was not legally entitled;
- Claims arising out of criminal or fraudulent acts;
- Losses arising out of illegal payments to directors and officers; and
- Losses arising out of violations of insider trading laws.



**Practical Tip:
Know Your Coverage (Cont'd)**

An insurance broker can provide detailed information and recommendations regarding appropriate D&O insurance coverage. Insurance counsel or other experts can also analyze your company's D&O insurance needs. Liability counsel can advise your company on the terms of D&O insurance coverage, particularly terms relating to retentions and exclusions. The Board should periodically evaluate the coverage to ensure that it continues to meet the evolving needs of your company.

In addition to D&O insurance policies that concurrently cover directors, officers and the company, many companies also purchase supplemental "Side A" coverage that covers only directors and officers. This avoids a claim in a bankruptcy context that D&O insurance proceeds of the general policy are assets of the debtor's estate and are not available to indemnify directors and officers. We provide a visual guide to D&O insurance in Appendix 3.



**Practical Tip:
The Cautious Director: Six Questions to Ask
Your General Counsel Every Year**

To help ensure that your company has taken the necessary steps to reduce its own exposure to liability as well as that of its directors and officers, ask your company's general counsel these six questions annually:

- *Do we have a robust system for oversight of enterprise-wide compliance with law? Do we identify and disclose material risks as part of the process for determining the effectiveness of financial controls or the process for certifying financial statements?*
 - Who owns this process?

Practical Tip:
**The Cautious Director: Six Questions to Ask
Your General Counsel Every Year (Cont'd)**



- What is your role in our enterprise-wide risk management program?
- Is there anything about the oversight program that you would improve?
- *Have we established and kept current reliable policies, controls and procedures for gathering, assessing and in a timely manner reporting financial and other 1934 Act information and for communicating with investors?*
- *Would you do anything, if you had the authority, to improve our internal financial controls or our disclosure practices and procedures?*
- *Are the terms of our D&O insurance coverage sufficiently broad? What are the limits? Did we negotiate aggressively to expand coverage?*
- *Are our D&O insurance coverage limits high enough? (This question is especially pertinent if your company's market capitalization is growing quickly and might outstrip earlier coverage.)*
- *Would you suggest any changes to our certificate or articles of incorporation and bylaws to provide the maximum liability limitations and indemnification permitted by law?*

Chapter 3

Investor and Other Stakeholder Engagement

Public companies engage with their investors, as well as other stakeholders, in myriad ways. Chapters 4 and 5 discuss SEC rules pertaining to required and voluntary disclosures that companies make. This chapter addresses when and how companies engage with investors outside of SEC filings.

Many public companies have in recent years increasingly focused on efforts to engage with other key stakeholders in addition to investors. The Business Roundtable’s Statement on the Purpose of a Corporation (<https://opportunity.businessroundtable.org/ourcommitment/>), originally published in August 2019, exemplifies the growing awareness by public companies that consideration of these other stakeholders holds great importance to their long-term success. CEOs signing the Business Roundtable’s Statement committed their companies to serve and deliver value to all stakeholders including customers, employees, suppliers, communities in which the company works, and shareholders. This chapter also addresses the growing importance placed on these engagements, and how companies are reporting on these engagements to their investors.

Shareholder Engagement in the Ordinary Course

Public companies use a combination of channels and strategies to engage with investors. SEC filings provide periodic updates on management’s view of the company’s business, industry and competitive landscape, financial results, and known trends affecting the business. Outside these filings, common

forms of company-led investor engagement are generally of two types: engagement with management regarding financial results and business developments, and engagement that might include certain directors in addition to members of management on corporate governance and related topics.

Public companies typically schedule quarterly management earnings calls to supplement their SEC filing disclosures regarding financial results and business developments. Management also discusses strategy and results in industry-focused conferences and other investor presentations. As we discuss in Chapter 5, companies must take care to provide appropriate notice of and access to such presentations when necessary to comply with Regulation FD. Management also frequently follows these broadly accessible earnings calls and investor presentations with separate, Regulation FD-compliant engagements with significant investors or investment analysts on a one-on-one basis.

Proxy Statements and Sustainability Reports

For matters outside financial results, business developments and strategy, the primary vehicle for public company disclosure has long been the annual proxy statement. As discussed in Chapter 7, an annual meeting proxy statement calls for disclosures regarding directors and nominees, corporate governance matters, and executive compensation.

Companies might also provide investor-focused disclosures on environmental, social and governance (ESG) topics in separate reports, often called sustainability reports or corporate responsibility reports. These disclosures may be formatted as stand-alone reports or interactive websites. A trend that is currently emerging and may grow to become common practice in the next several years is to include disclosure on ESG topics and metrics that are material to a company in periodic reports and proxy statements. For example, the SEC adopted rule changes in 2020 requiring disclosure of material information about a company's human capital management in the annual report on Form 10-K and certain other filings, and has indicated that additional rule changes calling for disclosure on other ESG topics may follow.

Practical Tip:
What Should a Sustainability Report Include?



A company drafting a sustainability or corporate responsibility report for the first time will need to decide what topics to address. Topics can range from the environmental impact of the company's operations to community relationships to pay equality.

To identify topics for disclosure in an investor-facing sustainability report, a company can start by working with its internal stakeholders and then refine and expand on that analysis with information obtained from other resources. Investor engagement meetings, discussed below, are a great opportunity for a company to get feedback on potential disclosure topics. Existing internal reporting to senior management and the Board can also help guide what metrics to include in a sustainability report. A company may also want to review any previous public statements and company policies to confirm that its approach and disclosures are consistent across channels.

There are also several standard-setting bodies that provide frameworks for and guidance on sustainability reporting. Some of the prominent and widely used standards and frameworks are identified below.

- The Global Reporting Initiative (GRI; <https://globalreporting.org>) is a nonprofit organization founded in 1997 that has established sustainability reporting standards. GRI's standards focus on the economic, environmental and social impacts of a company, which may go beyond information that is material to investors.



Practical Tip:
What Should a Sustainability Report Include? (Cont'd)

- The Sustainability Accounting Standards Board, now a part of the Value Reporting Foundation (SASB; <https://sasb.org>), is a nonprofit organization that first published its set of 77 industry standards on financially material sustainability topics and associated metrics in 2018. SASB's approach is intended to help companies provide disclosure on ESG issues that are expected to have a financially material impact on the company.
- The Task Force on Climate-Related Financial Disclosures (TCFD; <https://fsb-tcfd.org>) was established by the Financial Stability Board to develop consistent climate-related financial risk disclosures. Its recommendations, released in June 2017, provide a framework for companies preparing disclosures about measuring and responding to climate change risks.

These different standards and frameworks serve different purposes, and therefore may not be consistent. While the SASB standards and TCFD framework both seek to elucidate material disclosures that are suitable for traditional corporate reports like SEC filings, the GRI standards have a wider range and encourage companies to disclose more information, whether or not it is material to the company and its investors.

A company's sustainability report is likely to be distinctive from any other, including reports by other companies in the same industry. But by making the most of existing knowledge and reporting within the company, along with insight from investors and existing disclosure standards, no company need start from scratch.

Investor Meetings on ESG Topics

Outside of disclosure through proxy statements and sustainability reports, companies may engage proactively with large shareholders on ESG topics in the months after the company's annual meeting of shareholders. This timing allows companies to have interactive discussions with investors without having to file discussion-related matter as proxy soliciting materials. (We address proxy solicitation and related filing requirements in Chapter 7.)

This engagement also helps a company prepare for its next proxy and annual meeting season. The company learns what ESG issues are important to shareholders, and can consider making governance changes or preparing additional disclosures to address these concerns and to avoid potential public activism by shareholders. Companies that have engaged on ESG topics with their large shareholders and have responded to raised concerns are also well-positioned to seek the support of these large shareholders in case of shareholder activism in the form of shareholder proposals or proxy fights.

Engagement with Other Stakeholders

Engagement with stakeholders other than investors is not a primary focus of this Handbook, but we mention it here in light of investors' growing interest in sustainability and ESG-related disclosures. Investors focused on a company's long-term prospects and sustainability want to understand the ways in which the company engages with other stakeholders and addresses their concerns.

Stakeholder groups a company might engage with or consider the viewpoints of include:

- Customers
- Employees
- Suppliers, including various participants in the company's supply chain

- Local communities in which the company works
- Society at large

Companies will have different approaches to engaging with these various stakeholders, and the relative importance of, and level of effort involved in, these engagements will vary. For many companies, engaging with and understanding the perspectives of different stakeholder groups is already an important part of the company's culture and operations. For others, such engagement may be practiced in less formal or operationalized ways. In either case, there is a growing trend for public companies to inform investors – through their proxy statements or stand-alone sustainability or corporate responsibility reports – about how they engage with stakeholders and how they have considered the input received from stakeholders.

As discussed in Chapter 13, companies can be subject to securities law liability for materially misleading statements, even when those statements are not included in SEC filings. For this reason it is important to bring a critical eye to disclosures that are investor-facing, such as sustainability or corporate responsibility reports, to ensure that statements about topics like stakeholder engagements are accurate and not misleading. As investors focus more attention on ESG-related topics, companies should ensure that the disclosures are thoroughly vetted and based on repeatable and verifiable data-gathering processes, particularly where quantifiable metrics are provided.

Shareholder Activism

Investors, including activist funds, pension funds, unions and institutional shareholders, may seek to engage with companies in a more public manner than ordinary-course investor meetings discussed above. This engagement comes in various forms, ranging from shareholder proposals for consideration at an annual meeting, discussed in Chapter 7, to “vote no” campaigns urging shareholders to vote against a director or management proposal. An investor's most potent tool is to bring a proxy contest.

A proxy contest typically involves a challenge to existing management by a third-party acquirer or shareholder group seeking control of the company. The challenge may also be posed by a shareholder activist seeking to influence the direction of the company. Often, the challenger has obtained a significant ownership position in the company and seeks to either control the company through the election of a majority of the directors or propose a merger or tender offer for shares. (Although a detailed discussion of takeover transactions and defenses is beyond the scope of this Handbook, we summarize corporate structural defenses in Chapter 11.)

Shareholder activism has increased in recent years, and generally is targeted to affect share price, bring about governance changes or advance a social agenda. A wide variety of activists have emerged, including small and large players as well as those focused on single or multiple strategies, issues or sectors. The style and approach of activists also varies, from contentious and aggressive to constructive and cooperative.

Company size and industry no longer matter in terms of companies that are targeted by shareholder activists. In the current climate, several characteristics can make a company vulnerable to activist interest, including:

- Excess cash/low debt (“return capital to shareholders”);
- Multiple business lines/owned real estate (“unlock value”);
- Management/Board composition (“entrenchment”/“lack of diversity”);
- Undervaluation/overvaluation (“sell the company”/“sell the stock”);
- Strategic actions/inaction (“vote against the deal”/“sell the company”); and
- Governance structure.

Activists engage with companies in many different ways:

- Sending public or private letters to the Board or to management;
- Filing a Schedule 13D, which may be ordinary course or specific messaging;
- Writing public or private white papers;
- Enlisting or engaging other shareholders;
- Threatening or initiating a proxy contest;
- Submitting shareholder proposals;
- Publicly calling for the exploration of “strategic alternatives,” an outright sale of the company, or governance or Board reforms;
- Challenging announced transactions; and
- Mounting “vote no” campaigns in director elections.



Practical Tip:
Shareholder Engagement Best Practices

In the event your company is contacted by a shareholder activist, we suggest you consider the following in formulating your response plan.

Know Who Your Shareholders Are. Your investor relations team can proactively monitor any changes in positions of your company’s known shareholders. Investor calls and interactions with analysts are a good normal-course method for taking the pulse of the investment community. Also review and monitor Schedules 13D and 13G filings both proactively and after any engagement begins.

Response and Monitoring Depend on Activist Approach. Consider keeping your response team small to lower distraction within the company and the risk of leaks. Generally, a response team will include the CEO, CFO, general counsel,



**Practical Tip:
Shareholder Engagement Best Practices (Cont'd)**

investor relations, the Board (usually the chairperson or lead independent director), financial advisors, outside counsel, and possibly an investor relations/public relations firm and proxy solicitor.

Communication Is Critical. In the event of engagement, whether proactive or reactive, establish a dialogue so that each side understands what the other wants to accomplish. Open lines of communication with the CEO and rapport with the Board are critical.

Also, consider these tips about best practices for activist engagement:

Top Things TO Do:

- Be proactive / engage;
- Involve the Board early;
- Maintain tight communication – speak with one voice;
- Define your core messages (as in a political campaign, sound bites matter);
- Be prepared for escalation and be nimble;
- Emphasize Board independence and good corporate governance;
- Show a record of engagement; and
- Be vigilant about Regulation FD compliance.

Top Things NOT to Do:

- Be defensive or engage in personal attacks;
- Create the perception that management dominates the company or that the Board is not fully engaged;



**Practical Tip:
Shareholder Engagement Best Practices (Cont'd)**

- Appear closed to ideas or refuse to interact with the activist;
- Rely on too broad a set of messages or respond to every attack from the activist shareholder;
- Undertake fundamental strategic or financial actions that are not critical during the fight;
- Change governance provisions or take other tactical actions that are viewed to disadvantage the activist shareholder;
- Attempt to placate the activist shareholder by implementing fundamental changes that are inconsistent with the long-term strategic, operational or financial objectives of the company; and
- Assume that a negative recommendation from proxy advisory firms is dispositive.

Chapter 4

Nuts & Bolts: The Basics of Public Company Periodic Reporting Obligations

A company subject to the 1934 Act files annual, quarterly and current reports with the SEC. These reports regularly update and supplement the information that the company has made available to the public in previous 1933 Act and 1934 Act filings. Companies file the reports within a specified number of days after the end of each reporting period or after certain material events.

Practical Tip:
How to Keep Pace with Periodic Reporting?
Maintain a Periodic Reporting Disclosure Checklist



Corporate failures, starting in the late 1990s and early 2000s, focused public attention on the integrity and quality of disclosures in companies' annual, quarterly and current reports. Reforms to periodic reporting and corporate governance have been instituted through NYSE, Nasdaq and SEC implementation of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) and the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). These initiatives have thrust the most basic of public company obligations – periodic reporting – into the forefront of directors' and officers' attention, and challenge even the most organized companies to keep track of what must be disclosed in reports filed with the SEC.



Practical Tip:
How to Keep Pace with Periodic Reporting?
Maintain a Periodic Reporting Disclosure Checklist
(Cont'd)

In Appendix 1, we provide companies with a model Annual 1934 Act Reporting Calendar, which we discuss in greater detail in this and later chapters. We urge you to use this model to create a comparable checklist for your company. Preparing your company's 1934 Act reports will require extensive input from your Disclosure Practices Committee, discussed later in this chapter, and finance and legal departments, as well as review by outside auditors and lawyers. To ensure that your working group remains on schedule and to allow adequate review time, circulate your 1934 Act reporting calendar to the members of the working group well in advance of each reporting cycle.

CEO and CFO Certifications and Disclosure Practices

Public company CEOs and CFOs must certify each annual report on Form 10-K and each quarterly report on Form 10-Q. To ensure that a disclosure system is in place to backstop these certifications, each company must also maintain disclosure controls and procedures and internal control over financial reporting.

Certifications by CEO and CFO

In each Form 10-Q and 10-K, a company's CEO and CFO are each required to provide two separate certifications, a "Section 302" certification and a "Section 906" certification. In a Section 302 certification, the CEO and CFO make statements in two areas:

1. *Accuracy of Report.* The CEO or CFO has reviewed the report, and to the CEO's or CFO's knowledge:

- The report does not contain any material misstatements or omissions; and

- The financial statements, and other financial information included in the report, fairly present in all material respects the company's financial condition, results of operations and cash flows.

2. *Controls and Procedures.* The CEO or CFO is responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting, and has:

- Designed the disclosure controls and procedures to ensure that all material information is made known to the CEO and CFO;
- Designed the internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in conformity with generally accepted accounting principles (GAAP);
- Evaluated the effectiveness of the disclosure controls and procedures as of the end of the period covered by the Form 10-Q or 10-K and described in the Form 10-Q or 10-K the effectiveness of the disclosure controls and procedures based on the evaluation;
- Indicated in the Form 10-Q or 10-K whether there were any changes in the internal control over financial reporting during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the internal control over financial reporting; and
- Disclosed to the company's auditors and Audit Committee any significant deficiencies or material weaknesses in the design or operation of internal control over financial reporting or any fraud that involves employees who have a significant role in internal control over financial reporting.

In a Section 906 certification, the CEO and CFO make two basic statements that overlap with their Section 302 certifications:

- The periodic report containing financial statements fully complies with the requirements of the 1934 Act; and

- Information contained in the report fairly presents, in all material respects, the company's financial condition and results of operations.

Unlike the Section 302 certification, the Section 906 certification may take the form of a single statement signed by both the CEO and CFO, and may be "furnished" rather than "filed" with the related report. (We discuss the difference between "furnishing" and "filing" later in this chapter.) Section 302 and Section 906 certifications are submitted as exhibits to Forms 10-K and 10-Q, and need not accompany reports on Form 8-K or 11-K.

Disclosure Controls and Procedures

To back up the certifications, companies maintain a system of disclosure controls and procedures designed to ensure that the company records, processes, summarizes and discloses on a timely basis information required to be disclosed in 1934 Act filings. Companies also need to evaluate on a quarterly basis the effectiveness of their disclosure controls and procedures. The phrase "disclosure controls and procedures" is broad in scope and extends beyond financial matters to cover all controls and procedures relating to required disclosure, including interactive data. (We discuss interactive data filing requirements later in this chapter.)

Internal Control Assessment

The most costly and controversial aspect of Sarbanes-Oxley is the internal control requirement of Section 404. Section 404 and related rules require each public company to include in its Form 10-K a management report on the effectiveness of the company's internal control over financial reporting, beginning with the company's second annual report on Form 10-K after becoming a reporting company. If the company, other than an emerging growth company, is an accelerated or large accelerated filer (generally companies with market capitalizations of more than \$75 million and, for smaller reporting companies, annual revenues of \$100 million or more), the company's independent auditor is required, in a separate audit-like analysis, to attest to, and

report on, management's assessment. (We discuss emerging growth companies later in this chapter.)

Internal control over financial reporting includes policies and procedures that:

- *Track Transactions in Assets* – relate to the maintenance of records that in reasonable detail accurately and fairly reflect the acquisitions and dispositions of assets.
- *Control Receipts and Expenditures* – provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures are being made only in accordance with authorizations of management and directors.
- *Protect Assets* – provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of assets that could have a material effect on the financial statements.

Management needs to base its internal control evaluation on some “recognized control framework” in order to have a widely accepted standard of comparison. The SEC identified the Committee of Sponsoring Organizations of the Treadway Commission (COSO) report “Internal Control – Integrated Framework,” which framework was updated in 2013, as the evaluation framework of choice. Although the SEC does not mandate any particular framework, U.S. companies quickly adopted the COSO report as the standard, indeed as the only realistic standard readily available for domestic issuers.

Methods of conducting evaluations of internal control vary from issuer to issuer. Companies should review, among other publications, COSO's “Guidance on Monitoring Internal Control Systems” released in 2009 (and, if applicable, COSO's guidance on “Blockchain and Internal Control: The COSO Perspective” released in 2020). The COSO 2009 report expanded on the guidance issued in prior COSO publications, and remains relevant

even after publication of the updated 2013 framework. Although the SEC does not specify the methods or procedures to be used, it has made the following observations that encourage documentation – one of the expensive side effects of internal control:

- *Develop – and Test – Procedures.* Management must base its assessment on procedures to evaluate the design of internal control over financial reporting. And management then should “actively” test its operating effectiveness, going beyond simple inquiry.
- *Incorporate Test Results.* Management must base its assessment on evidence, including documentation of the internal control design, and on the process and results of testing.
- *Keep Records.* Companies should develop, and maintain in company records, documentation and other evidence that support management’s assessment.
- *Coordinate with Outside Auditors.* Outside auditors can help, within limits. Management must be actively involved in the process and cannot delegate its responsibility to assess internal control to the auditor. However, the SEC recognizes the need for coordination between management and auditors. For example, the auditor may provide advice and recommend improvements to internal control, so long as management, and not the auditor, makes the accounting decisions. Also, someone other than the auditor (management or a third-party provider) needs to design the control procedures, because for an auditor to do so would place it in the position of auditing its own work and violate auditor independence rules.

If a company identifies a material weakness, it must disclose the existence of the material weakness in its Form 10-K, and management is not permitted to conclude that the company’s internal control over financial reporting was effective for that period. The SEC defines material weakness to be a deficiency, or a combination of deficiencies, in internal control over financial reporting that creates a reasonable possibility that a material misstatement of a company’s annual or interim financial statements will not be

prevented or detected on a timely basis. The SEC encourages companies to provide additional disclosure to allow investors to assess the potential impact of the material weakness. Experience has shown that analysts and investors are, with sufficient information, able to quickly assess the impact, in many cases with no negative effect on stock price or company reputation. The SEC's three suggested topics are useful as a checklist for disclosure:

- The nature of the material weakness;
- Its impact on financial reporting and the control environment; and
- Management's plans, if any, or actions already undertaken, for remediating the weakness.

Practical Tip:
Form a Disclosure Practices Committee



Most widely traded public companies follow an SEC recommendation to establish a non-Board "Disclosure Practices Committee." This Committee of officers and employees develops and oversees the procedures that support the CEO's and CFO's Sarbanes-Oxley certifications. The Committee's mandate is simple:

- Identify and analyze information for inclusion in 1934 Act reports;
- Develop, implement and evaluate disclosure controls and procedures and internal control over financial reporting (under the supervision of the CEO and CFO); and



Practical Tip:
Form a Disclosure Practices Committee (Cont'd)

- Review all SEC filings, press releases containing financial information or a discussion of material events, correspondence broadly disseminated to shareholders, presentations to analysts and the investment community, and disclosure policies for the company's corporate/investor relations website.

The Committee should be composed of two to ten officers or employees from the key functional areas in your company best able to gather and analyze material financial and other information. The SEC suggests including the following individuals:

- Controller or principal accounting officer;
- General counsel or lawyer responsible for disclosure;
- Risk management officer;
- Investor relations officer;
- Human resource manager; and
- Internal audit manager.

The Disclosure Practices Committee should meet at least three times during each quarter to fulfill its three categories of duties:

1. Information Gathering. Put into place and oversee the internal procedures for gathering information for possible disclosure in your company's 1934 Act reports. For example, interview personnel who have authority over significant business functions or subsidiaries.

2. Review and Communication. Analyze the materiality of information collected and communicate recommendations to management to allow timely decisions regarding required disclosures.



Practical Tip:
Form a Disclosure Practices Committee (Cont'd)

3. Evaluation and Improvement. Evaluate your company's disclosure controls and procedures and internal control over financial reporting. Identify weaknesses and recommend improvements.

The Committee or its chair will report its conclusions to the CEO, CFO and, possibly, the Audit Committee.

Forms 10-K and 10-Q Filing Deadlines

Filing deadlines for Forms 10-K and 10-Q depend on the company's category of filer as set forth below:

- *Accelerated Filer.* Companies that:
 - Have a public equity float of at least \$75 million but less than \$700 million as of the last business day of the most recently completed second fiscal quarter;
 - Have been subject to the 1934 Act's reporting requirements for at least 12 calendar months;
 - Previously have filed at least one annual report on Form 10-K; and
 - Are not eligible to use the scaled disclosure requirements for smaller reporting companies for Forms 10-K and 10-Q under the revenue test for smaller reporting companies described in this section.
- *Large Accelerated Filer.* Companies that have a minimum public equity float of \$700 million as of the last business day of the most recently completed second fiscal quarter and that otherwise meet the definition of accelerated filer.
- *Non-Accelerated Filer.* Companies that do not meet the definition of accelerated filer or large accelerated filer.

- *Smaller Reporting Company.* Companies that are not investment companies, asset-backed issuers or majority-owned subsidiaries of a larger reporting company parent and that:
 - Had a public equity float of less than \$250 million as of the last business day of the most recently completed second fiscal quarter; or
 - Had annual revenues of less than \$100 million in the most recent fiscal year for which audited financial statements are available and either a public float of less than \$700 million or no public float (e.g., wholly owned subsidiaries and debt-only issuers) as of the last business day of the most recently completed second fiscal quarter.

Smaller reporting company status and entry into or exit from accelerated filer and large accelerated filer status is determined annually. A smaller reporting company with a public float of at least \$75 million that had \$100 million or more in annual revenues will qualify as an accelerated filer. For accelerated filers and large accelerated filers, once filer status is determined, subsequent determinations of filer status are based on public float. The table below summarizes how a company's status changes based on subsequent public float determinations:

Initial Public Float Determination	Resulting Filer Status	Subsequent Public Float Determination	Resulting Filer Status
\$700 million or more	Large Accelerated Filer	\$560 million or more	Large Accelerated Filer
		Less than \$560 million but \$60 million or more	Accelerated Filer
		Less than \$60 million	Non-Accelerated Filer
Less than \$700 million but \$75 million or more	Accelerated Filer	Less than \$700 million but \$60 million or more	Accelerated Filer
		Less than \$60 million	Non-Accelerated Filer

The table below summarizes the Forms 10-K and 10-Q filing deadlines for each category of filer:

Category of Filer	Form 10-K Deadline	Form 10-Q Deadline
Large Accelerated Filer (\$700+ MM)	60 days after year-end	40 days after quarter-end
Accelerated Filer (between \$75 MM and \$700 MM)	75 days after year-end	40 days after quarter-end
Non-Accelerated Filer (less than \$75 MM)	90 days after year-end	45 days after quarter-end

Integrated Disclosure Under Regulations S-K and S-X

Regulation S-K, the SEC's disclosure guidance "cookbook," sets forth detailed disclosure requirements governing the content of 1934 Act periodic reports. Regulation S-K is a centralized source of disclosure requirements for periodic reports, proxy solicitations, registration statements and other filings pursuant to the 1933 and 1934 Acts.

Regulation S-X is the financial information counterpart to Regulation S-K. Regulation S-X provides the centralized source of requirements for the form and content of financial information required to be included in filings under the 1933 and 1934 Acts.

Scaled Disclosure for Smaller Reporting Companies

For some disclosure items, Regulations S-K and S-X provide scaled disclosure requirements for smaller reporting companies. For example, smaller reporting companies are only required to provide two years of audited income statements (instead of the three years required for larger companies) and are not required to include compensation discussion and analysis (CD&A) disclosure (discussed in Chapters 2 and 7) in their Form 10-Ks or proxy statements. Smaller reporting companies may choose to comply

with scaled or nonscaled financial and nonfinancial disclosure requirements on an item-by-item basis in any one filing. However, where the smaller reporting company requirement is more rigorous, the smaller reporting company must satisfy the more rigorous standard. For example, the related person transactions disclosure requirement (discussed in Chapter 7) is more stringent for smaller reporting companies, establishing a potentially lower dollar threshold and requiring a two-year lookback. Companies that meet the smaller reporting company standard should consult with counsel regarding these scaled disclosure requirements.



Practical Tip:
Exemptions and Scaled Disclosure for Emerging Growth Companies

The JOBS Act was enacted in 2012 to spur job creation by improving access to capital for smaller companies. Among other things, the JOBS Act relaxed certain requirements relating to IPOs by creating a new category of issuers called “emerging growth companies,” and eased certain post-IPO disclosure requirements for these issuers.

An emerging growth company (EGC) is a company with less than \$1.07 billion in total annual gross revenue during its most recently completed fiscal year. EGC status is determined in connection with a company’s IPO. The company can continue to have EGC status until the earliest of:

- the last day of the fiscal year on which it has total annual gross revenue of \$1.07 billion or more;
- the last day of the fiscal year following the fifth anniversary of its IPO;
- the date on which it has, during the previous three-year period, issued more than \$1 billion in nonconvertible debt; and
- the date on which it is considered a “large accelerated filer” under the 1934 Act.

Practical Tip:
**Exemptions and Scaled Disclosure for Emerging
Growth Companies (Cont'd)**



The annual gross revenue threshold is updated every five years for inflation. Among the post-IPO benefits of EGC status are exemption from the Dodd-Frank Act say-on-pay vote requirements (discussed further in Chapter 7), exemption from the requirement to include an audit of internal control assessment in its Form 10-K, and the ability to take advantage of the smaller reporting company scaled disclosure provisions for executive compensation reporting.

Interactive Data

Data submitted in XBRL (eXtensible Business Reporting Language) format is often referred to as “interactive data.” The XBRL process requires a company to tag certain numbers and content in filings to allow easy identification, extraction and comparison by computer programs. The SEC began requiring companies to use XBRL in 2009, and, on a phased-in basis starting in 2019, began requiring the use of Inline XBRL (iXBRL). The iXBRL format allows XBRL data to be embedded directly into the filing itself, avoiding the need to create and attach a separate exhibit. This change also makes filings more interactive for users (they can hover over tagged data points for additional information) and allows computers to more easily search, gather and analyze data contained in SEC filings.

The iXBRL tagging requirements apply to financial statements and accompanying footnotes and schedules located in registration statements (other than IPO registration statements) and in Forms 10-Q, 10-K and 8-K.

Hyperlinks for Documents Incorporated by Reference and Exhibits

Documents incorporated by reference into a filing, as well as exhibits listed in an exhibit index in a registration statement or report pursuant to Item 601 of Regulation S-K, must be hyperlinked to the incorporated document as filed on the SEC's EDGAR website, which we discuss later in this chapter. These hyperlinking rules streamline the filing process by allowing companies to link to previously filed documents. These rules also make it easier for investors and other market participants to find and access incorporated-by-reference documents and exhibits.

Companies should be careful to identify and include the required hyperlinks for documents incorporated by reference. However, companies do not need to file an amendment to a document solely to correct an inaccurate hyperlink; they can simply correct it on the next filing. While hyperlinks are required for material that is incorporated by reference, companies should use inactive textual references for any other websites, such as reports available on the company's investor relations website, to avoid such referenced websites being considered part of the filing.



Practical Tip: Build in Time to Add iXBRL Tags and Hyperlinks

Tagging inline interactive data accurately and consistently, and inserting hyperlinks in an EDGAR filing, adds extra steps to the filing process. Whether your company prepares filings internally using software that facilitates EDGAR filings or uses an outside service provider, be sure to build in time for the filing team to prepare and proof iXBRL tags and hyperlinks.

In particular, companies will want to consider the impact on timing in a few specific instances:

- The first time a company asks an outside service provider to file each type of report;

Practical Tip:
Build in Time to Add iXBRL Tags and Hyperlinks
(Cont'd)



- When the filing has a significant number of documents or exhibits incorporated by reference;
- If the filing is long or not a regular report; and
- When making more than one filing in sequence, and one or more earlier filings is incorporated by reference in the later filings.

Annual Report on Form 10-K

A public company must file an annual report on Form 10-K following the end of each fiscal year. The first Form 10-K is due 90 days after the end of the first fiscal year in which the issuer becomes subject to the periodic reporting requirements of the 1934 Act. (We summarize the filing deadlines for subsequent years earlier in this chapter.)

Information Included in Form 10-K

Form 10-K is the most comprehensive periodic report filed with the SEC. It includes much of the same information that is required in a registration statement filed for an IPO under the 1933 Act. Required information includes:

- A description of the company's business, including the general development of the business and the business done and intended to be done by the company;
- MD&A – management's discussion and analysis of financial condition and results of operations (discussed in more detail below);
- Qualitative and quantitative disclosure about market risks (smaller reporting companies are not required to provide this disclosure);

- A description of material legal proceedings;
- Full year-end audited financial information, including the independent auditor's opinion, in compliance with Regulation S-X, and a discussion of any material retrospective changes;
- Management's conclusions regarding the effectiveness of the company's disclosure controls and procedures as of the end of the fourth quarter; and
- Management's report on internal control over financial reporting and (for accelerated and large accelerated filers, other than emerging growth companies) the related independent auditor's attestation.

The following items, known as "Part III" information, are also required, but companies that file a proxy statement within 120 days after the end of the fiscal year may meet these requirements by including these items in the proxy statement and incorporating them by reference into the Form 10-K:

- Information regarding directors, executive officers and more than 5% beneficial owners, including compensation, transactions with related parties and security ownership;
- Identification of the company's Audit Committee financial expert or experts (if a company does not have at least one financial expert on its Audit Committee, the company must explain why);
- Identification of independent directors and committee members;
- Report of the Compensation Committee and any compensation committee interlocks (smaller reporting companies are not required to provide this disclosure);
- Disclosure of whether or not (and if not, why not) the company has adopted a code of ethics for its principal executive officer, principal financial officer and principal accounting officer or controller;
- Textual and tabular information regarding equity compensation plans; and

- Disclosure of the fees billed by the company's independent auditor for audit, audit-related, tax and other fees and of the Audit Committee's preapproval policy for audit and nonaudit services.

Signatures and Certifications

The company's principal executive officer, principal financial officer and principal accounting officer, along with at least a majority of the members of the company's Board, must sign the Form 10-K. (We discuss requirements for the use of electronic signatures later in this chapter.)

In addition, the CEO and CFO must each sign Section 302 certifications and a Section 906 certification for each Form 10-K.

MD&A

The heart and soul of the Form 10-K is MD&A, management's discussion and analysis of financial condition and results of operations. MD&A, governed by Item 303 of Regulation S-K, requires a discussion of liquidity, capital resources, results of operations and other information necessary to an understanding of the company's financial condition, changes in financial condition and results of operations.

In December 2003, the SEC issued detailed interpretive guidance regarding disclosure in MD&A, including key concepts that continue to be extremely helpful guidelines for the drafters of MD&A. In adopting amendments to Regulation S-K Item 303 that became effective in February 2021, the SEC underscored the 2003 guidance and codified it in part through a new section outlining the objective of MD&A. The following are key concepts for consideration in preparing MD&A.

Through Your Eyes: The Purpose of MD&A

- The purpose of MD&A is to "allow investors to view the registrant from management's perspective" and to pro-

vide readers with the information they need to readily understand the company's financial condition and performance.

Overall Presentation

- Include an executive-level overview to provide a context for the presentation of MD&A.
- Encourage top-level participation in the drafting process.
- Give the greatest prominence to the most important information.
- Omit duplicative information, like information already included in financial statement footnotes.

Focus and Content

- What are the key performance metrics that management uses to run the business? Identify and discuss them.
- Focus on material information and eliminate the immaterial.
- Disclose known trends and uncertainties and their impact on the company's prospects. (This is required MD&A disclosure – not just a best practice – and a healthy MD&A will provide a thoughtful CEO's-eye view of trends.)
- Explain management's view of the significance of the information presented.
- Where there have been material changes in one or more line items of the financial statements, discuss the underlying reasons for these material changes in quantitative and qualitative terms.

Substantive Guidance

- *Liquidity and Capital Resources.* Focus analysis on the company's ability to generate and obtain adequate cash to meet its requirements and plans for cash in both the short term (i.e., the next 12 months) and the long term (i.e., beyond the next 12 months). The discussion should identify trends, demands, commitments and uncertainties

relating to liquidity and capital resources, such as any trends or uncertainties relating to the ability to access the capital markets. In addition, the SEC has advised companies to consider disclosure, where material, regarding intraperiod variations in liquidity and capital resources (e.g., arising from the issuance of commercial paper), the company's cash and risk management policies and the nature and composition of the company's cash portfolio. Companies should also consider enhanced disclosure regarding debt instruments, guarantees and related covenants, such as leverage ratios.

- *Critical Accounting Estimates*. Provide information necessary to understand estimates made in accordance with GAAP that involve a significant level of estimation uncertainty and have had a material impact on financial condition or results of operations. While the MD&A amendments effective in February 2021 codified the requirement to discuss critical accounting estimates, the rules also clarify that this discussion should supplement, and not duplicate, the description of accounting policies disclosed in the notes to the financial statements.

Practical Tip:
Pick Up the Pen! Ask Your CEO or CFO to Draft an MD&A Overview



According to the 2003 SEC interpretive release, management should provide “early top-level involvement” in “identifying the key disclosure themes and items” to include in a company’s MD&A. These key themes should first appear in the “executive-level” overview. Although the content of an introduction or overview will depend on the circumstances of each particular company, the SEC suggests that a good overview will discuss:

- Economic or industrywide factors relevant to the company;
- How the company generates revenue, cash flow and net income;



Practical Tip:
**Pick Up the Pen! Ask Your CEO or
CFO to Draft an MD&A Overview (Cont'd)**

- The company's lines of business, locations of operations and principal products and services in a way that does not duplicate the Business section of the Form 10-K; and
- Material opportunities, challenges and risks, such as those presented by known material trends and uncertainties, on which the company's executive officers are most focused for both the short and long term, as well as the actions they are taking to address these opportunities, challenges and risks.

Ask your CEO or CFO to sketch out a one-page narrative or outline addressing these factors in his or her own words, or to discuss them with the principal MD&A drafter, to provide a "through the eyes of management" starting point for the MD&A overview.

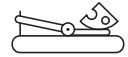
In the SEC's continuing focus on the quality of MD&A disclosure, it has re-emphasized the need to identify and analyze material trends, demands, commitments, events and uncertainties that could impact a company's liquidity, financial condition or operating results. This disclosure, the SEC believes, is critical to understanding a company's reported financial information and the extent to which reported information is indicative of future results or financial condition. SEC regulations require that MD&A focus on material events and uncertainties known to management that could cause reported financial information not to be indicative of future operating results or future financial condition. A disclosure duty exists where a trend, demand, commitment, event or uncertainty is both:

- Presently known to management; and
- Reasonably likely to have a material effect on a company's liquidity, financial condition or results of operations.

The “reasonably likely” threshold is higher than “possible” but lower than “more likely than not.” The SEC indicates that it expects disclosure of an identified trend, future event or uncertainty unless management concludes that either:

- It is not reasonably likely that the trend, event or uncertainty will occur or come to fruition; or
- The trend, event or uncertainty is not reasonably likely to have a material effect on the company’s liquidity, capital resources or results of operations.

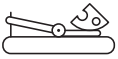
**Trap for the Unwary:
Caterpillar’s Samba with MD&A**



The year 1989 was a profitable one for the Brazilian subsidiary of Caterpillar Inc. It accounted for 23% of the earnings of the Peoria, Illinois, maker of heavy machinery engines. A number of nonoperating gains caused by hyperinflation and currency exchange rates contributed to the strong year.

In its 1989 Form 10-K, as in years past, Caterpillar presented its financial results on a consolidated basis, melding the Brazilian subsidiary with the rest of the company. Its MD&A did not discuss the extent to which Caterpillar’s 1989 earnings were derived from the subsidiary. Moreover, neither the Form 10-K nor Caterpillar’s Form 10-Q for the first quarter of 1990 discussed what seemed to be known risks faced by the Brazilian subsidiary arising from possible economic reforms in Brazil that could have had a material adverse effect on the subsidiary’s financial performance and the overall financial performance of Caterpillar.

When, in June 1990, Caterpillar announced that new economic policies in Brazil would hurt the company’s overall earnings, its stock price plummeted by 16%.



**Trap for the Unwary:
Caterpillar's Samba with MD&A (Cont'd)**

The SEC charged Caterpillar with disclosure violations in a proceeding that centered on the MD&A section of the company's 1989 Form 10-K and first-quarter 1990 Form 10-Q. In the SEC's interpretive release, which it still refers to today for MD&A guidance, the SEC described Caterpillar's MD&A disclosure as deficient in that:

- Caterpillar's Form 10-K should have discussed the impact of the Brazilian subsidiary's earnings on Caterpillar's overall results of operations; and
- Both the Form 10-K and the Form 10-Q should have discussed future uncertainties regarding the subsidiary's operations, the possible risk of Caterpillar's having materially lower earnings as a result of that risk, and, if practicable, the quantifiable impact of the risk.

Caterpillar's experience reminds us that an MD&A that provides a view of the company "through the eyes of management" will:

- Transparently describe the contributions of subsidiaries, divisions or sectors;
- Disclose the risks, trends or uncertainties that may affect future financial performance, identifying them as they develop; and
- Quantify, where possible, the potential consequences of these risks.

Incorporation by Reference

Most companies' Form 10-Ks incorporate portions of the "glossy" annual report to shareholders and the proxy statement by reference, without repeating the incorporated information. For example, companies generally incorporate by reference from the proxy statement all compensation information and related person transactions regarding directors and officers, known as "Part III" information. (We describe this information in this chapter under "Annual Report on Form 10-K.") This is permitted even though the proxy statement is filed later than the Form 10-K.

Incorporation by reference requires that:

- All the incorporated information be included in a definitive proxy statement that involves the election of directors;
- The company file its definitive proxy statement within 120 days after the end of the fiscal year covered by the Form 10-K; and
- The Form 10-K specifically identify the incorporated material by page, paragraph, caption or otherwise.

The Form 10-K may also incorporate by reference the "glossy" annual report to shareholders. If so, the company must file the annual report with the SEC as an exhibit to the Form 10-K. (We discuss both the glossy annual report and the proxy statement in greater detail in Chapter 7.)

Risk Factors and the Safe Harbor

Most companies are required to include disclosure of risk factors in their Form 10-Ks. Risk factor disclosure involves a discussion of material circumstances, trends or issues that may affect the company's business, prospects, future operating results and financial condition, making an investment in the company speculative or risky. The SEC discourages including risks that could apply generically to any company, and requires companies to organize the risk factor section with headings and subcaptions.

Companies are also encouraged to make risk factor disclosures concise. If the risk factors are longer than 15 pages, a summary of no more than two pages must be provided. This risk factor disclosure requirement does not extend to smaller reporting companies, although these companies will want to consider including this disclosure for the reasons discussed below.

Although the SEC discourages companies from unnecessarily repeating the risk factors in their Form 10-Qs, companies filing Form 10-Qs will need to consider on a quarterly basis whether there have been any material changes from their Form 10-Ks. If a risk factor is updated in a Form 10-Q, the updated risk factor will need to be included in each subsequent Form 10-Q until the next Form 10-K is filed.

Even if not mandated to include risk factors, many issuers include risk factors in 1934 Act reports to take advantage of the safe harbor provided by Section 21E of the 1934 Act. Section 21E provides a public company with a safe harbor defense in securities litigation challenging a forward-looking statement made by the company. To fall within the safe harbor, the forward-looking statement must be identified as a forward-looking statement and be accompanied by meaningful cautionary language that, in the case of written statements, identifies important factors that could cause actual results to differ materially from those projected in the forward-looking statement. (We discuss and provide practical tips for using these safe harbors in Chapter 5.)

Periodic reports usually include forward-looking statements, particularly in the MD&A section where the SEC encourages disclosure of forward-looking information. Risk factors accompanying these forward-looking statements will provide the meaningful cautionary language that identifies important factors that could cause actual results to differ from projected results. In addition, the company can protect oral forward-looking statements under the safe harbor provisions of Section 21E of the 1934 Act by referring to the risk factors disclosed in the most recent Forms 10-K and 10-Q.

Form 10-K Exhibits

Some of the most valuable sources of information about a public company are the exhibits to its Form 10-K. Item 601 of Regulation S-K identifies the documents to be filed as exhibits. Companies generally incorporate by reference documents that they have previously filed as exhibits to other SEC filings. As mentioned previously, a filing that incorporates an exhibit by reference must include a hyperlink to the previously filed exhibit.

The most significant category of documents that must be filed as exhibits to Form 10-K is material contracts. All material contracts made outside the ordinary course of business must be filed as exhibits. If a contract was made in the ordinary course of business, it does not have to be filed unless it is material and falls within one of the following categories:

- A contract with a director, officer or shareholder named in the report;
- A contract on which the company is substantially dependent;
- Any contract involving the acquisition or sale of property, plant or equipment for consideration exceeding 15% of the company's fixed assets;
- Any material lease; or
- A management contract or compensatory plan for a director or executive officer that is not generally available to all employees.

Immaterial exhibits and schedules attached to any document required to be filed as an exhibit under Item 601 may be excluded from the exhibit filing. The document must include a list identifying the contents of the omitted exhibits and schedules. In addition, the company can redact or seek confidential treatment for certain redacted items under specific circumstances. (We discuss redaction and confidential treatment later in this chapter.)

Quarterly Reports on Form 10-Q

Public companies file a quarterly report on Form 10-Q after the end of each of their first three fiscal quarters. (We summarize the filing deadlines earlier in this chapter.) Companies that go public during a quarter must file a Form 10-Q that covers the entire quarter in which the 1933 Act registration statement becomes effective.

Information Included in Form 10-Q

Form 10-Q generally includes:

- Unaudited interim financial statements in compliance with Regulation S-X;
- MD&A;
- Qualitative and quantitative disclosure about market risks (smaller reporting companies are not required to provide this disclosure);
- Management’s conclusions regarding the effectiveness of the company’s disclosure controls and procedures as of the end of the quarter; and
- Any changes in the company’s internal control over financial reporting during the quarter that have materially affected, or are reasonably likely to materially affect, the company’s internal control over financial reporting.

In addition, a company will disclose specific events that occurred during the quarter, including:

- Material changes to the risk factors included in the Form 10-K; and
- Material legal proceedings and material developments during the quarter in previously reported legal proceedings.

Signatures and Certifications

A duly authorized officer signs a Form 10-Q on behalf of the company, as does either its principal financial or chief accounting officer. Unlike the Form 10-K, the Form 10-Q does not require CEO or Board signatures. (We discuss requirements for the use of electronic signatures later in this chapter.)

Although the CEO does not necessarily sign the Form 10-Q, the CEO and CFO each sign Section 302 certifications and a Section 906 certification for each Form 10-Q.

Form 10-Q Exhibits

Item 601 of Regulation S-K identifies the documents that must be filed as exhibits to Form 10-Q. Companies may and generally do incorporate previously filed exhibits by reference.

Missed Form 8-K Filings

Form 10-Q must identify any information required to be disclosed in a Form 8-K during the quarter but not reported.

Current Reports on Form 8-K

Form 8-K is a current report filed between quarterly and annual reports to provide the public with information on recent material events. Form 8-K disclosure is mandatory if specified events occur. In addition, many companies make optional filings on Form 8-K to ensure maximum public disclosure of material developments. A duly authorized officer of the company signs the Form 8-K.

Mandatory Filing

Appendix 2 contains a complete list and description of the items a company is required to report on Form 8-K. These items include:

- Entry into or termination of, or material amendment to, material agreements;
- Significant acquisitions or dispositions;
- Specified financial information, including earnings releases, creation of direct financial obligations or off-balance sheet arrangements and events that accelerate or increase those obligations or arrangements, costs associated with exit and disposal activities and material impairments;
- Information regarding the company's securities and trading markets, including delisting notices or failure to satisfy listing standards, sales of unregistered securities and material modifications to rights of security holders;
- Matters relating to accountants and financial statements, including changes in the independent auditor and restatements of financial statements;
- Bankruptcy or receivership;
- Information regarding corporate governance and management, including change of control of the company; departures or appointments of directors and executive officers; entry into, adoption of or material amendments or modifications to material compensation agreements; amendments to the company's charter documents, amendments or waivers to the company's code of ethics and suspension of trading under employee benefit plans; and
- The results of matters submitted to a vote of the company's shareholders.

Optional Filing

A company may elect to voluntarily report other material events under Item 8.01 of Form 8-K.

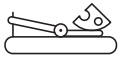
Regulation FD Disclosure

Regulation FD requires that when a public company discloses material nonpublic information to certain shareholders and investment professionals, it must also simultaneously make general public disclosure of that information. Regulation FD public disclosure requirements may be met by reporting the information under Item 8.01 or Item 7.01 of Form 8-K. (We discuss Regulation FD in detail in Chapter 5.)

Information provided under Item 7.01 (and Item 2.02) of Form 8-K is considered “furnished” rather than “filed.” As a result, this information will not be subject to liability under Section 18 of the 1934 Act and will not be incorporated by reference into shelf registration statements filed under the 1933 Act.

Form 8-K Exhibits

Companies file exhibits with Form 8-K to the extent required by Form 8-K or Item 601 of Regulation S-K.



**Trap for the Unwary:
Best Practice May Be to File Material Agreement as
Exhibit to Form 8-K When Practicable**

The SEC encourages, but does not require, companies to file a copy of the reported material definitive agreement as an exhibit to the Form 8-K. A company will file any agreement not filed as a Form 8-K exhibit as an exhibit to the company's next periodic report or registration statement.

Because the Form 8-K disclosure must contain sufficient information not to be misleading and must not contain any material misstatements or omissions, your company should take steps to ensure that it discloses all material information concerning an agreement on Form 8-K. To ensure compliance with this requirement, many companies file agreements with Form 8-K, where practicable, to ensure that the disclosure is complete. However, if you seek confidential treatment of the agreement, you must submit your request for confidential treatment of sensitive information no later than the date on which you file the Form 8-K that includes the agreement.

Timing

Companies must file mandatory Form 8-Ks generally within four business days of the reported event and “promptly” file an optional report made pursuant to Item 8.01 after the triggering event. Regulation FD establishes timelines for filing a report made to satisfy Regulation FD requirements. (We discuss Regulation FD in detail in Chapter 5.)

Limited Safe Harbor from Rule 10b-5 Liability. Because several of the Form 8-K disclosure items require management to quickly assess the materiality of an event or to determine whether a disclosure obligation has been triggered, the SEC provides a limited safe harbor from claims under Section 10(b) of the 1934 Act and Rule 10b-5 under the 1934 Act for failure to timely file a Form

8-K. (We discuss Section 10(b) and Rule 10b-5 in Chapter 13.) The safe harbor applies only to these items of Form 8-K:

- Entry into, material amendment to or termination of a material definitive agreement;
- Creation of a direct financial obligation or an obligation under an off-balance sheet arrangement, and triggering events that accelerate or increase these obligations or arrangements;
- Costs associated with exit and disposal activities;
- Material impairments;
- The company's determination that previously issued financial statements should no longer be relied on due to an error; and
- Entry into or adoption of, or material amendments or modifications to, material compensation arrangements, including material grants or awards made pursuant to the arrangements.

The safe harbor extends only until the due date of the next 1934 Act report for the period in which the Form 8-K was not timely filed. The safe harbor does not provide protection against, and the SEC may still bring, enforcement actions against the company under other 1934 Act rules for failure to timely file Form 8-Ks.

Failure to Timely File May Affect Form S-3 Eligibility. A company that fails to timely file a mandatory Form 8-K generally will lose its eligibility for a period of 12 months to use Form S-3, which is a streamlined registration statement form. (We discuss this registration statement in Chapter 12.) However, companies that fail to file timely reports on Form 8-K required solely by the Form 8-K items for which the limited safe harbor described above applies will not lose their eligibility to use Form S-3. A company must be current in its Form 8-K reports, and have filed the disclosure required by any of these Form 8-K items, on or before the date on which it files a Form S-3.

Practical Tip:
**Integrate Form 8-K Filing Requirements with Disclosure
Control Mechanisms**



To meet the challenges of real-time reporting on Form 8-K, management should work with your company's Disclosure Practices Committee to monitor your company's disclosure controls and procedures. They should consider whether to design and implement new controls and procedures to ensure that someone at your company identifies and evaluates information about events that may be reportable on Form 8-K, and does so in a timely way.

Here are some useful steps to help you assess and consider improvements to existing disclosure controls and procedures:

- Identify officers and others to whom the Board has delegated authority to execute material agreements or otherwise take actions that trigger Form 8-K disclosure obligations. Consider limiting the number of people who have authority to act on your company's behalf, and periodically remind this core group to be aware of when their actions can trigger a Form 8-K filing, and how the specific terms of an agreement can affect disclosure requirements.
- Evaluate current procedures for monitoring company-wide contracting and compensation activities and events relating to existing contracts and compensatory arrangements. If current monitoring does not occur continuously or at least daily, consider implementing more frequent monitoring.
- Reconsider the size and composition of your company's current Disclosure Practices Committee. Consider forming a smaller "rapid response" subcommittee for Form 8-K disclosure to improve response time.

**Practical Tip:
Integrate Form 8-K Filing
Requirements with Disclosure
Control Mechanisms (Cont'd)**



- Analyze current lines of communication from investor relations and each major function, including information security, to and from the Disclosure Practices Committee (or your company's general counsel or other appropriate person who staffs the Committee). Do the Investor Relations, Finance and other key groups understand these lines of communication? Have you built sufficient redundancy into the system to ensure that information flows to and from the Disclosure Practices Committee, even if one or more of the persons in the line of communication are unavailable?
- Evaluate existing procedures for identifying required disclosures for quarterly and annual reports. Consider whether additional procedures should be added to ensure that any missed Form 8-K disclosures are included in the Form 10-Q or 10-K.
- Review your company's current material agreements that have been filed as exhibits to reports on Form 10-K, 10-Q or 8-K. Are these all still material?



**Practical Tip:
Allow Plenty of Time for Preparation
of Conflict Minerals Report on Form SD**

In 2012, the SEC adopted the Conflict Minerals Disclosure Rule pursuant to the Dodd-Frank Act. This rule applies to a reporting company that uses conflict minerals that are necessary to the functionality or production of a product it manufactures or contracts to be manufactured. A company that used conflict minerals in the most recent calendar year must file a report on Form SD by May 31 of each year.

Form SD disclosure requirements vary depending on the circumstances for the particular company and product. The basic requirement is that a company perform a “reasonable country of origin” inquiry to determine whether any of the minerals originated in the Democratic Republic of the Congo or an adjoining country. Additional disclosure requirements apply if the company determines that any of its necessary conflict minerals originated in the Democratic Republic of the Congo or an adjoining country.

The reasonable country of origin inquiry and due diligence processes relating to supply chain source and chain of custody can be time and labor intensive. A company that will be subject to the Conflict Minerals Disclosure Rule should begin the inquiry and implement a compliance program well in advance of preparing its first Form SD report.

Following litigation over the constitutionality of the Form SD requirements, the SEC’s Division of Corporation Finance announced in 2017 that it would not take enforcement action against companies that do not satisfy the requirements under paragraph 1.01(c) of Form SD, including the detailed supply chain due diligence disclosure, Conflict Minerals Report and independent private sector audit.

Confidential Information: Redaction and Confidential Treatment Requests

The 1934 Act sometimes calls for the disclosure of information that a company wants to keep confidential, because disclosure may adversely affect the company's business and financial position or because the information is otherwise personally sensitive. The process for redacting or obtaining confidential treatment depends on the type of information and where the information is located. Potential disclosure of confidential information typically arises with respect to exhibits required to be filed under Regulation S-K Item 601.

Personally Sensitive Information

Personal or private information, such as bank account numbers or personal home addresses, may be redacted by the company without any other action required.

Material Contracts and Plans of Acquisition, Reorganization, Liquidation or Succession

If confidential information is located in a material contract being filed pursuant to Regulation S-K Item 601(b)(10), or in a plan of acquisition, reorganization, liquidation or succession being filed pursuant to Regulation S-K Item 601(b)(2), a company may redact such information without prior SEC approval if such redacted information is both customarily treated by the company as confidential and not material. The company must mark the exhibit index to indicate that certain identified information has been omitted, include a prominent statement on the first page of the redacted exhibit that certain information has been excluded for such reasons, and within the exhibit itself indicate by brackets where information is omitted.

The SEC can still request an unredacted copy of the exhibit as well as the materiality analysis conducted by the company to justify the company's decision to redact the confidential information, and if it disagrees with the redaction, can request the com-

pany to amend its filing to include the updated exhibit. The tips that follow regarding redactions, including limiting the amount of information that is redacted and material the SEC generally does not consider to be confidential, also apply to redactions made to exhibits without prior SEC approval.

All Other Information

In all other cases, a company must make a confidential treatment request (CTR). The company submits a CTR application to the SEC on paper, not electronically, and includes a copy of the relevant exhibit that identifies its confidential portions. Simultaneously, the company files a redacted version of the exhibit electronically with the 1934 Act report. The SEC reviews and comments on the CTR application, sometimes requiring an amended application in response to its comments.

Steps to submitting a successful confidential treatment request include:

- *File It on Time.* Any CTR must be made no later than the date the 1934 Act report is filed.
- *Find Your FOIA Exemption.* To receive confidential treatment, information must fall within one of nine exemptions articulated in the Freedom of Information Act. Most companies rely on the exemption that covers trade secrets and commercial or financial information.
- *Be Reasonable.* Generally redact only dollar amounts or formulas rather than entire sections of a contract. At times, when disclosing the existence of a section would be commercially harmful, it is appropriate to redact the full section.
- *State Your Case.* Describe those aspects of the company's business or the specific contract that will allow the SEC to evaluate the sensitivity and importance of the information.

- *Be Aware of Off-Limits Information.* The SEC usually will not grant confidential treatment for information material to investors, nor will confidentiality be appropriate for Regulation S-K disclosure or any other applicable disclosure requirement.
- *Watch for Inadvertent Disclosure of Confidential Information.* Once the confidential information becomes publicly available, even if inadvertently, the company will not be able to receive confidential treatment for the disclosed information.
- *Specify Duration for Confidential Treatment.* Confidential treatment beyond the term of an agreement usually is inappropriate, although the company can file an additional CTR to extend the initial period.

SEC Review of 1934 Act Reports

Sarbanes-Oxley requires the SEC to review a company's 1934 Act reports at least once every three years. The SEC may review a company's 1934 Act reports more frequently, however, often as part of an initiative to monitor specific companies. At other times, the SEC uses review to address specific issues (e.g., disclosure of non-GAAP financial measures, results of operations, "critical accounting policies" and liquidity in MD&A or revenue recognition). The SEC may also review 1934 Act reports in connection with its review of a company's 1933 Act registration statements.

Any SEC review may generate a comment letter to the company. The company addresses the comments in a response letter to the SEC. Ultimately, the comment process could cause the company to amend the reviewed report.

Accelerated filers, large accelerated filers and well-known seasoned issuers (discussed in Chapter 12) must disclose in their Form 10-Ks written comments from the SEC in connection with a review of a 1934 Act report that:

- The company believes are material;

- Were issued more than 180 days before the end of the fiscal year covered by the Form 10-K; and
- Remain unresolved as of the date of the filing of the Form 10-K.

The disclosure must be sufficient to convey the substance of the comments. Companies may provide additional information, including their positions regarding any unresolved comments.



Practical Tip:
Look to SEC Comment Letters for Disclosure Guidance. But Watch Out: Your Response Letters Are Public Too!

The SEC publicly releases SEC comment letters and company response letters on the SEC's EDGAR website. Letters are released by the SEC no earlier than 20 business days after the review of the disclosure filing is complete.

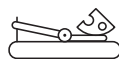
Although the SEC notes that comment letters reflect only the SEC staff's position on a particular filing, do not apply to other filings and are not the official expressions of the SEC, the availability of comment and response letters can be a valuable resource to your company's disclosure team. Prior to making a filing, you will be able to review comments made on similar filings and potentially avoid issues encountered by other companies.

But remember, your response letters will be public too! Before submitting a response letter to the SEC, consider whether your letter includes confidential information that should be protected from public disclosure. If so, work with your counsel to develop an appropriate CTR for the portion of your response letter that contains confidential information.

Amending 1934 Act Reports

Amendments to Form 10-K, 10-Q and 8-K filings bear the letter “A” after the title of the form being amended (e.g., Form 10-Q/A). The amendment sets forth the complete text of the item that is being amended. For example, if Item 1 of Form 10-K (Business) is the only item that requires amendment, the filing need only include Item 1, but it must include the complete text of Item 1. Amendments are signed on behalf of the company by a duly authorized representative.

Trap for the Unwary: Include CEO and CFO Certifications with Amendments When Required



Section 302 certifications are required with amendments to Forms 10-K and 10-Q. You may omit the certification paragraph regarding the accuracy of the financial statements if no financials or other financial information is included with the amendment, and you may omit the paragraphs regarding disclosure controls and procedures and the evaluation of internal control over financial reporting if the amendment does not contain or amend disclosures regarding controls and procedures.

Section 906 certifications are required with an amendment to Form 10-K or 10-Q only if the amendment contains financial statements or other financial information.

Applying Plain English Rules to 1934 Act Disclosure

Historically, the SEC’s plain English rules applied only to prospectuses filed pursuant to the 1933 Act. However, the SEC encourages plain English drafting in all SEC filings, and has mandated it in 1934 Act risk factors and disclosures in 1934 Act reports regarding executive compensation, security ownership, related person transactions and corporate governance. As a result, many companies now use plain English throughout their

1934 Act documents. Companies should strongly consider converting their entire Form 10-K (and other periodic reports) to the plain English style.

Drafting in Plain English

Draft a plain English document in a clear, concise and understandable manner. Design the text to be visually inviting and easy to read. The SEC provides these guidelines:

- Present information clearly and concisely, using short sentences and bullet lists whenever possible;
- Use descriptive headings and subheadings;
- Avoid frequent reliance on defined terms and glossaries;
- Avoid legal jargon, boilerplate language and highly technical business terminology;
- Use the active voice and definite, concrete and everyday language; and
- Use tabular presentations or bullet lists for complex material.

A highly accessible SEC guide to drafting plain English documents is “A Plain English Handbook: How to Create Clear SEC Disclosure Documents,” available on the SEC’s website at <https://www.sec.gov/reportspubs/investor-publications/newsextrahandbookhtm.html>. The Warren Buffett preface alone is a quick, amusing and useful read.

The EDGAR Filing System

Most documents filed with the SEC, including periodic reports on Forms 10-K, 10-Q and 8-K, must be filed electronically via the SEC’s Next-Generation EDGAR (Electronic Data Gathering, Analysis, and Retrieval) system. Documents filed via EDGAR are available promptly on the SEC’s website.

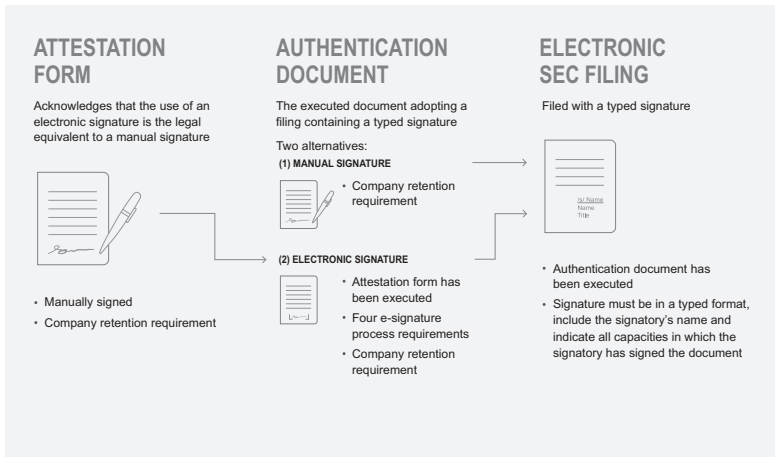
Companies can obtain the SEC's software package and submit filings directly with the SEC or use an outside service provider, such as a financial printing company, to convert SEC filings to the EDGAR format and file the documents on the EDGAR system. Prior to making filings on EDGAR, a company must apply to the SEC for a unique identification number, known as a CIK (Central Index Key) code, and a confidential password to enable the company to log into, and be identified by, the EDGAR system.

Regulation S-T contains the rules and procedures for filing via EDGAR and supersedes many requirements in other SEC regulations and forms.

Signatures for Electronically Submitted SEC Filings

Rule 302(b) of Regulation S-T and the EDGAR Filer Manual set forth rules and procedures for including signatures with electronically submitted filings. In 2020, the SEC modernized these rules by allowing electronic signatures on the signature page or other document (which the SEC refers to as an "authentication document") that adopts the signature appearing in typed form within the electronic filing, provided that (1) the signatory has previously signed (in wet ink) a document attesting to their agreement to the use of electronic signatures, and (2) the e-signature process used by the company meets four process requirements designed to ensure verification and security, including through authentication and nonrepudiation. Companies can also continue

to rely on manually signed (i.e., “wet ink”) authentication documents. The following diagram summarizes the signature process.



Liabilities Relating to Periodic Reporting

Public companies and their officers and directors face potential personal liability resulting from the failure to make required periodic reports or from making materially misleading statements in them. Companies and individuals can be subject to SEC enforcement actions or private civil actions, including class actions and derivative actions. (We discuss these liabilities in Chapter 13.)

Practical Tip:
Join a Board but Consider Your Timing



Directors who join a Board shortly before the company files a 1934 Act report may be concerned about potential liability associated with the report, especially if they must sign a Form 10-K. Directors can take steps to minimize this liability and still meet their responsibilities:

- If you are comfortable that you can assimilate the company's business, schedule as many meetings with the company's management and independent auditor as necessary. Sign the report only if you believe that you understand the company and the information in the report.
- If there is not enough time to conduct a sufficient review, wait to join the Board until after the company files the report.
- Join the Board but decline to sign the first Form 10-K report. (Directors are not required to sign a Form 10-Q, and only a majority of the members of the Board need sign the Form 10-K.)

Failing to comply with all securities laws requirements for periodic reporting may also cause an issuer to lose eligibility to use short-form 1933 Act registration statements. (We discuss these registration statements and their advantages in Chapter 12.)

Chapter 5

Finding Your Voice: Disclosure Practices for Non-GAAP Financial Measures and Regulations FD and M-A

Managing disclosures to shareholders and to the “street” – equity analysts, investment professionals and the financial press – presents CEOs, CFOs and investor relations officers (IROs) with the daily challenge of controlling the uncontrollable: human communication.

Mandatory and Voluntary Disclosures

Many of an issuer’s disclosures are *mandatory*. The 1933 and 1934 Acts, as well as SEC and stock exchange rules, all require a variety of periodic reports and other filings. In addition, issuers make *voluntary* disclosures – sharing news or facts with the market as part of a financial public relations strategy. The SEC has set forth ground rules for disclosures of non-GAAP financial measures in Regulation G (GAAP), Item 10(e) of Regulation S-K and related interpretations, as well as for other voluntary statements with Regulation FD (Fair Disclosure) and Regulation M-A (Mergers and Acquisitions).

Public companies are not generally required to publicly disclose all material information at all times. But there are so many “triggers” of mandatory disclosure that it can seem like it! Mandatory disclosures must be made:

- In any 1933 Act registration statement, beginning with an IPO prospectus on Form S-1 and later in a Form S-3 or other forms;

- In every 1934 Act annual or quarterly report (Form 10-K or 10-Q);
- For every event for which Form 8-K (the 1934 Act “current” report) requires disclosure;
- Any time a company is in the marketplace to buy or sell its stock (referred to as the “disclose or abstain” rule);
- When a company needs to confirm or correct a rumor that began with information leaked from the company, causing unusual trading activity likely to impact the marketplace;
- When required by stock exchange requirements (Chapters 9 and 10 describe how the NYSE and Nasdaq call on companies to promptly release material information and dispel unfounded rumors); and
- To update prior statements that the market considers current or “evergreen,” but which the passage of time has rendered inaccurate or incomplete.

Specific SEC regulations and interpretations cover three key categories:

- Regulation G, Item 10(e) of Regulation S-K and SEC Compliance and Disclosure Interpretations (referred to as SEC interpretations or C&DIs) cover the disclosure of non-GAAP financial measures;
- Regulation FD covers the intentional or inadvertent disclosure of material nonpublic information; and
- Regulation M-A requires target companies and acquirers in mergers and acquisitions to file all their written communications on the date of first use.

Virtually all other communications, both formal and informal, by a public company – such as holding earnings calls, attending analyst conferences, posting information on a company website or social media account, and discussions with analysts, investors or the press – are *voluntary*.

“Mind the GAAP” – Presenting Non-GAAP Information

Non-GAAP financial measures are voluntary disclosures made by companies to provide investors and analysts with a better understanding of their business. Recently, Audit Analytics determined that over 97% of S&P 500 companies use at least one non-GAAP metric in their financial statements. Initially with Regulation G, and increasingly with interpretive releases in the late 2010s, the SEC has set bounds around the use and presentation of non-GAAP measures. By *non-GAAP financial measures*, the SEC means any numerical measure of historical or future performance, financial position or cash flow that a company creates by adjusting a comparable GAAP measure, generally by selectively eliminating or including specific metrics.

For example, non-GAAP financial measures include adjusted earnings before interest, taxes, depreciation and amortization (EBITDA), adjusted free cash flow, net debt or other similar measures. Where business or operational performance metrics – often known as key performance indicators or KPIs – are calculated on a non-GAAP basis, they are considered non-GAAP metrics for purposes of Regulation G and Item 10(e) of Regulation S-K. However, metrics that are based on operating and statistical data alone, such as same-store sales or the number of employees, will not be considered non-GAAP measures. Similarly, ratios calculated using only GAAP financial measures are not included in the definition of non-GAAP measures.

Non-GAAP financial measures have in recent years been the most frequent subject of SEC comment letters, largely due to their increased use and prominence. While non-GAAP measures can provide valuable information, the SEC has sought, through its interpretations and comment letters, to establish guardrails limiting the risk that such measures mislead investors.



Practical Tip:
Key Performance Indicators and Other Metrics
as Part of MD&A Disclosure

In interpretive guidance, the SEC has noted that it may be necessary for issuers to disclose certain financial and operating metrics – such as KPIs – used by management in managing the business as material information, particularly as part of their management’s discussion and analysis (MD&A) in periodic reports. To the extent such metrics are presented, issuers should carefully consider including the following disclosures to avoid misleading investors, which apply even if the metric is not a non-GAAP measure:

- Provide a clear definition of the metric and how it is calculated;
- Include a statement indicating why the metric is useful to investors and how management uses the metric in managing the business;
- Consider whether any estimates or assumptions underlying the metric need to be disclosed in order for the metric not to be misleading; and
- Consider whether any differences in presentation or calculation from previous years need to be explained or whether prior metrics need to be recast, given the differences.

Public Disclosures

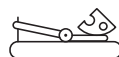
All public releases of material information that contain a non-GAAP financial measure – whether in writing; orally; telephonically; on blogs, social media or websites; or in a webcast – must comply with Regulation G and related interpretations and rules, which require a company to:

- *Reconcile to GAAP.* In any release of non-GAAP financial information, and usually when incorporating by reference a document that contains non-GAAP financial information, companies must present the most

directly comparable GAAP information and a reconciliation of the non-GAAP information to the GAAP information.

- *Comply with Regulation S-K Requirements for “Filed” Information.* In any disclosure of non-GAAP financial information that is filed (as opposed to furnished) with the SEC, companies must comply with the stricter Regulation S-K requirements under Item 10(e).

**Trap for the Unwary:
Regulation G Rules
Apply to All Public Communications**



When publicly disclosing non-GAAP information, whether in a press release, analyst call or slide show from an investor conference, provide the required reconciliation to the most directly comparable GAAP information in the disclosure. For an oral disclosure, you can do this by:

- Posting the reconciliation on your company’s website; and
- Providing the website address during the oral presentation. The SEC expects companies to present non-GAAP information consistently in all public disclosures, whether filed or not. Be cautious about disclosing non-GAAP financial measures that you are not prepared to include in your Form 10-K or 10-Q filings.

SEC-Filed Documents

Item 10(e) of Regulation S-K, like Regulation G, requires that companies reconcile the differences between non-GAAP financial measures and the most directly comparable GAAP financial measures in any filings with the SEC. Item 10(e) of Regulation S-K, which applies only to SEC-filed documents, also requires:

- *Prominence.* Companies must present the comparable GAAP financial measure with prominence that is

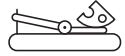
equal to or greater than that given to the non-GAAP financial measure. (For example, headers of earnings releases that contain a non-GAAP number should also contain the comparable GAAP number.)

- *Explanation.* Management must disclose the reasons it believes the non-GAAP financial measure is useful and, to the extent material, any additional purposes for its use of the non-GAAP financial measure.

And Item 10(e) of Regulation S-K prohibits:

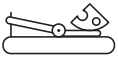
- *Other Than EBIT or EBITDA, Liquidity Measures Excluding Charges or Liabilities Requiring Cash Settlement.* Companies may use earnings before interest and taxes (EBIT) and earnings before interest, taxes, depreciation and amortization (EBITDA), but otherwise should not present *liquidity* measures that exclude charges or liabilities requiring settlement of these amounts in cash.
- *Smoothing.* Companies should not adjust non-GAAP *performance* measures to smooth nonrecurring or unusual items when the nature of the charge or gain is reasonably likely to recur within two years or a similar charge or gain occurred in the previous two years. However, even when an item meets the “within two years” criteria, companies can produce a non-GAAP financial measure that adjusts for a nonrecurring or unusual charge or gain if appropriate, as long as the company does not describe it as nonrecurring, infrequent or unusual.
- *Non-GAAP Financial Statements on Face.* Companies should not present non-GAAP financial measures on the face of financial statements, notes to financial statements or pro forma financial statements.
- *Confusingly Similar Titles.* Companies should use titles or descriptions for non-GAAP financial measures that are clearly different from titles or descriptions used for GAAP financial measures.

**Trap for the Unwary:
SEC Guidance on Non-GAAP Financial Measures:
Don't Mislead Investors!**



Non-GAAP measures should be used to present investors and analysts with a more accurate understanding of the company, not merely a more favorable one, the SEC staff has stated. When presenting non-GAAP financial information, companies should be cautious that the measures they present do not mislead investors by avoiding:

- *Misleading Adjustments.* Even if not prohibited explicitly, certain adjustments that make a non-GAAP number misleading would violate the rules. For example, presenting a measure of performance that excludes normal, recurring cash operating expenses necessary to operate the company's business could be misleading, because this would not present investors with complete information on the expenses necessary to run the business.
- *Inconsistent Presentation.* Be consistent between time periods! If certain types of charges or gains are adjusted for in one period, similar charges or gains should be subsequently adjusted for in the subsequent period.
- *Selective Exclusions.* Selectively excluding nonrecurring charges, but not excluding nonrecurring gains, can make the non-GAAP measure misleading.



**Trap for the Unwary:
SEC Guidance on Non-GAAP Financial Measures:
Don't Mislead Investors! (Cont'd)**

- *Individually Tailored Metrics.* If a company substitutes its own revenue recognition and measurement methods for GAAP measures, it may be misleading to investors.

Regulation FD's Mandate: Share and Share Alike

Senior executives strive to maintain a dialogue with professional analysts, the financial press and major shareholders to help market professionals follow their company's stock and to provide shareholders with access to management. Reports that equity analysts write and distribute to their customers in turn encourage investor interest. Yet private discussions with analysts and major investors can create an imbalance of information, and absent Regulation FD, detailed private discussions could provide institutional shareholders and professional analysts more in-depth information than other investors receive. Regulation FD is the SEC's effort to create a level playing field.

Regulation FD promotes fair play by requiring issuers to widely share information that would otherwise be disclosed selectively to a mere handful of market professionals. Specifically, Regulation FD requires a company to inform the public when the company, or a person acting on its behalf, voluntarily discloses material nonpublic information to securities market professionals or to security holders when it is reasonably foreseeable that the holders will trade on the basis of that information.

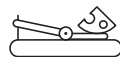
The timing of the company's required public disclosure depends on whether its voluntary selective disclosure was intentional or unintentional.

- If *intentional*, the company must make public disclosure of material information *simultaneously* with any selective disclosure. In practice, companies publicly distribute material information prior to disclosing it to a limited audience.

- If *unintentional*, the company must make public disclosure *promptly* after the inadvertent disclosure of material information. *Promptly* means by the later of:
 - 24 hours after the unintentional disclosure; or
 - If the next trading day does not begin for more than 24 hours, prior to the beginning of the next trading day.

(The SEC's 24-hour clock begins at the moment a senior official of a company learns of the unintentional disclosure and recognizes the disclosed information to be both material and nonpublic.)

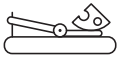
**Trap for the Unwary:
IROs Cannot "Go with the Flow" – SEC Penalizes
Private Reaffirmation of Earnings Guidance**



In a series of public statements from February to October, Flowserve Corporation reduced its full-year earnings projections by more than 30%. During a private meeting in November, Flowserve's CEO responded to an analyst's question by reaffirming the October earnings projections. The CEO's response was contrary to the company's disclosure policy:

Although business conditions are subject to change . . . the current earnings guidance was effective at the date given and is not being updated until the company publicly announces updated guidance.

Flowserve's IRO, present at the meeting, remained silent, and the company did not file a Form 8-K or issue a press release at that time. The day after, the stock price and trading volume increased substantially, and the SEC concluded that the CEO's reaffirmation was material information.



**Trap for the Unwary:
IROs Cannot “Go with the Flow” – SEC Penalizes
Private Reaffirmation of Earnings Guidance (Cont’d)**

Lessons Learned?

- As an IRO, speak up! Interrupt your CEO and fellow officers if you need to enforce your Regulation FD policy. Set boundaries based on your Regulation FD policy.
- If you are the spokesperson and feel that you may have made a mistake, act quickly. Pause and talk off-line with your IRO or general counsel. When you start again, reiterate your company’s Regulation FD policy and correct the statement. Then distribute the material nonpublic information in a press release, Form 8-K or both that day.

“Curing” Unintentional Disclosures

Unintentional disclosures will happen. When they occur, the company should promptly distribute the disclosed material nonpublic information through a press release or appropriate website or social media disclosure. The company may also wish to include the curative press release on Form 8-K, which includes a Regulation FD item, Item 7.01, designed precisely to “furnish” rather than “file” the information. Issuers can use Item 7.01 as a “super-press release” to ensure broad dissemination of the relevant information.



**Practical Tip:
“Follow the Script” at Conferences**

Unscripted questions during an analyst or industry conference regarding the company’s performance could lead to the release of material nonpublic information. To avoid inadvertent disclosures, follow a script for the presentation, anticipating any questions that could come up, and:

- Prior to presenting at an analyst or industry conference, disclose in a press release or Form 8-K the material nonpublic information that you would like to be free to discuss.
- Arrange for (and pre-announce) a webcast of the company’s presentation.
- Have your IRO or CFO listen for and help your CEO decline to answer “unscripted” questions that may require disclosure of material nonpublic information.

What Is Material? Is It Just “Market Moving”?

Regulation FD applies only to the disclosure of *material* nonpublic information. Although Regulation FD does not itself define what constitutes material information, the U.S. Supreme Court and the SEC provide guidance. Information is material to an investor making an investment decision if there is a “substantial likelihood that a reasonable shareholder would consider the information important in making an investment decision” or if the information “would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” The Supreme Court has rejected any bright-line test for determining materiality. Materiality with respect to contingent events depends on balancing the probability that the event will occur with the magnitude of the expected event in light of the company’s other activities.



**Practical Tip:
Hot Buttons of Materiality**

The SEC has provided a list of seven categories of information that a company should review carefully when determining materiality:

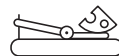
- Earnings information – historical results or future estimates;
- Mergers, acquisitions, tender offers, joint ventures and other similar transactions;
- New products or discoveries, or developments concerning customers or suppliers (such as gaining or losing a contract);
- Changes of control or of senior management;
- A change in auditors;
- Events regarding securities, such as defaults on senior securities, splits, dividend changes or public or private sales of additional securities; and
- Bankruptcy or receivership.

The most sensitive category is earnings estimates. The SEC's other principal statement on materiality is Staff Accounting Bulletin No. 99 – Materiality (SAB 99). In SAB 99, the SEC sought to put to rest the practice of using certain dollar or percentage thresholds to judge nonmateriality. SAB 99 asked:

[M]ay a registrant or the auditor . . . assume the immateriality of items that fall below a percentage threshold . . . to determine whether amounts and items are material . . . ?

The SEC answered with a resounding “No.” Why? Qualitative factors can cause misstatements of even small amounts to be material.

**Trap for the Unwary:
Misstatements of Small Amounts May Be Material**



In SAB 99, the SEC gave these examples of issues that might cause information to be material regardless of the dollar amount involved:

- Does it mask a change in earnings or forward-looking trends?
- Was it capable of precise measurement?
- Does it hide a failure to meet analysts' consensus earnings estimates?
- Would it change a loss into an income item or vice versa?
- Does it touch upon a segment or an aspect of the issuer's business that plays a significant role in operations or profitability?
- Does it affect the company's compliance with regulatory requirements?
- Does it affect the issuer's compliance with debt covenants or other contracts?
- Does it conceal an unlawful transaction?
- Would it have the effect of increasing management compensation, for example, by satisfying a bonus or option-vesting threshold?



Practical Tip:
Use a “Rule of Thumb” Test?
Only with Caution and Just as a Starting Point

In SAB 99, the SEC acknowledges that some issuers and accountants may use a “rule of thumb” test such as 5%. But measures like this should be used only as a starting point. Any percentage threshold can be only a first step toward answering the question:

Is there a substantial likelihood that a reasonable person would consider this to be important?

SAB 99 notes that stock price volatility may be an indicator of materiality. SEC enforcement actions demonstrate that the SEC will assess materiality in hindsight by looking at a company’s stock price and trading volume in the period immediately following a selective disclosure of nonpublic information.



Practical Tip:
How to Conduct an Earnings Call That Complies
with Regulation FD and Non-GAAP Disclosure
Requirements

Quarterly earnings calls are the best example of the voluntary disclosures for which the SEC designed Regulation FD and non-GAAP disclosure requirements. Prior to each earnings call, your company should do the following:

- *Issue Notice.* Issue a press release or broadly disseminated website or social media notice several days or weeks in advance, notifying the public of the earnings call and webcast. Include a statement that discussion may also cover any material developments occurring after the date of the notice but before the date of the call. Consider using a commercial news service to broadly disseminate the

Practical Tip:
How to Conduct an Earnings Call That Complies with Regulation FD and Non-GAAP Disclosure Requirements (Cont'd)



time, date and access information, and post the access information on your company's website.

- *Pre-Release Information.* Announce earnings results by press release or web disclosure prior to the call and “furnish” (a less formal action than “filing”) the release to the SEC under Item 2.02 of Form 8-K. Form 8-K has a narrow safe harbor exemption that allows an earnings call to proceed promptly after a filed earnings release, without a new Form 8-K filing, even if the call contains material nonpublic information. This safe harbor allows a company to disclose new information about a completed earnings period in an oral, telephonic or webcast communication, typically an earnings call, without having to file a transcript of the call in a new Form 8-K filing. Some companies may combine press releases with social media and web disclosure, issuing advisory releases that point investors to the full earnings results on their websites. If possible, do this either immediately following the market close the day before the call or before the market open the morning of the call.
- *Post Data.* Post all financial and statistical data provided in the call or presentation on the company's website before the call. Post any required reconciliations of non-GAAP financial information to GAAP.
- *Hold Call Promptly.* Conduct your earnings call within 48 hours after the Form 8-K filing. If the call includes new material nonpublic information and



Practical Tip:
**How to Conduct an Earnings Call That Complies
with Regulation FD and Non-GAAP Disclosure
Requirements (Cont'd)**

occurs more than 48 hours after the related Form 8-K filing, file a new Form 8-K “furnishing” a transcript of the earnings call within four business days after the call.

- *Post New News.* Following your earnings call, promptly post an audio file or transcript of any newly disclosed material. The SEC encourages companies to provide access to website postings for at least one year. After a brief period, be sure to archive the data with appropriate disclaimers on the investor relations page of your website.
- *Use Overviews.* You may use overviews or summaries to present financial information. If an overview or summary stands alone, then take care to mark it as an overview or summary and include additional information about where to locate more detailed information.

Website and Social Media Disclosure Can Satisfy Regulation FD

Disclosing material information on your company’s website or social media accounts can fulfill the requirements of Regulation FD “public disclosure” if the company’s web or social media presence is prominent enough to constitute broad, nonexclusive distribution to the public. The SEC has offered three tests to determine whether the release of information on a company’s website or social media is public for Regulation FD purposes:

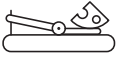
- *Recognized Channel for Distribution?* Is the company’s website or social media account recognized as a channel for distribution of information to the market? What steps has the company taken, if any, to alert the market to its intent to use its website or social media account to distribute

information? Do investors and market professionals know to look to the company's website or social media posts for this kind of information?

- *Broad Dissemination?* Does posting information on the website or social media account disseminate the information so as to make it available to the securities marketplace in general? Is the website designed to lead investors to the disclosures? Is the social media profile one that can be followed or accessed by the general public?
- *Time to Absorb?* Did the posting give investors and the marketplace enough time to absorb and react to the information? The length of time before information may be considered public for Regulation FD purposes depends on the facts and circumstances of the release and the company. These may include the size and market following of the company, the steps taken to alert investors to information on the website and relevant social media accounts, the nature and complexity of the information, and the efforts made by the company to disseminate the information.

Companies should caution employees and directors that posting material information on a personal social media account may violate Regulation FD if the company has not laid the appropriate groundwork to prepare investors. For example, when the SEC investigated Netflix for a post by the CEO on his personal Facebook page containing material performance metrics (without any other disclosure from Netflix), the SEC questioned not the use of social media generally but whether investors knew to monitor the CEO's personal account for new material information.

Before relying on a company website or social media account to communicate with the marketplace, make sure that these outlets have become recognized channels for distribution. Do this by including a cautionary legend in your Form 10-K or 10-Q filings that describes the company's intent to disclose material information by website or social media, as well as which social media channels the company intends to use.



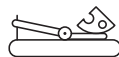
Trap for the Unwary: Go Viral for the Right Reasons

On August 7, 2018, the founder and CEO of Tesla, Inc., Elon Musk, announced on Twitter: “Am considering taking Tesla private at \$420. Funding secured.” The implication that Mr. Musk had secured funding for a go-private deal at a significant premium to the then-current trading price of Tesla stock created volatility in the company’s stock for weeks. On August 24, 2018, Mr. Musk sent another tweet stating that the company would stay public, and he included a link to a blog post on the company’s website with more explanation.

On September 27, 2018, the SEC alleged that Mr. Musk had engaged in securities fraud, stating that the initial tweet was “materially false and misleading.” As part of the announcement of a settlement agreement, the SEC noted that while the company had informed investors that it would use Musk’s social media as a channel for releasing material information, the company failed to put in place any disclosure controls to determine whether Mr. Musk’s social media posts contained information that required further disclosure in SEC filings or to determine whether the information in Mr. Musk’s social media posts was accurate and complete.

On September 29, 2018, the SEC announced a settlement with Mr. Musk and Tesla where Mr. Musk agreed to pay \$20 million and step down as chair of Tesla’s Board for three years. Tesla further agreed to appoint two independent directors and pay a \$20 million fine. Finally, Tesla agreed to establish a committee of independent directors and put in place additional disclosure controls on Musk’s communication.

Trap for the Unwary: Go Viral for the Right Reasons (Cont'd)



Lessons Learned?

- *Create a Policy.* Companies should put in place a robust policy governing social media posts, specifically addressing communications on recognized channels of distribution, such as official company or CEO accounts. The policy should provide guidelines on what types of communications are permitted and establish clear review and approval processes.
- *Personal Posts May Not Be Personal.* Make sure that employees, officers and directors understand the pitfalls of disclosing information in their personal capacities, since investors may believe that these individuals are speaking for the company.

Exemptions from Regulation FD

Regulation FD applies only to certain communications. Communications exempt from Regulation FD include:

- Discussions with persons who agree expressly to maintain the information in confidence. For example, a company may bring one or a small number of investors “over the wall” to pre-market a securities offering. In that case, the nondisclosure agreement may be either written or verbal and may be made before or after the disclosure. It must be more than an implicit agreement or a mere belief on the issuer’s part that there is an agreement.
- Discussions with the press. But in practice, most companies treat disclosures to the press as equivalent to disclosures to an analyst. Some journalists will agree to “embargo” news temporarily and sign a nondisclosure agreement to that effect. Otherwise, make the statements Regulation FD-compliant.

- Ordinary course of business disclosure to customers and suppliers.
- Disclosure made by foreign private issuers. (Chapter 15 discusses the qualifications necessary for a non-U.S. company to qualify as a foreign private issuer.)
- Disclosure to persons who owe a duty of trust or confidence to the company (e.g., lawyers, bankers, financial advisors and accountants).
- Communications – such as a road show – made in connection with most 1933 Act registered offerings. Most, but not all, 1933 Act registrations are exempt from Regulation FD. For example, both a shelf offering to employee optionees on Form S-8 and a Form S-3 resale registration statement are fully subject to Regulation FD.

Rating Agencies

Disclosures made to nationally recognized statistical rating organizations (NRSROs), such as Moody's and Standard & Poor's, are not subject to Regulation FD. While rating agencies are no longer explicitly exempt from Regulation FD, NRSROs have regulatory obligations that prevent them from using the information to trade or to advise others on trading, and so are not "covered persons." A cautious issuer may wish to ask a smaller non-NRSRO to sign a nondisclosure agreement prior to sharing confidential information as part of the rating review process.

Liability for Selective Disclosure

To prevent Regulation FD from having a chilling effect on issuers' communications to the public, the SEC has limited Regulation FD liability:

- Regulation FD is not an antifraud rule – an issuer may be liable only for knowing and reckless conduct (not for good faith mistakes in making materiality judgments); and

- Regulation FD does not create private rights of action. Outside Regulation FD, liabilities imposed under Rule 10b-5 under the 1934 Act for selective disclosure continue unchanged. For example, an issuer's failure to make a public disclosure might give rise to liability under a duty-to-correct or duty-to-update theory.

While not a separate antifraud rule, Regulation FD compliance is actively monitored by the SEC. The SEC closely follows corporate disclosure and continues to bring enforcement actions in the challenging area of one-on-one discussions of earnings guidance with analysts.

Corporate Disclosure Policy: Forward-Looking Statements and the Safe Harbor

Providing required disclosures under Regulation FD or non-GAAP financial information often relates to future events, creating a level of uncertainty. Thankfully, Section 21E of the 1934 Act, Section 27A of the 1933 Act (both part of the Private Securities Litigation Reform Act of 1995) and Rule 175 under the 1933 Act give companies guidelines for disclosing *forward-looking statements* to the investing community. Forward-looking statements are projections, plans, objectives, forecasts and other discussions – whether oral or written – of future operations. These guidelines provide a safe harbor defense to securities litigation challenging forward-looking statements that fail to predict the future accurately.

Written Forward-Looking Statements

Sections 21E and 27A incorporate a caselaw concept known as the “bespeaks caution” doctrine, which provides that a reader or listener needs to take any forward-looking statement in context. If the context provides fair warning of future uncertainties, the reader cannot fairly ignore them. To fall within the safe harbor, the forward-looking statements must be accompanied by:

- Meaningful cautionary language that identifies the forward-looking statements; and

- In the case of written statements, the important factors that could cause actual results to differ materially. Boilerplate disclaimers are insufficient for this purpose.



**Practical Tip:
Sailing into the Safe Harbor by
Updating Risk Factors**

The risks that companies face can evolve quickly. Risk factors and other cautionary statements from last year's or last quarter's Form 10-K or 10-Q (or even from an earlier press release) may be inadequate for the report you are filing today.

When preparing to file a new periodic report or press release:

- Review the report or press release to identify its forward-looking statements;
- Tailor cautionary language to the forward-looking statements and make the warnings conspicuous (do not bury cautionary language in legal jargon);
- Clearly disclose any assumptions underlying each specific forward-looking statement and identify a variety of reasons for possible deviation from projected results;
- Describe the existence of a specific risk and its magnitude; and
- Update the statements to remain current and add any new cautions or risks that your Disclosure Practices Committee, Audit Committee or managers can identify.

Oral Forward-Looking Statements

For oral forward-looking statements, meaningful cautionary language must include a declaration that additional information

concerning factors that could cause actual results to vary materially is contained in a readily available written document, such as a recent Form 10-K or 10-Q. As with written forward-looking statements, boilerplate disclaimers are insufficient.

Regulation M-A: Merger and Acquisition Communications

A company in the midst of a business combination transaction – such as a stock-for-stock merger, cash merger or tender offer – will need to file with the SEC many communications that relate to the transaction.

Regulation M-A is a series of rules that fashion safe harbors permitting companies to communicate freely about planned business combination transactions (both before and after a registration statement is filed) so long as the company files its written communications with the SEC.

What communications must a company file with the SEC? It must file any written communication made in connection with, or that relates to, a business combination transaction that is provided to the public or to persons not a party to the transaction (e.g., written information about the transaction that is provided to a company's employees generally).

In contrast, a company does not need to file:

- Factual business information that relates solely to ordinary business matters;
- Internal communications that are provided solely to parties to the transaction; and
- Oral communications (but if a company posts an audio or video clip or slides of a conference call on its website, then it must file a transcript of the recording with the SEC).

Regulation M-A's filing requirement begins from the first public announcement of the transaction and continues until the

transaction closes. During that period, information subject to Regulation M-A must be filed with the SEC on or before the “date of first use.” Each Regulation M-A written communication must include a prominently displayed legend that advises investors to read the relevant registration statement, proxy statement or tender offer statement and that directs investors to the SEC’s website for copies of the relevant documents.



**Practical Tip:
Interplay Between Regulations M-A, G and S-K**

In business combination transactions, financial forecasts are often used by financial advisors and disclosed as part of the M&A disclosure documents to stockholders. The SEC has issued guidance that clarifies that such forecasts do not trigger Regulation G or Item 10(e) of Regulation S-K, and therefore do not need to be reconciled to GAAP, so long as the measures are:

- Used by the financial advisor to render an opinion materially related to the business combination transaction; and
- Disclosed to comply with the requirements of Regulation M-A.

Similarly, where a company provides forecasts to bidders and includes these forecasts in the M&A disclosure documents (for purposes of antifraud concerns and to ensure that other disclosures are not misleading), the forecasts are excluded from the definition of non-GAAP financial measures under Regulation G. However, the SEC guidance states that if the same non-GAAP financial measures are disclosed in a registration statement or proxy statement, Regulation G and Item 10(e) of Regulation S-K will apply.



Practical Tip:
Interplay Between Regulations M-A and FD

Regulations M-A and FD have overlapping, but slightly different, timing and disclosure requirements. Regulation M-A requires filing of a written public communication on the “date of first use.” In contrast, Regulation FD requires public disclosure of all material nonpublic communications simultaneously with (and, as a practical matter, prior to) any selective disclosure of the information. When both Regulations M-A and FD apply, use a format that satisfies Regulation M-A, but for timing, comply with Regulation FD by making a prior or simultaneous filing.

Key Takeaway:
Adopt a “Best in Class” Disclosure Policy

Most public companies will want to adopt a corporate disclosure policy and investor relations practices that comply with rules and regulations around non-GAAP measures, with Regulations FD and M-A, and that take full advantage of the safe harbor for forward-looking disclosures. A compliant disclosure policy will include some variation of the following elements:

1. **Non-GAAP Measures.** When disclosing non-GAAP measures, make sure that the presentation is not misleading and that all non-GAAP measures are reconciled to the most directly comparable GAAP measure.
2. **Spokespersons.** Designate procedures for drafting, reviewing, approving and distributing all material communications. This includes specifying which individuals (e.g., the chairman, CEO, CFO and IRO) can act as spokespersons for the company to analysts and investors.
3. **Materiality and Need for Disclosure.** Have a process for determining, with company counsel as necessary, whether information is material and whether it needs to be disclosed.

4. **Cautionary Language.** For all oral and written communications, include a legend cautioning against reliance on forward-looking statements.

5. **Earnings Calls.** Adhere to the procedures suggested earlier in this chapter to conduct earnings calls that comply with non-GAAP financial measures and with Regulation FD.

6. **One-on-One Calls or Meetings.**

Timing. Limit the timing of conversations with analysts and/or investors to the period following an earnings call up until a blackout period.

Subject Matter. Consider preparing a script or responses to anticipated questions. Limit responses in these conversations to elaboration of previously disclosed or generally known information.

7. **Analyst Projections and Previous Earnings Guidance.** Do not comment on or confirm previous earnings guidance or individual analyst projections. Addressing the “street” consensus in your guidance is okay, but take care to comply with Regulations FD and G.

8. **Extraordinary Transactions or Unusual Market Activity.** Unless required by law, do not respond to questions about potential financings, restructurings, acquisitions, mergers or other transactions or unusual market activity.

9. **Interviews with News Media.** Treat communications with the media as if they were subject to Regulation FD.

10. **Merger and Acquisition Transactions.** File with an appropriate legend all written communications that relate to a business combination transaction *before* publicly disclosing the information.

Chapter 6

Insider Reporting Obligations and Insider Trading Restrictions; Rule 10b5-1 Trading Plans

Directors, executive officers and significant shareholders of a public company are subject to a number of reporting obligations and trading limitations relating to their ownership of and transactions in the company's securities. Compliance with these rules requires strong procedures for both the company and its insiders. This chapter gives an overview of these reporting requirements and trading limitations and suggests ways in which a public company and its insiders can best comply with them.

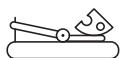
Section 16 Reporting Obligations of Directors, Executive Officers and 10% Beneficial Shareholders

Who Is an Insider?

Directors and Officers. Section 16(a) of the 1934 Act requires directors and specified officers of a public company to report their beneficial ownership of and transactions in the company's securities to the SEC and the public. An officer for this reporting purpose generally includes the company's "executive officers," as that term is used in the rules governing proxy statements and other SEC disclosure documents, and covers:

- President and principal executive officer;
- Principal financial officer;
- Principal accounting officer or, if none, the controller;
- Any vice president in charge of a principal business unit, division or function (such as sales, administration or finance); and

- Any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the company, including officers of the company's parent or subsidiaries.



Trap for the Unwary: More Than "Executive Officers"

The definition of Section 16 officers is nearly identical to the general 1934 Act definition of executive officers, except in one important respect that often leads to filing errors. For purposes of Section 16, if the principal financial officer is not also designated as the principal or chief accounting officer (CAO), the CAO must be a Section 16 filer, even if not considered an executive officer by the company. If a company does not designate a CAO, then the controller must be a Section 16 filer.

More Than 10% Beneficial Shareholders. In addition to directors and officers, persons, including entities, who beneficially own more than 10% of a class of a company's registered securities are subject to Section 16(a) reporting obligations. In determining who is a more than 10% holder, Section 16(a) uses the concept of *beneficial* ownership rather than legal or record ownership. A person's *voting* or *investment* power over a security is a key factor in determining beneficial ownership. For example, a person with sole or shared voting or investment power over securities will usually beneficially own the securities for Section 16(a) 10% ownership purposes. This is the same test used for determining 5% beneficial ownership for purposes of Schedules 13D and 13G.

What Is the Scope of Section 16?

Equity Securities. Section 16 applies only to equity securities of the company, including the right to acquire equity securities. It does not apply to non-equity securities, such as pure debt securities.

What Do Section 16(a) Insiders Report?

Beneficially Owned Shares. For Section 16(a) insiders, the SEC uses a second beneficial ownership test to determine which

holdings and transactions the insider must report. Beneficial ownership for purposes of reporting holdings and transactions to the SEC (and for short-swing profit liability) is based on the insider's *direct or indirect pecuniary interest* in the securities. This test is based on an insider's ability to profit from purchases or sales of securities.

Shares Held by Household Members. An insider is considered to have indirect beneficial ownership of securities held by members of the insider's immediate family sharing the same household. These immediate family household members include grandparents, grandchildren, siblings and in-laws, as well as the insider's spouse, children and parents.

Trust Shares. An insider is considered a beneficial owner of shares in a trust for Section 16 purposes if the insider has or shares investment control over the trust securities and the insider is a:

- Trustee, and either the trustee/insider or a member of the trustee/insider's immediate family (whether or not they share the same household) has a pecuniary interest in the trust securities;
- Beneficiary; or
- Settlor, and the settlor/insider has the power to revoke the trust.

Partnership or Corporation Shares. An insider who has control or a controlling influence over a partnership or corporation will generally have beneficial ownership of the securities held by that partnership or corporation.

Derivative Securities. Section 16(a) applies not only to a company's common stock but also to derivative securities. Derivative securities include stock options, stock appreciation rights, warrants, convertible securities or similar rights with an exercise or conversion privilege at a price related to an equity security. Derivative securities also include third-party contracts: puts,

calls, options or other rights to acquire the company's securities that an insider enters into with a person other than the company.

How Does an Insider Report Beneficial Ownership?

Initial Report – Form 3. Upon becoming an insider, an insider initially files a Form 3 with the SEC listing all the insider's holdings of the company's securities, including derivative securities such as stock options. The insider must file a Form 3 within ten calendar days of the triggering event, for example, within ten days after becoming an officer, director or more than 10% shareholder of a public company. The insider must file a Form 3 even if the insider does not beneficially own any securities of the company at the time of the filing. Insiders of a newly public company file a Form 3 on the date the company becomes a reporting company under the 1934 Act.

Current Report – Form 4. Generally, any change in an insider's beneficial ownership of the company's securities is reported on a Form 4. Insiders usually must file a Form 4 within two business days after a change in beneficial ownership. This two-day reporting period begins when a transaction is executed, not when it settles.



Practical Tip: When to File Form 4?

If an executive vice president places an order with a broker to purchase or sell company securities on a Monday morning in Los Angeles, she must file the Form 4 with the SEC no later than 10 p.m. Eastern time (7 p.m. Pacific time) on Wednesday. The Form 4 must indicate the officer's total direct and indirect ownership in the company's securities after the reported transaction. In accordance with company compliance procedures discussed later in this chapter, the officer should notify the company compliance officer before placing the order to enable the company to begin preparing a Form 4 on the officer's behalf.

The Form 4 two-day filing deadline also applies to any transaction between an insider and the company, including transactions that are exempt from short-swing profit recovery under Rule 16b-3 under the 1934 Act, such as the grant, exercise or conversion of stock options or other derivative securities or the withholding of shares for tax purposes (such as upon vesting of restricted stock units).

Three transactions are exempt from the two-day filing deadline:

- Gifts;
- Inheritances; and
- Small acquisitions other than from the company that do not exceed in the aggregate \$10,000 in market value within a six-month period, provided the insider makes no nonexempt dispositions during the six months thereafter.

The insider must report these transactions at the end of the company's fiscal year on a Form 5 annual report if they were not voluntarily reported earlier on a Form 4.

Practical Tip:
Awards at Hire and Initial Board Election



Officers often receive option grants or other awards at the time of hire as do directors at the time of election to the Board. The Form 3 filed upon becoming an insider should report only securities owned *immediately prior* to becoming an insider. Report the awards granted *as a result* of becoming an insider on Form 4. In this situation, the Form 4 would be due before the Form 3, so the better practice is to file the Form 3 and the Form 4 at the same time (within two business days after the grant), even though the Form 3 would not technically be due until ten calendar days after the triggering event.

Insiders are not required to report on Form 4 or 5 transactions that effect only a mere change in the form of the insider's beneficial ownership of securities without changing the insider's pecuniary interest in the securities. For example, a distribution to the insider of securities previously beneficially owned by the insider through an employee benefit plan merely changes the form of the insider's beneficial ownership (from indirect to direct) and is exempt from Forms 4 and 5 reporting requirements. Likewise, a pro rata distribution of securities from a general partnership to its general partners is a mere change in the form of ownership and exempt from Forms 4 and 5 reporting requirements. This change in form exemption does not apply to:

- The conversion or exercise of a derivative security (this is reported on a Form 4); or
- A transfer of securities to a person whose holdings are attributed to the insider, such as a gift to a minor child or a transfer to a family trust (this is reported on a Form 5 or earlier on a voluntarily filed Form 4).

Even though a mere change in the form of an insider's beneficial ownership does not in itself trigger a Form 4 or 5 reporting obligation, the insider must reflect the resulting changed ownership in the total direct and indirect beneficial ownership column on the next Form 4 or 5 the insider files.

Acquisitions of company securities in ongoing, tax-conditioned employee benefit plans (e.g., broad-based employee stock purchase plans or 401(k) plans) generally are also exempt from Section 16(a) reporting obligations. But the insider needs to reflect the changes to her current holdings as a result of those acquisitions in the total beneficial ownership column on all subsequent Forms 4 and 5. By contrast, dispositions of securities acquired under employee benefit plans must be reported on Form 4. Transfers into and out of company stock funds in employee benefit plans generally must be reported on Form 4 but, in specific circumstances, the insider may be provided additional time to report.

Annual Report – Form 5. Insiders must file any required Form 5 within 45 calendar days after the end of the company's fiscal year. Any person who was an insider at any time during the fiscal year must file a Form 5 unless the insider had no reportable transactions during the year or had already filed one or more Forms 4 during the year covering all transactions required to be reported on a Form 4 or 5. A Form 5 must include all reportable transactions that were exempt from Form 4 reporting requirements and not reported earlier and all holdings or transactions that should have been reported on Form 3 or 4 during the fiscal year but were not.

Consequences of Late Filing: Embarrassment, Publicity and Fines

Civil Penalties. Failure to timely file a Form 3, 4 or 5 can result in substantial penalties to the insider. The SEC can seek fines in judicial enforcement actions of up to \$9,753 for each violation by an individual and up to \$97,523 for each violation by a corporation or other entity. If the violation includes fraud, deceit or deliberate disregard of a regulatory requirement, the fine can be as much as \$195,047 for an individual and \$975,230 for a corporation. (These amounts are subject to adjustment for inflation.) The SEC can also issue cease-and-desist orders in administrative proceedings against future violations. Failure to file reports also prevents the two-year statute of limitations from running on suits against insiders to recover any profits due to the company under the short-swing profit rules in Section 16(b).

SEC Enforcement. Aided by sophisticated computer algorithms and quantitative data sources, the SEC has made clear that it has the tools and the intention to vigorously investigate and enforce Section 16 reporting violations. In a major enforcement initiative in 2014 specifically targeting Section 16 reporting violations, the SEC recovered significant monetary penalties from individual insiders and companies. More recently the SEC has focused enforcement attention on cases in which an insider committed other, more serious violations of the federal securities laws, but could initiate another sweep based solely on Section 16(a) violations at any time. A company's agreement to

make filings on behalf of insiders is not a valid defense against individual director and officer liability since insiders bear the ultimate responsibility for Section 16 filings.

Proxy Statement Disclosure. A public company must disclose by name in its proxy statement any insiders who reported transactions late or failed to file required reports during the fiscal year. In 2019 the SEC adopted amendments changing the caption for proxy statement disclosure from “Section 16(a) Beneficial Ownership Compliance” to “Delinquent Section 16(a) Reports” and encouraged companies to exclude this disclosure and heading if there are no delinquencies to disclose. At the same time, the SEC eliminated the requirement that a company note by checkbox on the cover of its Form 10-K if there is proxy statement disclosure of late Section 16 reports.

Mandatory Electronic Filing and Website Posting of Beneficial Ownership Reports

Electronic Filing. Insiders must file Section 16 reports electronically. The reports are due by 10 p.m. Eastern time on the filing deadline. Although insiders can file reports directly through the SEC’s online filing system (located at www.onlineforms.edgarfiling.sec.gov), it is far more common for companies or third-party service providers to submit Section 16 reports on behalf of insiders, although the insiders remain legally responsible for their individual electronic filing obligations.

Electronic Signatures. Effective December 4, 2020, insiders can elect to sign Section 16 reports electronically by using existing platforms such as DocuSign and Adobe Sign. Previously, people who filed Section 16(a) reports for insiders were required to have in hand a manually signed paper copy with ink signature before submitting the filing. Before utilizing the electronic signature process, the filer must manually sign an attestation agreeing that the filer’s electronic signature will constitute the legal equivalent of a manual signature. The attestation must be furnished to the SEC on request and retained by the company for at least seven years from the date it was last used in connection with an electronically signed filing.

**Practical Tip:
Apply for EDGAR Codes Early**



To file electronically, insiders must apply for EDGAR access codes. It can take up to five days to receive the codes, so do not delay in submitting an application until the last minute. Since only one set of codes is permitted for an insider, companies obtaining codes on an insider's behalf should verify that the insider does not already have assigned codes (e.g., if an insider is or was also a director or officer of another reporting company). Please visit the SEC's website to generate access codes.

Website Posting. Section 16 rules mandate that companies post on their corporate websites all Forms 3, 4 and 5 filed by their insiders and 10% beneficial owners by the end of the business day after the date of filing. Companies must keep the reports posted for at least 12 months. Although companies may post the reports directly, most post by linking to third-party service providers or to the EDGAR database. The link must be directly to the forms or a list of the forms, and the link caption must clearly indicate access to insider Section 16 reports.

**Practical Tip:
Link to www.sec.gov**



To easily and efficiently satisfy the website posting requirements, link to the EDGAR database on the SEC's website. The advantage is that the EDGAR link will not require an update each time you file a new Section 16 report and will capture reports of 10% beneficial owners that your company might not otherwise notice.



Practical Tip:
Implement Section 16(a) Compliance Procedures

As a best practice for compliance with Section 16(a) reporting obligations, we suggest that your company implement the following procedures:

- *Preclearance.* Require all insiders to preclear their transactions (or those of any family members sharing their household) with the company's CFO, general counsel or other designated compliance officer at least two business days before they initiate any transaction in the company's equity securities.
- *Broker Interface Procedures.* Establish coordinated procedures with knowledgeable brokers and encourage your insiders to use those brokers to facilitate trading in company securities.
- *Powers of Attorney.* Have each director and officer execute a power of attorney authorizing at least two of the company's officers to sign Forms 4 and 5 on behalf of the director or officer. This written authorization is filed with the SEC, typically as an exhibit to the first report authorizing the power of attorney.

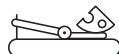
Section 16(b) – Short-Swing Profit Liability

Section 16(b) of the 1934 Act imposes liability on insiders for profits realized on *short-swing trades*, that is, for any profits an insider receives from the purchase and sale (or sale and purchase) of registered securities of the company within a period of less than six months in nonexempt transactions. In other words, the insider must be sure that no "matchable" transactions occurred in the six months prior to the planned nonexempt transaction and must avoid any matchable transactions in the following six months. The insider is liable for profits realized in either cash or noncash form (such as securities). Under Section 16(b), the company or a shareholder acting on behalf of the company may bring an action

against the insider for disgorgement of the realized profits. Section 16(b) applies to all Section 16(a) insiders (i.e., directors, executive officers and more than 10% beneficial shareholders).

The test for Section 16(b) liability is purely objective: an insider who purchases and sells (or sells and purchases) registered securities in nonexempt transactions within a period of less than six months is liable for the profits received as a result of the transactions. It does not matter whether the insider was aware of confidential information, whether the confidential information was material, whether the insider relied on the information in making the transaction or whether the insider acted in good faith.

Trap for the Unwary: Indirect Ownership



Insiders can be liable under Section 16(b) for nonexempt transactions in shares that they hold indirectly as well as directly – particularly for shares held by household members.

An insider is presumed to have indirect beneficial ownership of securities held by members of the insider's immediate family sharing the same household, including the insider's spouse, children, parents, grandparents, grandchildren, siblings and in-laws. As a result, if an insider's spouse or a relative living with the insider sells the company's stock, and the insider then purchases lower-priced shares within six months of the sale, the insider is liable for short-swing profits.

This is true even if the insider was not aware that the insider's spouse or household-sharing relative had sold the shares. Liability follows from the presumption that the insider has beneficial ownership of the shares held by the spouse or relative. This is a rebuttable presumption, and the insider may disclaim beneficial ownership of the spouse's or relative's securities in the insider's Section 16 filings.

Transactions Exempt from Section 16(b) Liability

Transactions Between the Company and Its Officers or Directors. Transactions between the company and its officers or directors may be exempt from Section 16(b) short-swing liability. For example, a grant of stock options to a director or officer will not be treated as a purchase under Rule 16b-3 if the company's Board, a committee of nonemployee directors or the shareholders approve the grant or if the director or officer holds the stock options or shares acquired upon exercise of the stock options for at least six months from the stock option grant date. The exercise by the director or officer of the stock options will also be exempt. Similarly, a sale or disposition of securities by the director or officer back to the company generally will not be treated as a sale for purposes of Section 16(b) if the Board or a committee of nonemployee directors pre-approves the sale or disposition.

Stock Options and Other Derivative Securities: Purchase Occurs at Time of Grant. Shares subject to stock options and other types of derivative securities are deemed to be purchased for Section 16(b) purposes upon the grant of the stock option or other acquisition of the derivative security rather than upon exercise or conversion. This is because a derivative security is treated as the functional equivalent of the underlying security into which it can be exercised or converted. For example, the grant of an option to purchase common stock is treated as the functional equivalent of the insider's purchase of the common stock. The exercise, conversion or vesting of a derivative security is generally exempt from Section 16(b) liability.

Although exempt from Section 16(b) liability, insiders must report separately the grant and the exercise or conversion of an option or other derivative security on Form 4 within two business days after each transaction.

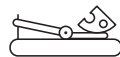
Calculating Profit Realized in a Short-Swing Transaction

When applying Section 16(b) to a single purchase and single sale of securities within a six-month period, the profit calculation is straightforward: the aggregate purchase price of the securities is subtracted from the aggregate sale price.

For multiple sales and purchases within a six-month period, the profit realized is calculated under the lowest-in, highest-out method. The following example illustrates the application of the rule:

Assume that Director Bertrand Brass purchases 100 shares of his company's common stock in January for \$40 a share, purchases an additional 100 shares in February for \$45 a share, sells 100 shares in March for \$60 a share, purchases 100 shares in April for \$50 a share, sells 100 shares in May for \$55 a share and sells 100 shares in June for \$80 a share. Under the lowest-in, highest-out approach, the January purchase (\$40 per share) would be matched with the June sale (\$80 per share), the February purchase (\$45 per share) would be matched with the March sale (\$60 per share) and the April purchase (\$50 per share) would be matched with the May sale (\$55 per share). Mr. Brass would be liable for \$6,000 in realized profits.

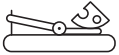
**Trap for the Unwary:
The Six-Month Shadow – Continuing Obligations
and Liability of Former Directors and Officers**



Former directors and officers continue to have Section 16(a) reporting obligations (and Section 16(b) short-swing profit liability) for nonexempt trades that they make after termination if the trade occurs within six months of a nonexempt *opposite-way* transaction (e.g., open market purchase vs. sale) that the insider effected before termination. The former insider must report these post-termination, opposite-way transactions on a Form 4 (indicating a short-swing violation) and will be liable for any short-swing profits resulting from the transactions.

Former directors or officers who did not engage in any transactions during their last six months in office have no Form 4 reporting obligations after termination of service. However, no later than 45 days after the end of the fiscal year in which a director or officer ceased service, she is required to report on Form 5 any exempt transactions (such

**Trap for the Unwary:
The Six-Month Shadow – Continuing Obligations
and Liability of Former Directors and Officers
(Cont'd)**



as gifts) that occurred while she was still an insider and that were not reported earlier. It is a “best practice” for companies to obtain from a departing director or officer who has no Form 5 reportable transactions a representation at the time of departure that no Form 5 is due. On any Form 4 or 5 filed after termination of service, former directors and officers must check the “exit” box indicating that their insider status has terminated.

Schedules 13D and 13G Reporting Requirements for 5% Shareholders

Entirely apart from any Section 16(a) reporting obligations they may have, shareholders who beneficially own more than 5% of a public company’s stock must report their stock ownership to the SEC on Schedule 13D or 13G filed on EDGAR. Shareholders who through shared control or other similar relationship have agreed to act together with respect to a public company’s stock become a group, and if together they beneficially own in excess of 5% of a public company’s stock, they must report the group’s ownership on Schedule 13D or 13G.

Initial Schedule 13G Report

Within 45 days following the end of the calendar year in which a company completes its IPO, every person (including directors and officers) that beneficially owned more than 5% of the company’s stock at the time of the IPO and as of the last day of the calendar year must report that ownership to the SEC on a short-form Schedule 13G. The term *person* includes entities. These initial 5% shareholders are referred to as *exempt shareholders* because their shares were acquired prior to the company’s IPO.

Schedule 13D or 13G Filings Once the Company Is Public

After a company is public, any exempt shareholder who acquires more than 2% of the company's stock in a 12-month period, or any other shareholder who acquires more than 5% of the company's stock (following its IPO), may be required to file a Schedule 13D, which is more lengthy than Schedule 13G. Shareholders who are passive investors can initially file or continue to file reports on Schedule 13G, avoiding the more burdensome Schedule 13D. A passive investor is a shareholder who beneficially owns less than 20% of the company's stock, provided the investor did not acquire the securities for the purpose, or with the effect, of changing or influencing control of the company. A person in a control position – such as a director or executive officer – does not qualify as a passive investor.

In general, an investor must amend Schedule 13G annually to report any changes in the information previously reported, including any change in beneficial ownership. Whenever a passive investor acquires more than 10% of the company's stock, the investor must amend the Schedule 13G "promptly" after the date of the acquisition. From then on, the passive investor must file an amended Schedule 13G promptly after the date on which its beneficial ownership increases or decreases by more than 5%, until the passive investor has reported beneficial ownership below 10% again. A nonpassive investor must amend its more detailed Schedule 13D promptly to report any material change in the information previously reported, which includes any change of 1% or more in its beneficial ownership.

A passive investor loses Schedule 13G eligibility – and must file a Schedule 13D – if the investor acquires 20% or more of a class of securities or no longer holds the shares with no purpose, or effect, of changing or influencing control of the company. In either case, the investor must file a Schedule 13D within ten days of the acquisition or change in passive investor status. In addition, the investor may not vote its shares or acquire more shares during the period that begins at the time of the acquisition of 20%

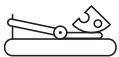
or more of the company's shares or loss of passive investor status and ends ten days after the investor files Schedule 13D.

Individuals and entities who fail to file timely and accurate Schedules 13D and 13G can be subject to significant monetary penalties and cease-and-desist orders. The SEC's enforcement initiative targeting Section 16 beneficial ownership reporting violations (discussed above in the section on Section 16 reporting) has also been directed against Schedule 13D and 13G filers.



**Practical Tip:
Apply for EDGAR Codes Early**

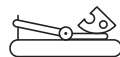
New Schedules 13D and 13G filers who don't already have EDGAR access codes must obtain their EDGAR access codes before the applicable due date. It can take up to five days to receive the codes, so do not delay in submitting an application until the last minute. Please visit the SEC's website to generate access codes.



**Trap for the Unwary:
Form 13H Large Trader Identification**

Under the SEC's Large Trader Identification System, individuals or entities who, for their own account or for an account for which they exercise investment discretion, effect certain large transactions in exchange-listed securities must file Form 13H identifying themselves as a Large Trader. Transactions aggregating two million shares or \$20 million in value on any day, or 20 million shares or \$200 million in value in any calendar month, trigger the filing requirement. Form 13H filers must update filings annually. Although Form 13H filers must submit the filings on EDGAR, only the SEC can access the filings, which cannot be viewed by the

**Trap for the Unwary:
Form 13H Large Trader Identification (Cont'd)**



public. The SEC assigns each Form 13H filer a Large Trader Identification Number, which the filer must provide to the filer's brokers. To avoid an inadvertent failure to make a required Form 13H filing, or to avoid inadvertently exceeding the applicable size-of-transaction threshold, companies should advise their officers and directors to consider the Form 13H filing requirements in advance of any anticipated large transactions, including exercising expiring stock options.

Rule 144 Restrictions on Trading Restricted Stock and Stock Held by Directors, Executive Officers and Other Affiliates

The 1933 Act requires that any sale of a security must be registered with the SEC, unless the security or transaction qualifies for an exemption. Rule 144 under the 1933 Act provides the most frequently used exemption for the public resale of restricted and control securities.

Although brokerage firms generally play the primary role in assisting their clients with Rule 144 compliance, as a best practice companies should educate insiders who are subject to Rule 144 regarding the applicable resale limitations and assist with Rule 144 compliance. (See our Practical Tip later in this chapter, which includes our suggestions for compliance with Rule 144.)

Securities Subject to Rule 144

Rule 144 covers two types of securities: restricted securities and control securities.

- *Restricted securities* result from a purchase directly from the issuer or an affiliate of the issuer in a private offering exempt from registration. Restricted securities typically bear a restrictive notation or legend that

states that the securities are not registered and can only be offered or sold in an offering registered with the SEC or under an exemption from registration.

- *Control securities* are securities owned by any person who directly or indirectly may exercise control over the issuer, either alone or as a member of a control group. Control securities may be acquired in any manner, including on the open market, from the company through a public offering or upon the exercise of a stock option or vesting of restricted stock units (RSUs). The SEC uses the term *affiliate* to describe such a control person.

Who Are Affiliates?

Under Rule 144, a company's affiliates generally include its directors, executive officers and significant shareholders that can influence the company either individually or in concert with others, as well as:

- The spouse or any relative of the affiliate who lives in the same household as the affiliate;
- Certain trusts or estates for which the affiliate (or a member of the affiliate's family sharing the same household) serves as a trustee, executor or 10% beneficiary;
- Certain corporations, partnerships or other entities in which the affiliate or the affiliate's family owns a 10% interest; and
- Affiliates of companies acquired in transactions regulated by Rule 145 under the 1934 Act – even if they do not become affiliates of the acquiring company.

Determining which persons may be affiliates for purposes of Rule 144 requires a fact-specific inquiry.

Rule 144 Requirements

General requirements:

- *Current Public Information.* Requires that adequate public information be available concerning the issuer of the securities. To satisfy this requirement, a company that has been a reporting company for at least 90 days before the date of sale must have filed all SEC-required reports during the 12 months immediately preceding the proposed sale (or such shorter period in which it was required to file), other than current reports on Form 8-K. In addition, the company must have filed electronically and posted on its website, if any, all interactive data files it was required to submit and post during the 12 months immediately preceding the sale (or such shorter period in which it was required to file and post the files). (We discuss interactive data files in Chapter 4.)
- *Holding Period for Restricted Securities.* A person who acquires restricted securities of a reporting company must hold the restricted securities for at least six months. In some situations the holder may measure this holding period starting from the date the previous holder acquired the securities (e.g., if the restricted securities are acquired as a gift). The holding period does not begin until the seller has fully paid the purchase price for the securities. For example, if the stock was purchased with a promissory note, the purchase price would not be considered fully paid unless the note is full recourse and secured by collateral, other than the stock, having at least equal value to the shares (and the note must also be paid in full before the stock may be sold). Control securities that are not restricted securities have no holding period.

Three additional requirements of Rule 144 apply only to affiliates:

- *Volume Limitations.* During any three-month period affiliates may only sell up to a number of shares equal to the greater of 1% of the outstanding securities of the class or the average weekly reported trading volume for the previous four calendar weeks. (For most insiders, this limitation does not limit sales.) An alternate volume limitation exists for debt securities, which limits the sale of debt securities to 10% of the outstanding tranche (or class).
- *Manner of Sale.* Affiliates must sell shares only in unsolicited broker transactions, transactions directly with a market maker or in *riskless principal transactions*. A riskless principal transaction occurs where, after having received an order to buy (or sell), a broker or dealer buys (or sells) the security as principal in the market to satisfy the order to buy (or sell). The seller may not solicit or arrange for the solicitation of orders to buy the stock or make any payment in connection with the sale of the stock to any person other than ordinary commissions payable to the broker who executes the order to sell the stock. In a broker transaction, the broker must do no more than execute the order to sell the stock and receive no more than the usual and customary broker commission. The broker must neither solicit nor arrange for the solicitation of customers' orders to buy the stock. (Most national brokerage firms have a Rule 144 sales unit that ensures compliance with this manner-of-sale requirement.) The manner-of-sale restriction does not apply to debt securities.
- *Notice of Sale.* If an affiliate intends to sell more than 5,000 shares or expects to receive aggregate sale proceeds of over \$50,000 in any three-month period, the affiliate must file a Form 144, "Notice of Proposed Sale of Securities," with the SEC concurrently with either the placing with a broker of an order to execute

a sale or the execution directly with a market maker of a sale. The person filing the notice must have a bona fide intention to sell the securities referred to in the notice within a reasonable time after filing the notice. The purpose of the filing is to serve as a non-binding notice to the public that a significant number of additional shares are likely to enter the market. The Form 144 filing covers sales of the securities referred to in the notice during the three-month period that begins on the filing date. If the seller wishes to sell additional securities, or to sell securities after the end of that three-month period, the seller must file a new Form 144. The seller has the option to submit the Form 144 in paper form by mail to the SEC or electronically on EDGAR or by email. In addition, if the subject securities are traded on any national securities exchange and the seller does not submit the Form 144 on EDGAR, the seller must also mail a copy of the Form 144 to the principal exchange on which such securities are traded.

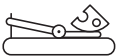
Although affiliate status generally ceases upon termination of a director's or officer's employment or service relationship with a company, brokers may require that a former affiliate continue to sell under Rule 144 until 90 days after the date affiliate status terminates.

Rule 144 and Shell Companies

Generally, sellers may not rely on Rule 144 for the resale of securities initially issued by current or certain former shell companies, other than a business combination-related shell company.

Rule 144 Compliance Chart for Reporting Companies

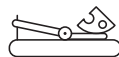
AFFILIATE	NON-AFFILIATE (and who has not been an affiliate during the three months prior to resale)
<p><u>During six-month holding period:</u></p> <ul style="list-style-type: none"> • No resales under Rule 144 permitted. 	<p><u>During six-month holding period:</u></p> <ul style="list-style-type: none"> • No resales under Rule 144 permitted.
<p><u>After six-month holding period:</u></p> <ul style="list-style-type: none"> • May resell in accordance with all Rule 144 requirements including: <ul style="list-style-type: none"> ➢ Current public information; ➢ Volume limitations; ➢ Manner-of-sale requirements for equity securities; and ➢ Notice of Sale – filing of Form 144. 	<p><u>After six-month holding period and until one year:</u></p> <ul style="list-style-type: none"> • Unlimited public resales under Rule 144, except that the current public information requirement still applies. <p><u>After one-year holding period:</u></p> <ul style="list-style-type: none"> • Unlimited public resales under Rule 144; need not comply with any other Rule 144 requirements.



**Trap for the Unwary:
Hart-Scott-Rodino Filing**

Officers or directors with significant holdings may trigger a Hart-Scott-Rodino (HSR) filing obligation by acquiring even one additional share of their company’s stock, including through the exercise of stock options or the vesting of restricted stock units (RSUs). Although the value of the stock

**Trap for the Unwary:
Hart-Scott-Rodino Filing (Cont'd)**



acquired through the exercise of stock options or vesting of RSUs typically falls well below the size-of-transaction threshold that would trigger an HSR filing (\$92 million in 2021, and adjusted annually), that value must be aggregated with the value of the officer's or director's existing holdings when determining whether an HSR filing is necessary. Failure to make a required filing could result in substantial monetary penalties for the individual officer or director, as well as company disclosure obligations. To avoid an inadvertent failure to make a required HSR filing, companies should implement an HSR warning system that reminds the company and its officers and directors to confer with counsel about potential HSR implications well in advance of the anticipated date of any stock option exercise or RSU vesting.

Insider Trading and Rule 10b-5

The antifraud provisions contained in Rule 10b-5 under the 1934 Act prohibit directors, officers, employees and others who are aware of material nonpublic information from trading while aware of that information. Disclosing material nonpublic information to others who then trade while aware of that information is also a violation of Rule 10b-5, and both the person who discloses the information and the person who trades while aware of the information are liable. These illegal activities are commonly referred to as *insider trading*. In the context of insider trading, the term *insider* covers all employees and certain others who are aware of the material nonpublic information, such as consultants, in addition to Section 16 insiders.

Penalties

Insider Liability: For Trading. Potential penalties for insider trading violations include imprisonment for up to 20 years, civil

finances of up to three times the profit gained or loss avoided by the insider trading and criminal fines of up to \$5 million.

Issuer Liability: For Inaction. The company, as well as directors and officers, may be subject to controlling-person liability under federal securities laws. Controlling-person liability may apply if the company or the director or officer knew, or recklessly disregarded, that a person directly or indirectly under the company's or the responsible person's control was likely to engage in insider trading and the company or person failed to take appropriate steps to prevent the trading. The penalty for inaction is a civil fine of up to the greater of \$2,166,279 (subject to adjustment for inflation) or three times the profit gained or the loss avoided as a result of the insider trading and criminal fines of up to \$25 million.

Company Insider Trading Policy

The best way to protect a company and its insiders from potential liability under the insider trading laws is to adopt and enforce a clear policy that defines insider trading and prohibits trading while aware of material nonpublic information. The insider trading policy should apply to all directors, officers, employees and consultants of the company.

Establish Blackout Periods. The insider trading policy should establish trading blackout periods. A trading *blackout period* is a time period during which the company prohibits Section 16 insiders and other employees and consultants who have access to material nonpublic information about the company from buying and selling the company's securities. Blackout periods generally begin two to four weeks before the end of the quarter and end after the first or second full business day following the company's earnings release for that quarter. If a material event occurs (or material information is known) outside a blackout period, the company generally will impose an event-specific blackout period for applicable insiders while the event (or information) remains material and nonpublic.

Require Preclearance. Section 16 insiders and certain other employees and consultants with access to material nonpublic

information should be required to notify and seek approval from a company compliance officer for any transactions in company stock by them or their family members at least two business days before the contemplated transaction.

Rule 10b5-1 Trading Plans

Rule 10b5-1 provides an affirmative defense for insiders who sell securities pursuant to a previously established Rule 10b5-1 trading plan, even if the insider is aware of material nonpublic information at the time of the actual trade. (We discuss Rule 10b5-1 trading plans in detail later in this chapter.) A company's insider trading policy will generally permit an insider to adopt a Rule 10b5-1 trading plan during a period of time outside a blackout period and when the insider is not aware of material nonpublic information, but only if the trading plan is precleared by a compliance officer. The insider trading policy should exclude trades under appropriately established Rule 10b5-1 trading plans from the preclearance policy and blackout periods.

Insider Trading During Pension Plan Blackout Periods Prohibited

Under the SEC's Regulation Blackout Trading Restriction (Regulation BTR), executive officers and directors may not, during any pension plan blackout period, directly or indirectly (including through a family member) acquire, sell or transfer any company equity securities that the director or executive officer acquired in connection with employment or service as a director or executive officer.

A Regulation BTR blackout period means any period of more than three consecutive business days during which pension plan participants cannot trade in securities held in their individual accounts, but only if this suspension affects at least 50% of the participants in all of the company's "individual account plans." A Regulation BTR blackout period does not include:

- Any regularly scheduled trading suspension that the company incorporates into the pension plan's govern-

ing documents and timely discloses to employees before they become participants; or

- Certain temporary trading suspensions imposed by the pension plan in connection with individuals' becoming (or ceasing to become) participants in the plan by reason of a corporate merger, acquisition or similar transaction.

A variety of transactions over which directors and executive officers have no control fall outside Regulation BTR. For example, transactions under Rule 10b5-1 trading plans, changes that result from a stock split or dividend and compensatory grants and awards under plans that clearly set out the amount, price and timing of awards or include a formula for determining these items are all exempt.

To satisfy Regulation BTR and notify the directors, executive officers and the public, companies must, within specific time frames:

- Provide their directors and executive officers with a Regulation BTR notice of pension plan blackout periods; and
- File the Regulation BTR notice on Form 8-K.

**Practical Tip:
Provide Your Directors and Officers
with a Trading Compliance Checklist**



In addition to implementing an insider trading policy and Section 16(a) and Rule 144 compliance procedures, providing your insiders with a Trading Compliance Checklist similar to the following will serve as a basic reminder of trading prohibitions and SEC filing requirements:

1. Comply with the Company's Insider Trading Policy

Any time you engage in a transaction involving company securities, you must comply with the company's insider trading policy and applicable insider trading laws. The company's insider trading policy requires that transactions by insiders be precleared with the company's compliance officer and that insiders trade only during periods that are not blackout periods. Before effecting any transaction in company securities, you should ask:

- Is the company in a blackout period?
- Am I aware of any material nonpublic information?
- Have I precleared the transaction with the company's compliance officer?



Practical Tip:
Provide Your Directors and Officers
with a Trading Compliance Checklist (Cont'd)

2. Short-Swing Profit-Matching Liability Under Section 16(b) and Reporting Under Section 16(a)

Any nonexempt trade you make that effects a purchase within six months before or after a sale or a sale within six months before or after a purchase results in a violation of Section 16(b). The profit will be determined by matching the highest-priced sale with the lowest-priced purchase within six months of the sale. Even if you do not realize this profit in an economic sense, the company or any shareholder acting on behalf of the company may recover this profit from you. It makes no difference how long you held the shares, that you were not aware of inside information, that you had no harmful intent or that one of the two matchable transactions occurred after you were no longer an insider. Before effecting any transaction in company securities, you should ask:

For Sales:

- Have I, my immediate family members or any trust, partnership or corporation that I am affiliated with made any purchases within the past six months?
- Do I anticipate that I, my immediate family members or any trust, partnership or corporation that I am affiliated with will make any purchases within the next six months?

For Purchases:

- Have I, my immediate family members or any trust, partnership or corporation that I am affiliated with made any sales within the past six months?
- Do I anticipate that I, my immediate family members or any trust, partnership or corporation that I am

**Practical Tip:
Provide Your Directors and Officers
with a Trading Compliance Checklist (Cont'd)**



affiliated with will make any sales (including sales occurring through a broker-assisted cashless option exercise) within the next six months?

Before Any Transaction in Company Securities:

- Have I notified the company's compliance officer prior to engaging in the transaction for purposes of facilitating Section 16 filings?

3. Compliance with Rule 144

To comply with Rule 144, certain limitations on sales of company securities must be met, and generally, insiders must file Form 144s. Before effecting any transaction in company securities, an insider should ask:

- Has a Form 144 been prepared?
- Have I reminded my broker to sell under Rule 144?

Get with the Program: Rule 10b5-1 Trading Plans

One cost of inside knowledge for a public company director or executive officer is illiquidity. The insider cannot sell shares during a trading blackout period or when the insider is aware of material nonpublic information. For many insiders, this may leave little or no time in which to trade. The SEC, by adopting Rule 10b5-1, opened a path that can bring transparency and order to insider selling, and so both eases this liquidity squeeze and helps ensure compliance with the antifraud provisions of Rule 10b-5.

Rule 10b5-1 begins by clearly stating that anyone trading in a company's securities while aware of material nonpublic informa-

tion is engaging in unlawful insider trading. The rule then provides a limited safe harbor (technically, an affirmative defense) that, when closely followed, creates a shield from liability. Rule 10b5-1 allows insiders to adopt, at a time when the insider is not aware of material nonpublic information, a written trading plan that will permit future sales, even when those future sales may occur at times that the insider is aware of material nonpublic information. Rule 10b5-1 trading plans are relatively easy to understand, establish and administer, and court cases have demonstrated the usefulness of properly structured trading plans in defending against charges of insider trading. However, perceived abuses of Rule 10b5-1 trading plans have led to scrutiny in academic studies and by the SEC and the courts. In early 2021 the SEC chair asked the SEC staff to make recommendations to “freshen up” Rule 10b5-1 to incorporate and expand upon best practices.

Benefits to the Company and Its Insiders on Adopting Rule 10b5-1 Trading Plans

In addition to helping establish protection from liability, written Rule 10b5-1 trading plans can:

- Enable insiders to make orderly dispositions of stock for diversification, estate planning or other personal needs and to facilitate stock option exercise and sale programs;
- Reduce the number of times a company faces a decision about whether material nonpublic information exists that requires the company to prohibit trading in its stock by insiders;
- Help market perceptions by bringing transparency and advance disclosure to insiders’ sales of company stock; and
- Protect an insider from the risk of “conduit theory” liability for gifts to charitable organizations or others when the insider knows the donee is likely to sell the gifted securities in the near future.

The Three “Legs” of a Rule 10b5-1 Trading Plan

A successful Rule 10b5-1 trading plan stands on three legs. First, the trading plan must be established when the insider is not aware of material nonpublic information. SEC guidance clarifies that the affirmative defense of a trading plan is not available if an insider establishes the plan while aware of material nonpublic information, even if the plan is structured so that transactions will not begin until after that material information is made public.

Second, the trading plan must be in writing and must:

- Specify the amount (either number of shares or dollar value), price (market price on a particular date, a limit price or a specified dollar price) and dates of the trades (this may be the day on which a market order is to be executed or on which “best execution” begins or on which a limit order is in force); or
- Include a formula, algorithm or computer program for determining the amount, price and dates of the trades to be made; or
- Delegate to another person sole discretion to determine the amount, price and dates of the trades to be made, provided that the person is not aware of material nonpublic information.

Third, each trade should comply with the trading plan. The insider must not alter or deviate from the trading plan (by changing the amount, price or timing of the trade) or enter into or alter a corresponding or hedging transaction or position with respect to the securities. SEC guidance clarifies that the cancellation of one or more plan transactions represents an alteration of or deviation from the trading plan that may affect the availability of the affirmative defense.

In addition to these three legs, the insider must enter into the trading plan in good faith and not as part of a scheme to evade the prohibitions of Rule 10b5-1. SEC guidance clarifies that in

creating a new trading plan after cancelling a prior trading plan, all surrounding facts and circumstances, including the period of time between the cancellation of the old plan and the creation of the new plan, must be evaluated in determining the insider's good faith intent.

Drafting a Rule 10b5-1 Trading Plan

The legal or compliance department of the insider's broker usually will take the lead in drafting the insider's Rule 10b5-1 trading plan. The insider and the company must then closely review and tailor the draft trading plan to ensure that it fits their requirements. The trading plan should first establish the amount, price and dates of the trades, or a method to determine the amount, price and dates. Next, a Rule 10b5-1 trading plan will state explicitly in writing that:

- *No Inside Information.* When the insider enters into the trading plan, the insider is not aware of material non-public information with respect to the company or its securities.
- *Waiting Periods.* The first transaction under the trading plan will take place only after a waiting period (typically at least 30 days to three months from the date the plan is executed). Similarly, there are typically waiting periods of at least 30 days before trading can be resumed under a modified trading plan and before an insider who has terminated a plan can enter into a new plan. These waiting periods help solidify the insider's good faith in establishing the trading plan.
- *No Hedge.* The insider has not entered into or altered a corresponding or hedging transaction with respect to the stock to be traded under the trading plan and agrees not to enter into any of those transactions while the plan is in effect.
- *Rule 144.* The insider and the broker will take any steps necessary to comply with Rule 144.

- *Filings.* The insider will be responsible for making all filings, if applicable, under Sections 13(d) and 16 of the 1934 Act, and the broker will supply the insider with all the information necessary for those filings on a timely basis.
- *Independent Broker.* The insider acknowledges that the insider does not have any authority, influence or control over any actions by the broker and will not attempt to exercise any authority, influence or control, and the broker will not seek advice from the insider with regard to the manner in which the broker acts under the trading plan.
- *Purpose.* The trading plan will generally set forth a specified purpose, for example, to permit the orderly disposition of a portion of the insider's holdings or to facilitate the exercise of options and sale of the underlying stock.
- *Good Faith.* The insider is entering into the trading plan in good faith and not as part of a plan or scheme to evade the provisions of Rule 10b5-1.
- *Intent.* The trading plan is intended, and will be interpreted, to comply with Rule 10b5-1 and related SEC interpretations.

Review by the Company

A company's insider trading policy should require insiders to submit Rule 10b5-1 trading plans to the company's compliance officer for preclearance before adoption. The purpose of preclearance is not for company "approval" of the terms of the trading plan, but to permit the compliance officer to determine that the plan is being adopted outside a trading blackout period and otherwise complies with the company's insider trading policy. To assist with this review, companies should consider adopting written Rule 10b5-1 guidelines that all insiders must follow in adopting a Rule 10b5-1 trading plan.

Public Disclosure; Filing the Right Forms

If the Rule 10b5-1 trading plan relates to a senior executive and a material number of shares, the company should consider disclosing the establishment of the executive's trading plan to maximize transparency, preempt market reaction and alleviate shareholder concerns. A company can make the public disclosure through one or some combination of a Form 8-K, Form 10-Q, press release or website posting.

Companies should implement procedures to ensure that insiders timely report Rule 10b5-1 trading plan transactions on Forms 4, 5 and 144 and, as required, on Schedule 13D or 13G. When reporting transactions on Form 144 (initially filed when the first trade under the trading plan is executed or a sell order is placed), the insider must sign the form and indicate in the space provided below the signature line the date on which the insider adopted the trading plan, which actions serve as the insider's representation that the insider was not aware of material non-public information as of the date the plan was adopted (rather than the date the Form 144 was signed). Sales under a trading plan that will occur over a period of more than three months will require multiple filings of Form 144. In the Form 4, filed to report the transaction, insiders should also note that the trade was pursuant to a Rule 10b5-1 trading plan to minimize speculation that the transaction reflected the insider's current perception of the status of the company.



Practical Tip: Six Simple Steps

Insiders should be cautioned that a Rule 10b5-1 trading plan, even one that meets all the requirements of Rule 10b5-1, only provides an affirmative defense in an enforcement action or lawsuit alleging unlawful insider trading. It does not prohibit someone from bringing the enforcement action or lawsuit. It is possible to strengthen this affirmative defense by following the six steps suggested below.

- Ask the broker that will be executing the insider's trades for a copy of the broker's current form of a Rule 10b5-1 trading plan. This will be the starting place for drafting a trading plan. The company's counsel or a compliance officer should then review the draft for compliance with the company's insider trading policy and Rule 10b5-1 guidelines and to ensure that the plan protects the company's interests.
- An insider can terminate a trading plan, but termination must be done with caution. Termination may call into question whether the trading plan was entered into in good faith and not as part of an effort to evade insider trading rules. If an insider terminates a trading plan, she should observe a waiting period before entering into a new plan.
- An insider may modify a trading plan, provided that the insider is not aware of material nonpublic information at the time of the modification. But any modification is, in effect, the adoption of a new trading plan and a waiting period should be imposed before effectiveness of the modification. Frequent modifications, like terminations, can call into question the good faith of the insider.



**Practical Tip:
Six Simple Steps (Cont'd)**

- An insider may make trades outside the trading plan provided the insider is not aware of material nonpublic information. Trades outside the trading plan are not protected by Rule 10b5-1's affirmative defense and must not hedge trades made under the plan. Some Rule 10b5-1 trading plans prohibit trades outside the plan with a different broker to avoid the risk of exceeding the Rule 144 volume limitations.
- Carefully review the insider's contractual lock-up agreements. Underwriters, for example, may have prohibited or restricted any trades for a set period after an offering.
- A trading plan should provide for automatic suspension or termination upon specified events. These may include the insider's death or bankruptcy, imposition of an underwriter's lock-up agreement or the announcement of a tender offer for the company's stock or a merger.

Chapter 7

Proxy Statements and Proxy Solicitation

The Proxy Statement

Prior to each shareholders' meeting, a public company solicits a proxy from each of its shareholders by providing a proxy statement and a proxy card (or voting instructions). A *proxy* is a power of attorney allowing the company's management (or another designee) to vote the shares owned by a shareholder as directed by the shareholder or at the designee's discretion. The *proxy solicitation process* allows shareholders to exercise their voting rights without being physically present at the shareholders' meeting. The *proxy statement* informs shareholders about the items of business to be voted on at a shareholders' meeting, provides certain other SEC-required disclosures and solicits a proxy from each shareholder entitled to vote at the meeting.

The Annual Meeting of Shareholders

In connection with a public company's annual meeting of shareholders, a public company provides its shareholders with a proxy statement and an annual report to shareholders, which together play a critical role:

- They provide an annual, formal communication from management to the company's shareholders; and
- They serve as an annual corporate governance checkup.

Typical annual meeting matters include director elections, say-on-pay proposals and ratification of independent auditors. Other matters to be voted on may include approval of equity incentive plans and qualified shareholder proposals.

Special Shareholders' Meetings

A public company may also hold a special meeting of shareholders for a variety of reasons, including seeking shareholder approval for a sale of the company or certain other major transactions involving the company. In connection with these special meetings, a company provides its shareholders with a proxy statement containing, among other things, information regarding the matter to be voted on at the meeting.

Regulations Governing the Proxy Statement

Regulation 14A of the 1934 Act governs any communication by a public company reasonably calculated to cause a shareholder to grant, withhold or revoke a proxy. Regulation 14A requires a public company to disclose relevant material information and prohibits fraud in connection with a proxy solicitation. State corporate law, as well as the provisions of each company's certificate or articles of incorporation and bylaws, also govern aspects of the proxy solicitation process.

The Proxy Statement as a Solicitation Tool

With the increasing influence of shareholder activists and proxy advisory firms (such as Institutional Shareholder Services Inc. (ISS) and Glass, Lewis & Co. LLC (Glass Lewis)), the proxy statement has evolved from a pure SEC disclosure document to become a solicitation tool that savvy companies use to connect with shareholders to tell their companies' story. In addition to the required disclosures, many companies focus on making their proxy statements clearer and more user-friendly through the use of executive summaries, graphics and other techniques. See the "Proxy Statement Usability" Practical Tip later in this chapter for our suggestions about using your proxy statement to tell a compelling story.

Information Included in the Proxy Statement

Schedule 14A outlines the information that a public company must include in a proxy statement. Companies typically include, for example, many Form 10-K-required disclosures in the proxy statement and incorporate them by reference into the Form 10-K. (Form 10-K permits this so long as the company files its proxy statement within 120 days after its fiscal year-end.) Mandatory Schedule 14A disclosures include:

- *The Meeting.* The date, time and location of the shareholders' meeting.
- *Voting Information.* A description of the shareholder vote required for approval of each matter to be voted on at the shareholders' meeting, the record date for determining the holders of shares entitled to be voted and the method for counting votes.
- *Board Elections.* Detailed background information about the director nominees and incumbent directors.
- *Executive Compensation.* Detailed tabular and narrative information about the company's compensation for its principal executive officer, principal financial officer and three other most highly compensated executive officers (the named executive officers), as well as a compensation discussion and analysis (CD&A) of how and why the company decided on the types and amounts of compensation paid during the last completed fiscal year, and the ratio of CEO annual compensation to that of the company's median employee.
- *Say-on-Pay Proposals.* A nonbinding shareholder vote on the compensation disclosed for the company's named executive officers (required every one, two or three years) and a separate nonbinding vote (at least every six years) on how frequently to hold the say-on-pay vote.
- *Related Person Transactions.* A description of certain transactions between the company and any director, director nominee, executive officer or 5% shareholder,

or any of their immediate family members, and the company's procedures for approving these types of transactions.

- *Corporate Governance.* Detailed information regarding director independence, committee governance and composition, director compensation, the Board nomination process and Board leadership structure.
- *Risk Management.* The Board's role in risk oversight and the company's risk management for any material compensation-related risks.
- *Beneficial Ownership and Section 16 Compliance.* The identity of shareholders who beneficially own 5% or more of the company's shares, the share ownership of the company's directors, named executive officers, and directors and all executive officers as a group, and any failures by these persons to timely comply with the reporting requirements of Section 16(a) of the 1934 Act.
- *E-Proxy Disclosures.* How to access the company's proxy materials online.

Dodd-Frank Act's Impact on Proxy Voting and Proxy Statement Disclosures

The Dodd-Frank Act, which became law in 2010, has significantly impacted annual shareholders' meetings and proxy statement disclosures, including say-on-pay and say-on-frequency votes, CEO pay ratio disclosure, company policies on hedging of company securities by directors and employees, and disclosures regarding Compensation Committee independence and the use of compensation advisors. As of the time this Handbook went to press in 2021, the SEC had proposed but not yet adopted rules to implement two other provisions under the Dodd-Frank Act that will impact proxy statement disclosures: the relationship between executive pay and company performance, and mandatory clawbacks for some executive incentives, which will then require further NYSE and Nasdaq rulemaking.

Executive Compensation

Compensation Discussion and Analysis (CD&A). The CD&A is principles-based, similar to the MD&A in the Form 10-K, and must discuss the material information necessary to understand the objectives of a company's compensation for its named executive officers for the last completed fiscal year. This means that each company must determine, in light of its particular facts and circumstances, what elements of the company's compensation policies and decisions are material to investors' understanding. In addition, the proxy statement CD&A must answer these questions:

- What are the objectives of the company's compensation program?
- What is the compensation program designed to reward?
- What is each element of compensation?
- Why does the company choose to pay each element?
- How does the company determine the amount (and any formula) for each element?
- How do each element and the company's decisions regarding that element fit into the company's overall compensation objectives and affect decisions regarding other elements?
- Did the company consider the results of the most recent say-on-pay vote in determining compensation policies and decisions, and if so, how?

The SEC rules also provide a nonexclusive list of topics a company should address in the CD&A for the last completed fiscal year if material and necessary to an understanding of the company's policies and decisions for compensation of its named executive officers. Compensation actions or decisions taken before or after the last completed fiscal year should also be addressed, if necessary, to present a "fair understanding" of the named executive officers' compensation for the last completed fiscal year.

Due to proxy advisory firm and investor focus on executive compensation, the CD&A also often includes disclosures that go well beyond SEC requirements and the above-listed items. Such disclosures are typically aimed at more clearly explaining the executive compensation program's link to company financial and market performance with an eye toward soliciting support for the say-on-pay proposal.

Compensation Committee Report. A Compensation Committee Report, which accompanies the CD&A and is followed by the name of each member of the Committee, confirms that the Committee has reviewed and discussed the CD&A with management and recommended to the Board that the CD&A be included in the proxy statement.



Practical Tip:
Aim Carefully! Disclose Performance Targets

Your company must generally disclose company and individual performance targets for incentive compensation in the year covered by the CD&A as well as the actual achievement levels matched against the targets. You must include these targets if they are material elements of your company's compensation policies and decisions, unless you can demonstrate that the disclosure would result in competitive harm to the company. The SEC, through comment letters, imposes a stringent standard of review on omitted performance goals. It rarely accepts "competitive harm" arguments for corporate-level financial performance targets for completed fiscal periods. If your company omits performance targets, you must discuss in your CD&A with meaningful specificity how difficult it will be to achieve the undisclosed targets. In addition, proxy advisory firms are often critical of companies that fail to clearly disclose executive compensation performance targets.

Executive Compensation Tables and Related Narrative Disclosures. A series of required tables and supplemental narrative disclosures follow the CD&A, showing compensation of named executive officers in three categories:

- All compensation paid, earned or awarded in the last completed fiscal year and the two preceding fiscal years, with a specific breakdown of equity and nonequity plan-based awards during the last completed fiscal year;
- Equity holdings as of the end of the last completed fiscal year and realizations from the exercise of options or vesting of equity awards during the last completed fiscal year; and
- Post-employment compensation, including pension plans, nonqualified deferred compensation and other plans and benefits, including payments relating to severance, retirement and change of control.

Narrative disclosure provides the context for the compensation tables. By contrast, the narrative in the CD&A focuses on the broader “how” and “why” issues behind the company’s compensation policies and programs.

Analysis of Risk Related to Compensation for All Employees

Companies must specifically discuss and analyze employee compensation policies and practices to the extent that the policies or practices create risks that are reasonably likely to have a material adverse effect on the company.



Practical Tip:
Look Out! Disclose Process and Conclusions
Regarding Risk Analysis

The proxy disclosure rules do not require you to affirmatively state that your company has determined that the risks arising from your compensation policies and practices are not reasonably likely to have a material adverse effect on your company. However, consider this: affirm both your risk analysis conclusion and the process by which you arrived at that conclusion. If you do this, discuss the policies or practices (such as clawbacks or minimum stock ownership guidelines) that mitigate those risks that your incentive compensation programs create. If you discuss these risk-mitigation elements, set them off under a separate, identifiable heading to make it clear that you are not including these elements in the executive compensation covered by the say-on-pay vote. You should also consider including details regarding the consideration of risk for named executive officer compensation policies and practices within the CD&A.

Say-on-Pay and Say-on-Frequency

Public companies holding a shareholders' meeting to elect directors also conduct nonbinding advisory votes on both the compensation paid to named executive officers (the say-on-pay vote) and, at least once every six years, whether the say-on-pay vote should be held every one, two or three calendar years (the say-on-frequency vote).

Say-on-Pay Vote. The say-on-pay vote seeks approval of executive compensation as disclosed in the proxy statement.

Although SEC rules require no specific language or form of resolution, generally a company must:

- Indicate that the vote is to approve the compensation of named executive officers as disclosed in the proxy statement, including the CD&A, the compensation tables and the related narrative disclosures;

- Disclose that a say-on-pay vote is being presented pursuant to the SEC's proxy rules and explain the general effect of the vote (i.e., the nonbinding nature of the vote); and
- After the initial say-on-pay and say-on-frequency votes, disclose in subsequent proxy statements when the next say-on-pay and say-on-frequency votes will occur. In addition, companies must disclose in future CD&As how the results of the most recent say-on-pay vote have been considered in determining compensation policies and decisions.

Say-on-Frequency Vote. The purpose of the say-on-frequency vote is to ask, at least every six years, how often shareholders would prefer future say-on-pay votes to occur. The proxy card should give shareholders four alternatives: every one, two or three years or abstain. Companies must disclose that they are providing a separate say-on-frequency vote pursuant to the SEC's proxy rules and explain the nonbinding nature of the vote. Although a company's Board may include a recommendation on how shareholders should vote, the proxy statement should be clear that shareholders are not voting to approve or disapprove the Board's recommendation.

Practical Tip:
**Preserve Your Discretion to Vote Uninstructed
Say-on-Frequency Proxy Cards**



When drafting your proxy card, you can carefully preserve your ability to vote uninstructed proxy cards in accordance with management's recommendation for the say-on-frequency vote if you:

- Include a recommendation for the frequency of the say-on-pay votes in the proxy statement; and
- Include language in bold on the proxy card regarding how management intends to vote uninstructed shares.

Form 8-K Disclosure. Companies disclose the voting results for the say-on-pay and say-on-frequency votes under Item 5.07 of Form 8-K within four business days following the date of the shareholders' meeting. This may include the Board's decision on how frequently to hold future say-on-pay votes, although this decision can also wait until an amendment to the Form 8-K is filed within 150 days of the shareholders' meeting or, if earlier, 60 calendar days before the deadline for the submission of shareholder proposals under Rule 14a-8 under the 1934 Act for the next annual meeting.

Pay Ratio Disclosure

U.S. public companies are required to disclose the annual compensation of their median employee, the annual total compensation of their CEO, and the ratio of these two amounts. Emerging growth companies and smaller reporting companies are exempt from this disclosure.

To identify the median employee, companies may select a methodology based on their own facts and circumstances. For example, a company could use its total employee population, a statistical sampling of that population or other reasonable methods. In performing its pay ratio calculation, subject to limited exceptions, a company is required to include all personnel – U.S. and non-U.S., full-time, part-time, temporary and seasonal – employed by the company and any of its consolidated subsidiaries on any date of the company's choosing within the last three months of its last completed fiscal year.

In identifying the median employee, a company may rely on a compensation measure that uses the same rules that apply to the CEO's compensation, or any other compensation measure that is consistently applied to all employees included in the calculation, such as information from its tax or payroll records. Once the median employee has been identified, however, a company must calculate the annual total compensation for that employee using the same rules that apply to the CEO's compensation as disclosed in the summary compensation table.

A company is permitted to identify its median employee once every three years, unless there has been a change in its employee population or employee compensation arrangements such that the company reasonably believes would result in a significant change to its pay ratio disclosure. A brief description of the methodology used to identify the median employee, and any material assumptions, adjustments or estimates used to identify the median employee or to determine annual total compensation, must be provided.

Hedging Policy Disclosure

U.S. public companies are required to disclose in proxy statements any practices or policies they have adopted regarding the ability of any company employee, officer or director to engage in any transaction to hedge or offset any decrease in the market value of company equity securities granted to the individual as compensation or held by the individual directly or indirectly.

Companies must provide a “fair and accurate” summary of the practices or policies (whether written or unwritten) or disclose the practices and policies in full. Any disclosure must include the categories of persons covered and the categories of hedging transactions that are specifically permitted or disallowed. If the company does not have any hedging policies or practices, it must disclose that fact and state, if accurate, that hedging transactions are generally permitted.



**Practical Tip:
Proxy Statement Usability**

Drafting your proxy statement with “usability” in mind allows it to serve as your company’s voice in presenting your executive compensation and governance story to investors and proxy advisory firms. It also allows you to keep up with your peers in the ever-evolving world of shareholder engagement efforts. We suggest the following as ways to enhance proxy statement usability:

- Consider your target audience(s) for the current year in order to address particular shareholder or proxy advisory firm concerns or a specific area of shareholder engagement. The target audience may extend beyond shareholders to other stakeholders, particularly given the focus on ESG topics and engagement.
- Understand that proxy statement design and disclosure is now a “race to the top,” with companies of all sizes focused on creating user-friendly proxy statements that are more like shareholder outreach/solicitation documents than pure legally required disclosure filings.
- Kick off the proxy statement with an executive summary or overview as well as an executive summary of the CD&A, as these are often the most-read sections of the proxy statement and investors may review the summaries instead of full sections.
- Include user-friendly navigation tools such as a detailed table of contents and headings and sub-headings with live links as important guideposts.
- Consider making your proxy statement more interactive with a letter from the Board.



**Practical Tip:
Proxy Statement Usability (Cont'd)**

- Include details about any shareholder engagement the company participated in during the year, what the issues were and the results of the engagement.
- Describe key compensation and governance policies, including stock ownership guidelines, claw-back policies, perquisite policies and severance and postretirement benefits. Consider including these in a “What We Do” and “What We Don’t Do” list format.
- Because most proxy statements are read online, consider how to inexpensively make the layout of the online version more interesting and reader-friendly through the use of color or formatting.
- Consider adding a chart or matrix illustrating Board skills, tenure and diversity in response to investor interest on these topics. For example, in 2018, the New York City comptroller issued a letter suggesting best practices for Board skill and diversity matrixes and included a number of examples. See Chapter 10 for a discussion of new Nasdaq rules relating to Board diversity disclosures.
- Include pictures of Board members.
- Endeavor to clearly but concisely explain and highlight the alignment between the company’s pay and performance as part of your say-on-pay story.
- Use graphs, tables and color, especially in the CD&A and executive summary, to break up text and better tell your story, but avoid overly complex or misleading graphics.



**Practical Tip:
Proxy Statement Usability (Cont'd)**

- Consider explaining your compensation program mechanics and performance over multiple years rather than presenting a single year in a vacuum. Bar charts are a good way to show trends over time.
- Draft in plain English and avoid legalese whenever possible.

Most “leaders” in proxy statement disclosures have evolved over time. Starting from scratch on proxy statement usability requires a long lead time and can be cost-intensive. An alternative approach is to consider a few items to improve each year with an eye toward gradual and achievable long-term improvements.

Board and Corporate Governance

SEC disclosure requirements for annual reports and proxy statements highlight the composition and role of the Board and corporate governance generally. Key governance disclosures include:

- *Director Independence and Meeting Attendance.* Both the NYSE and the Nasdaq listing standards require a majority of a listed company’s Board to be independent (as defined by the applicable exchange). The company must identify its independent directors in its proxy statement. In addition, all non-management directors must meet in regular executive sessions, and NYSE companies must disclose in the proxy statement the name of the director who presides over these executive sessions. (We discuss NYSE listing standards in Chapter 9 and Nasdaq listing standards in Chapter 10.) A company must also disclose the total number of Board meetings held during the last

fiscal year and identify directors who attended fewer than 75% of the aggregate of the total number of their Board and committee meetings. A company must also disclose its policy on director attendance at the annual meeting and the number of directors who attended the prior year's meeting.

- *Board Leadership Structure and Role in Risk Oversight.* The proxy statement describes the Board leadership structure and explains why the Board believes its chosen structure is most appropriate in light of the nature and current circumstances of the company. In particular, if the roles of CEO and chair of the Board are combined and a lead independent director conducts the meetings of the independent directors, the company must disclose why it has a lead independent director and describe the specific role the lead independent director plays in the leadership of the company. The proxy statement discusses the Board's role in risk oversight and answers questions such as whether risk oversight is performed by the whole Board or by a separate risk committee.
- *Transactions with Related Persons.* The proxy statement provides an annual highlight of certain related person transactions and relationships that were considered by the Board in determining a director's independence. Companies also describe their policies and procedures for the review and approval or ratification of potential related person transactions.
- *Board Committees.* The proxy statement discloses whether the Board has each of the customary standing Board committees: Audit, Nominating & Governance and Compensation Committees (or a committee performing similar functions). Disclosure identifies the function of each committee and the directors who serve on each, confirms their independence, discloses whether each committee has a written charter and indicates where the charter is available. There are also specific disclosures required for each committee, such as whether the Audit

Committee includes an Audit Committee financial expert.

- *Compensation Consultants.* The proxy statement describes the engagement and role of compensation consultants in determining or recommending the amount or form of executive and director compensation. Companies generally must disclose additional information if the consultant provides other services to the company resulting in fees greater than \$120,000 during the company's fiscal year. If a compensation consultant has raised any conflict of interest, companies also must disclose the nature of the conflict and how the conflict is being addressed.



Practical Tip:
**Integrate ESG Disclosure into
the Proxy Statement**

Stakeholder focus on environmental, social and governance (ESG) topics continues to influence companies of all sizes across industries. Many companies provide ESG disclosure in separate reports, often called sustainability reports or corporate responsibility reports, but include limited disclosures in their SEC filings. While the required SEC proxy statement disclosures address many governance items, given that the proxy statement is a main form of stakeholder engagement, companies should consider highlighting their environmental and social efforts by adding such disclosure to the proxy statement. At a minimum, proxy advisors expect S&P 500 companies to explicitly disclose the Board's role in overseeing environmental and social issues, and many other ESG-related disclosures regarding human resources, compensation and the Board may fit naturally in the proxy statement. See Chapter 3 for more information about stakeholder engagement on ESG topics.

Director Nominations. A detailed description of the director nomination processes in the proxy statement, to give shareholders an understanding of Board operations, includes:

- *“Minimum Qualifications” of Director Candidates.* The proxy statement sets out the “minimum qualifications” needed by a director nominee to be recommended by the Nominating & Governance Committee. Companies then describe the experience, qualifications, attributes or skills of each director and nominee, including service on other public company and registered investment company Boards during the preceding five years.
- *Shareholder-Recommended Director Candidates.* The proxy statement describes the policy, if any, for consideration of shareholder-recommended director candidates and the procedures for recommending them. (And if there is no such policy? Then, the proxy statement needs to explain why not.)
- *Source and Evaluation of Director Candidates.* A description of the Nominating & Governance Committee’s process for identifying and evaluating potential director nominees includes an explanation of any differences in the process for shareholder-recommended candidates.
- *Board Diversity.* The critical diversity section discusses whether and, if so, how the Nominating & Governance Committee or Board considers diversity when identifying potential director nominees. The disclosure includes whether the Nominating & Governance Committee or Board has a policy on diversity for director selection and, if so, how it implements the policy and assesses its effectiveness.
- *5% Shareholder-Recommended Director Candidates.* If a 5% or greater shareholder or group that has owned its position for at least a year timely recommends a director candidate, the proxy statement, with the individual’s consent, discloses the name of the candidate,

the name of the shareholder and whether the company nominated the individual.

Communications with the Board. A company must describe whether and how shareholders (and for NYSE companies, other interested parties) can send communications to the Board or to specific individual directors (and for NYSE companies, to the non-management directors as a group).

Director Compensation. Finally, a company must disclose in a specified tabular format all compensation that it has paid to directors or that they have earned in the most recently completed fiscal year, and provide narrative disclosure of any material factors necessary to understand the information in the table.

Audit Committee Report & Auditor Fees

The Audit Committee publishes its own report in the proxy statement. This report includes disclosure that the Committee reviewed and discussed with management the audited financial statements, reviewed and discussed with the independent auditors written disclosures regarding the auditors' independence, and other matters required by applicable auditing standards. At the heart of this report is the Committee's recommendation to the Board to include the audited financial statements in the company's annual report. A company must also disclose in detail in its proxy statement and Form 10-K the fees paid to the independent auditors and a description of any preapproval policies and procedures.

A company also discloses in the proxy statement whether representatives of the auditors will attend the annual meeting and whether they will have the opportunity to make a statement or respond to questions.

Filing and Distributing Proxy Materials

E-Proxy Rules: No Cookies!

The SEC's e-proxy rules require each public company to post proxy materials on a publicly available "cookie-free" website. The posted materials include the proxy statement, proxy card, annual report to shareholders, notice of shareholders' meeting, other soliciting materials and any amendments to these materials.

There are two alternatives available to companies to satisfy additional e-proxy requirements related to distribution of proxy materials:

- *Notice-Only Method.* In lieu of mailing full sets of printed materials to shareholders, the notice-only option allows companies to post their proxy materials online and mail shareholders a "Notice of Internet Availability" at least 40 days before the shareholders' meeting informing them of the availability of such materials and how to access the materials. Companies are only required to mail or e-mail full sets of the printed materials upon the request of a shareholder.
- *Full-Set Delivery Method.* This traditional method requires mailing the paper proxy and annual report materials to shareholders. Companies still need to post such materials online.

Companies use a variety of ways to satisfy this mandate, many distributing proxy materials using a stratified or bifurcated approach, employing different methods for different shareholder groups based on status as a retail versus institutional holder or registered versus street name holder.

Filing the Notice of Internet Availability

Companies that use the notice-only method of distribution file a form of the Notice of Internet Availability on EDGAR as additional soliciting materials no later than the date the company first sends the notice to its shareholders.

Filing Preliminary Proxy Statements

Most annual meeting proxy materials relate only to routine matters such as the election of directors, say-on-pay and say-on-frequency proposals, approval of an equity compensation plan or ratification of the independent auditor. A company may file a routine proxy statement with the SEC in final form either prior to or concurrently with distributing the proxy materials to shareholders.

When the proxy materials relate to nonroutine matters (such as authorizing additional shares or otherwise materially amending the charter or approving a merger), a company must file them in preliminary form at least ten days prior to distributing them to shareholders. These preliminary proxy materials are subject to review and comment by the SEC. The SEC will promptly advise a company if it intends to review the preliminary proxy materials. If the SEC advises that it will not review the materials, the company may distribute the definitive proxy materials to its shareholders and concurrently file them with the SEC. If the SEC comments on the preliminary proxy materials, the company needs to file amended proxy materials for SEC review.

Distributing the Proxy Statement to Shareholders

State corporate law in the company's jurisdiction of incorporation and a company's governing documents establish the time period for delivery of notice of an annual or special shareholders' meeting under most state laws. The notice period is generally no less than ten days (20 days for business combinations) and no more than 60 days prior to the shareholders' meeting date. The notice is usually included as part of a company's proxy statement. In practice, well-organized companies distribute proxy materials as far in advance of the shareholders' meeting as permitted by applicable notice requirements. Early distribution allows sufficient time for proxy materials to reach beneficial owners, helps ensure the presence of a quorum at the meeting and gives the company time to follow up with shareholders regarding voting.

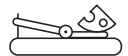
With the implementation of the e-proxy rules, a company is required to post its proxy materials on the e-proxy website no later than the date the company first sends the Notice of Internet Availability to shareholders. As a result, any website hosting company or other service provider involved in implementing the e-proxy website will need to receive finalized proxy materials in sufficient time to have the e-proxy website operational prior to that date. In addition, if companies utilize the notice-only method of distribution, the Notice of Internet Availability must be sent to shareholders at least 40 days before the shareholders' meeting. This means that companies must actually finalize proxy materials prior to the 40-day deadline and coordinate with various intermediaries to ensure timely mailing. With the full-set delivery method, this 40-day deadline does not apply.

The Proxy Card

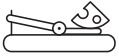
A shareholder can appoint a proxy by completing the proxy card that accompanies the proxy statement. Rule 14a-4 under the 1934 Act sets forth the specific form and content requirements for the proxy card.

If a company uses the notice-only method, it will need to hold off on mailing the proxy card until at least ten calendar days after mailing the Notice of Internet Availability to shareholders. This gives the shareholders time to access and review the proxy statement. Alternatively, rather than waiting ten days, the company could mail the proxy card if accompanied or preceded by a copy of the proxy statement and annual report.

**Trap for the Unwary:
Remember Your Optionees and 401(k)
Plan Participants**



Option Holders and 401(k) Plan Participants. Although the primary purpose of a proxy statement is to solicit votes from shareholders, you will also need to get your proxy statement and annual report, as well as other communica-



**Trap for the Unwary:
Remember Your Optionees and 401(k)
Plan Participants (Cont'd)**

tions distributed to shareholders generally, to holders of stock options and some participants in 401(k) plans with employer stock funds. Hidden in Rule 428(b) under the 1933 Act is an easy-to-overlook requirement identifying the information you need to deliver to optionees and other employee benefit plan participants, which includes delivery of proxy materials no later than when the materials are sent to the company's shareholders.

Electronic Delivery. If you adopt the notice-only option or use a stratified approach, pay special attention to ERISA plans with individual accounts invested in your company's stock, such as 401(k) plans and employee stock ownership plans. Rules adopted by the Department of Labor in May 2020 create a notice and access safe harbor for electronic delivery of proxy materials. To rely on the safe harbor, companies must first provide participants an initial notice of availability in paper form tailored to provide the participant's electronic address and stating that the proxy materials will be provided electronically unless the participant opts to receive only paper versions. The rules then provide detailed instructions about the content and manner of delivery of the electronic documents for individuals who have not opted out of electronic delivery.

We suggest approaching electronic delivery involving participants in equity and ERISA plans with extra care to address compliance with both SEC and ERISA rules.

Shareholder Proposals Submitted for Inclusion in Proxy Materials

Under certain conditions described in Rule 14a-8 under the 1934 Act, a public company must include in its proxy materials a *qualifying* proposal from a shareholder at no expense to that

shareholder. These rules provide a means for shareholders to seek shareholder consideration of actions not otherwise proposed by the Board. If the proposal does not meet the procedural and substantive requirements outlined in Rule 14a-8, the company may exclude the proposal from its proxy materials. If the Board does not favor a qualifying proposal, the company may include a statement in opposition to the proposal.

**Breaking News:
SEC Adopts Amendments to Modernize Shareholder
Proposal Rules**



In September 2020 the SEC adopted amendments to Rule 14a-8 increasing and tightening eligibility requirements for submitting and resubmitting shareholder proposals. The amendments will first apply to any shareholder proposal submitted for an annual or special meeting held on or after January 1, 2022.

Prior to the amendments, to be eligible to have a proposal included in a company's proxy statement, a shareholder proponent was required to have held at least \$2,000 of a company's securities continuously for at least one year. The amendments eliminated the alternative 1% threshold and adopted a tiered approach based on a combination of the amount of securities a shareholder proponent holds and the length of time the securities have been held. Under the amended rules, shareholder proponents must satisfy one of three alternative tests:

- Continuous ownership of at least \$2,000 of the company's securities for at least three years;
- Continuous ownership of at least \$15,000 of the company's securities for at least two years; or
- Continuous ownership of at least \$25,000 of the company's securities for at least one year.



**Breaking News:
SEC Adopts Amendments to Modernize Shareholder
Proposal Rules (Cont'd)**

Under a temporary phase-in period, a shareholder that has continuously held at least \$2,000 of a company's securities for at least one year as of the effective date, and continuously maintains at least \$2,000 of such securities through the date it submits a proposal, will be eligible to submit a proposal without satisfying the new ownership thresholds for an annual or special meeting to be held prior to January 1, 2023.

The amended rules also raise the threshold levels of shareholder support a proposal must receive to be eligible for resubmission at future shareholders' meetings. Previously, shareholder proposals could be excluded if they addressed substantially the same subject matter as a proposal or proposals formerly included in the company's proxy materials within the past five years if the most recent vote occurred within the preceding three years and the resulting vote in favor of the proposal was below 3% if submitted once, 6% if submitted twice and 10% if submitted three times. The new thresholds under the amended rules are 5%, 15% and 25%, respectively.

The new rules also require specified documentation when a proposal is submitted by a representative on behalf of a shareholder proponent and require shareholder proponents to identify specific dates and times they can be available to engage with the company to discuss the proposal.

Procedural Requirements

A shareholder must satisfy four procedural steps to be eligible to include a proposal in a company's proxy materials:

- *Stock Ownership.* The shareholder must meet the new ownership requirements described above and must

continue to hold the securities through the date of the shareholders' meeting.

- *One-Proposal Limit.* Each shareholder is limited to one proposal for a specific shareholders' meeting. The SEC interprets this to prohibit the submission of a proposal with numerous unrelated subproposals. The new rules prohibit a person acting as a representative from submitting more than one proposal for the same shareholders' meeting.
- *500-Word Limit.* The shareholder's proposal and accompanying supporting statement cannot exceed 500 words.
- *Notice.* The shareholder's proposal must be delivered to the company's principal executive offices not later than 120 days prior to the anniversary of the date on which the company first distributed its proxy statement for the prior year's shareholders' meeting. Companies generally publish this deadline in the prior year's proxy statement.

If a shareholder fails to satisfy any of these requirements, the company may exclude the proposal on procedural grounds – but only if it notifies the shareholder of any defects within 14 calendar days of receiving the proposal and permits the shareholder an opportunity to cure the defects. The company need not provide a shareholder notice of a defect if the defect cannot be remedied, such as if the shareholder failed to submit a proposal by the company's properly determined deadline.

If the shareholder, or a representative of the shareholder, does not personally appear at the meeting to present the proposal, the company may exclude any proposals submitted by that shareholder from its proxy materials for the following two years unless the shareholder can demonstrate good cause for failing to attend.

Substantive Requirements

Rule 14a-8 also includes several substantive bases on which a company may seek to exclude a shareholder proposal:

- *Improper Under State Law.* The proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization.
- *Violation of Law.* The proposal would, if implemented, cause the company to violate any state, federal or foreign law to which it is subject.
- *Violation of the Proxy Rules, Including False or Misleading Statements.* The proposal or supporting statement is contrary to any of the SEC's proxy rules, including Rule 14a-9 under the 1934 Act, which prohibits materially false or misleading statements in proxy-soliciting materials. The SEC has generally denied most no-action requests for exclusion or modification of shareholder proposals on the grounds that they were either vague or contained false and misleading statements. The effect of this has been that companies that are unsuccessful in negotiating with proponents to exclude offending language will address it either with a disclaimer or in the company's opposition statement included in the proxy statement.
- *Personal Grievance; Special Interest.* The proposal relates to the redress of a personal claim or grievance against the company or any other person, or is designed to result in a benefit to the shareholder proponent not shared by the other shareholders at large.
- *Ordinary Business/Relevance.* The proposal relates to operations that account for less than 5% of the company's total assets at the end of its most recent fiscal year and for less than 5% of its net earnings and gross sales for its most recent fiscal year, and it is not otherwise significantly related to the company's business.

- *Absence of Power or Authority.* The company would lack the power or authority to implement the proposal.
- *Management Functions.* The proposal deals with a matter relating to the company's ordinary business operations (excluding matters of significant social policy, e.g., senior executive compensation).
- *Election of Directors.* The proposal affects the election of a member to the Board at the shareholders' meeting. SEC rules do, however, allow shareholder proposals on this topic if they relate to "proxy access" (discussed later in this chapter).
- *Conflicts with Company's Proposal.* The proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same shareholders' meeting.
- *Substantial Implementation.* The company has already substantially implemented the proposal.
- *Duplication.* The proposal substantially duplicates another proposal previously submitted to the company by another proponent that will be included in the company's proxy materials for the same shareholders' meeting.
- *Resubmissions.* The proposal was previously rejected by a specific percentage of shareholders. The percentage is determined by the number of times the proposal has been submitted.
- *Dividends.* The proposal relates to specific amounts of cash or stock dividends.

No-Action Letter Requests

If a company intends to exclude a shareholder proposal from its proxy materials on procedural or substantive grounds, it generally must submit its reasons for doing so to the SEC, with a copy sent simultaneously to the shareholder proponent. This submission is referred to as a *no-action letter request* and must be

submitted to the SEC no later than 80 calendar days prior to filing the company's definitive proxy statement. Whether the company is ultimately able to exclude the proposal from its proxy statement will depend on the SEC's response to the no-action letter request. The SEC now accepts no-action letter requests and correspondence related to Rule 14a-8 shareholder proposals via e-mail at shareholderproposals@sec.gov.

The SEC staff may respond to no-action requests informally instead of by letter on well-settled matters. These responses are posted on the SEC website in a chart tracking the staff's no-action positions. The chart lists the company name, the proponent, date of the company's initial submission, bases asserted by the company for exclusion, whether the staff granted, denied or declined to state a view – and provides the basis for a decision granting no-action relief.

Statement in Opposition to Qualifying Proposal

If a company intends to make a statement in the proxy statement in opposition to a shareholder proposal, the company must provide a copy of the statement to the proponent at least 30 days before filing the definitive proxy statement. If the SEC's no-action letter request response requires the shareholder proponent to revise a proposal, the company must provide a copy of the statement in opposition no later than five calendar days after the company receives a copy of the revised proposal.

Identification of Proponent

The proxy statement must either include the shareholder proponent's name, address and share ownership or indicate that the company will provide this information upon request. Although in the past most companies did not identify shareholder proponents, many companies now include this identifying information in their proxy statements.

Shareholder Proposals Not Submitted for Inclusion in Proxy Materials

Under certain conditions a shareholder may submit a proposal for consideration at a shareholders' meeting even though the proposal does not meet the procedural requirements for inclusion in the company's proxy statement. The requirements for such submissions are described in the company's bylaws or, in the absence of applicable bylaw provisions, in Rule 14a-4(c). Companies should be aware of the deadlines for these types of shareholder proposals, which are usually provided for in the company's advance notice bylaw provisions, and the applicable deadlines should be disclosed in the company's proxy statement. In addition, a company can generally retain discretion to vote proxies it has received on this type of shareholder proposal if it includes in its proxy statement advice on the nature of the proposal and how it intends to exercise its voting discretion.

The Proxy Contest: Election Contests and Takeover Transactions; Proxy Access

As with shareholder proposals, there are various ways that management may appropriately anticipate and manage proxy contests with shareholder groups. A proxy contest typically involves a challenge to existing management by a third-party acquirer or shareholder group seeking control of the company or by a shareholder activist seeking to influence the direction of the company. Often, the challenger has obtained a significant ownership position in the company and seeks to either control the company through the election of a majority of the directors or propose a merger or tender offer for shares. (Although a detailed discussion of takeover transactions and defenses is beyond the scope of this Handbook, we summarize corporate structural defenses in Chapter 11.)

Proxy access is a method for shareholders to gain representation on the Boards of public companies. Unlike waging a proxy contest, utilizing proxy access does not require shareholders to bear the cost of preparing and distributing their own proxy materials. Market standard terms for proxy access have developed

over the past several years, to require the nominating shareholder (or a group of up to 20 shareholders) to hold at least 3% of the company's shares for at least three years to nominate up to 20% of the Board or at least two directors, with a nominating group size of 20 shareholders. While proxy access bylaws now have been adopted by over 70% of S&P 500 companies and over half of the companies in the Russell 1000, as of the date of this Handbook, proxy access has been used only once to include a director nominee in the proxy materials of a company pursuant to a proxy access right.

Directors' and Officers' (D&O) Questionnaire

A company's proxy statement, Form 10-K and annual report to shareholders provides a variety of detailed information about its directors and officers, including employment history, compensation, security ownership in the company, related transactions with the company and Section 16 reporting compliance history. Even if a company believes it already knows all the relevant information, the company should ask its directors and officers each year to complete a D&O questionnaire to elicit or confirm the required information. Companies will want to review and update their D&O questionnaires annually (as necessary) to incorporate changes to applicable SEC requirements and NYSE and Nasdaq rules. Companies should provide the D&O questionnaires to directors and officers sufficiently in advance to allow adequate time for responses to be incorporated into the proxy statement, Form 10-K and annual report. A helpful approach is to include a copy of relevant portions of the prior year's proxy statement, Form 10-K or annual report with the D&O questionnaire and request that the directors and officers update and edit the information as needed.

Annual Report to Shareholders

In the annual report to shareholders, senior executives have an opportunity to communicate directly with the company's shareholders. Unlike the corporate governance focus of the annual proxy statement, the annual report conveys information

regarding the company's business, management and operational and financial status.

Content Requirements of the Annual Report to Shareholders

The "glossy" annual report to shareholders has similar content requirements to Form 10-K, but serves a different purpose designed to communicate directly with shareholders. Rules 14a-3 and 14c-3 under the 1934 Act specify the minimum content requirements for an annual report. These include:

- *Financial Information.* Audited balance sheets for the two most recent fiscal years, audited statements of income and cash flows for the three most recent fiscal years, other selected and supplemental financial data, a discussion of material uncertainties and disagreements with accountants on accounting and financial disclosure, MD&A detailing financial condition and results of operations, and disclosures about market risk.
- *Stock and Dividend Information.* Identification of the principal markets in which the company's shares are traded, quarterly highs and lows in stock price, number of common shareholders, and frequency and amount of cash dividends declared over the previous two fiscal years.
- *Stock Performance.* A performance graph comparing the change in total shareholder return on common stock with an equity market index and the cumulative total return of a published industry index or peer issuers (and disclosing the basis for its selection) for the last five fiscal years. If you do a Form 10-K "wrap," as discussed later in this chapter, the performance graph instead may be included in the Form 10-K.
- *Operation and Industry Segment Information.* A description of the company's principal products produced or services rendered, accompanying markets and distribution methods, foreign and domestic operations, export sales, industry segments and classes of similar products or services.

- *Director and Officer Information.* Identification of the company's directors and executive officers along with their principal occupations, including the names of their employers.

Companies are free to include information in the annual report that goes beyond the minimum content requirements. Companies generally include a letter from the president or chair of the Board summarizing the company's operations, strategy, projected performance, key personnel changes and other highlights for the year. Because the annual report is furnished to the SEC and generally made publicly available, any information included in the annual report, even if not required, may be the source of legal liability if found to be materially misleading.

Format Requirements of the Annual Report to Shareholders

Format requirements for the annual report are minimal. The SEC permits virtually any format, but innovative presentation, including the use of tables, graphs, charts, schedules and other illustrations, can be useful in presenting operational and financial information in an easily understandable manner. Some of the financial information included in the body of the annual report must be presented in tabular form.



Practical Tip:
It's a Wrap!
Consider Doing a Form 10-K "Wrap"

Companies are increasingly using a Form 10-K wrap annual report to shareholders. This consists of up to a few pages of company message materials, usually including a president's or chair's letter, that simply wrap around the Form 10-K. This avoids duplication between the annual report and the Form 10-K, while reducing costs and environmental impact. A similar cost-saving approach is to send shareholders a combined document that includes both the proxy statement and the annual report.

Timing of the Annual Report to Shareholders

The SEC requires an annual report to shareholders to accompany or precede a company's proxy statement for any annual meeting at which shareholders will elect directors. Unlike the other proxy materials, a company's annual report to shareholders need not be filed with the SEC on EDGAR.

Chapter 8

Annual Meeting of Shareholders

For the first several months of each fiscal year, a public company's senior management and professional advisors will spend significant energy preparing for the company's annual meeting of shareholders. An important component in conducting a successful annual meeting is early and consistent preparation. Agreeing to a pre-meeting timetable can bring order to this process and help ensure timely completion, as many of the tasks require significant lead time.

Practical Tip:
**Create a Calendar or Time and Responsibility
Schedule and Update It During the Planning Period**



The Annual 1934 Act Reporting Calendar in Appendix 1 can help you plan your annual meeting process. Your calendar or time and responsibility (T&R) schedule should identify the group or individual in charge of each task and set a due date for accomplishing the task. One person should take responsibility for updating and recirculating the T&R schedule on a regular basis during the planning period to reflect the current status or completion of the necessary tasks.

Tailor your company's T&R schedule to the rules and regulations that govern the annual meeting process, which



Practical Tip:
**Create a Calendar or Time and Responsibility
Schedule and Update It During the Planning Period
(Cont'd)**

are derived from: (1) federal securities laws; (2) exchange rules and regulations; (3) the company's governing documents (i.e., certificate or articles of incorporation, bylaws, Board guidelines and policies, and committee charters); and (4) state corporate law. Care should also be taken to ensure that the company's T&R schedule incorporates lessons learned from the prior year's annual meeting and any changes to applicable rules and regulations.

The calendar for each company will be different, and its preparation will require some judgment. Given the requirements under state law, the company's charter, the company's bylaws, SEC rules and exchange rules, each company should work with its counsel to identify and comply with the most restrictive applicable requirements.

Pre-Meeting Planning

Setting the Annual Meeting Date

Companies should consider the following when setting the annual meeting date:

- State corporate law and exchange rules;
- The prior year's annual meeting date; and
- The company's articles or certificate of incorporation and bylaws, which generally either set the annual meeting date or give the Board discretion to choose a date.

Some state corporate laws set forth a time frame during which companies must hold an annual meeting. Failure to hold an annual meeting during the specified time frame generally gives shareholders the right to demand that a meeting be held. For example, if a Delaware company fails to hold an annual

meeting within 30 days after the date designated for the company's annual meeting or, if a date is not designated, 13 months after its previous annual meeting, a shareholder or director can bring an action to force the company to hold its annual meeting. In addition, companies listed on the NYSE and Nasdaq are generally required to hold an annual meeting during each fiscal year.

Keep in mind that a change in the annual meeting date by more than 30 days before or after the anniversary of the prior year's annual meeting will also affect the date by which shareholder proposals or director nominations need to be received by the company pursuant to SEC regulations and the company's advance notice provisions in its governing documents. In such case, the company is generally required to publicly disclose the annual meeting date and the date on which any shareholder proposals or director nominations are required to be received by the company.

Determining the Annual Meeting Location

As early as a year in advance, individuals with responsibility for annual meeting logistics should anticipate the number of shareholders who will attend the meeting and reserve an adequate facility. State corporate laws generally permit annual meetings to be held within or outside the state of jurisdiction (including, in the case of many jurisdictions, such as Delaware, a virtual annual meeting on the Internet), in accordance with the company's articles or certificate of incorporation and bylaws.

Many companies hold their annual meetings at the same location each year, either in their corporate offices or in conference facilities nearby. Holding the annual meeting at a corporate office can result in great price savings, and allows the company to be on familiar ground with everything from audiovisual equipment to security. An annual meeting at the company's offices also provides shareholders the opportunity, during or after the meeting, to see new product demonstrations or to take a facility tour. Some larger companies with an extensive shareholder base rotate their annual meeting from year to year among cities where they have facilities or

high shareholder density. In addition, some state corporate laws permit companies to supplement their annual meetings with virtual components or virtual shareholder participation at in-person meetings, such as broadcasting their meetings on the Internet.



Practical Tip:
Recent Development: Virtual Annual Meetings

In recent years, an increasing number of jurisdictions, including Delaware, have adopted laws allowing companies to hold an entirely virtual annual meeting in lieu of a physical meeting if the company's governing documents so provide. There are, of course, legal, procedural, technical and administrative issues that need to be thoroughly considered before holding a virtual annual meeting.

Virtual annual meetings gained rapid momentum in 2020 due to health and safety concerns surrounding the COVID-19 pandemic, despite historical objections from some shareholder groups. Prior to the pandemic, Glass Lewis recommended a vote against Nominating & Governance Committee members when a company held a virtual annual meeting without providing disclosure in its proxy statement to assure shareholders that they would be afforded the same participation rights and opportunities as at an in-person meeting. Glass Lewis suspended this policy through June 2020, and it is unclear how the company will apply the policy going forward, including whether it will amend the policy as a result of the COVID-19 pandemic.

Virtual annual meetings present the following potential benefits:

- Expanding attendance and shareholder participation;
- Saving meeting costs and reducing the amount of senior management and Board member time required for attendance at the meeting; and

Practical Tip:
Recent Development: Virtual Annual Meetings (Cont'd)



- Providing branding and messaging opportunities to employees, shareholders and others.

Opponents of virtual annual meetings claim that shareholders lose the valuable ability to confront management in person, that companies could manipulate virtual question-and-answer sessions, and that voting “surprises” or technology glitches could occur. In 2020, as a result of the COVID-19 pandemic, many companies opted to hold virtual annual meetings for health and safety reasons. It is currently unclear whether this trend will continue beyond the end of the pandemic.

If your company contemplates holding a virtual annual meeting, consider some or all of the following tips and best practices:

- Be sure to check your state corporate laws and articles or certificate of incorporation and bylaws to make sure that a virtual annual meeting is permitted;
- Early in the process, engage a service provider specializing in virtual annual meetings to ensure that you can reserve your desired annual meeting date and time and that those who will be leading the virtual annual meeting understand the logistics and the technology associated with a virtual annual meeting;
- While a majority of virtual annual meetings during the 2020 proxy season appeared to be in audio-only format, video conferencing technology has improved, and we expect that companies will increasingly use video for their meetings as a way to allow shareholders to better interact with company boards and management;



Practical Tip:
Recent Development: Virtual Annual Meetings (Cont'd)

- To address concerns as to whether companies selectively choose the questions they answer, consider granting all shareholders access to the questions submitted by other shareholders;
- Confirm that voting technology is functioning to be sure holders can log in and vote at the meeting;
- Consider the ability of shareholder proponents to present (e.g., establish a dedicated phone line);
- While there is no requirement to do so, posting shareholder questions to the company's website may be regarded as good corporate governance (keeping in mind that Glass Lewis recommends disclosure on how the questions received during the meeting and the company's answers will be posted to the company's website, if at all);
- Consider including a business presentation, given that more shareholders may attend a virtual meeting than an in-person meeting and they may find purely procedural meeting content disappointing; and
- After your first virtual annual meeting, solicit feedback from investors to incorporate into the planning for the next virtual annual meeting.

Setting the Record Date

Only shareholders of record on the record date for the annual meeting are entitled to receive notice of, and to cast votes during, the meeting. Therefore, shareholders that acquire a company's stock after the record date have no voting or notice rights with respect to the annual meeting. State corporate laws set the maximum and minimum number of days between the record date and the annual meeting date. In Delaware, for example, the

record date may not be more than 60 days nor less than 10 days before the annual meeting. A company's Board generally sets the record date for the annual meeting; however, some companies' bylaws set further limits on the record date.

Subject to the limitations described above, companies generally should set a record date far enough in advance to allow adequate time for the solicitation of proxies prior to the annual meeting.

Notifying Shareholders and Exchanges

State corporate law requires a company to notify its shareholders in writing of the annual meeting date, time and place. Notice periods vary from state to state. In Delaware, for example, the notice period is at least 10 days and no more than 60 days prior to the annual meeting, and unless notice is waived, a company's failure to adhere to that state's notice requirements voids any action taken at the annual meeting. Each company should also comply with any notice provisions in its governing documents. In addition, companies taking advantage of the "notice and access" option for distributing proxy materials are subject to additional notice requirements under the e-proxy rules, including providing the notice at least 40 calendar days prior to the annual meeting.

The exchange on which a company lists its shares may also require notice of an annual meeting. For example, companies listed on the NYSE must provide the exchange with notice at least 10 days prior to the record date established for the annual meeting, and must indicate the date of the meeting and the record date. Nasdaq does not require advance notice of the record date by its listed companies.

Reaching Past "Street Name" to Contact Beneficial Owners

Because many owners of public company stock hold their shares in *street name* (i.e., by having a brokerage firm, bank or other nominee hold the shares in its name for the benefit of the actual investor), a public company cannot contact its sharehold-

ers directly by simply using its transfer agent's list of record holders. To facilitate this contact, the SEC, the exchanges and the nominees themselves have developed rules, practices and procedures to make sure the materials will eventually be delivered to the investors (beneficial owners) that have economic ownership of shares held in street name.

Per SEC rules and exchange requirements, companies must send a sufficient amount of shareholder materials to the nominees for them to distribute to beneficial owners.

Under Rule 14a-13(a)(3) of the 1934 Act, companies must contact institutional nominees (through their transfer agent or other third-party service provider) at least 20 business days before the record date to learn the number of copies of the proxy and other soliciting materials needed for distribution to beneficial owners, which essentially imposes a 20-business-day advance notice requirement for setting a record date.

Shareholders intending to solicit proxies in opposition to a proposed action at an annual meeting have the right to access information regarding beneficial ownership. Delaware courts have ruled that soliciting shareholders are entitled, in addition to a list of record holders, to other information readily obtainable by the company that identifies beneficial owners, provided they take the necessary steps in time to obtain the information.

Who Attends the Annual Meeting?

Most annual meetings have few to no outside shareholders in attendance, but some large companies draw very large crowds of shareholders.

Additionally, senior management and some or all members of the Board typically attend the annual meeting. Their attendance provides shareholders an opportunity to meet and provide feedback to the Board and management team. A company must disclose in its proxy statement any policy regarding director attendance at the annual meeting and how many directors attended the prior year's annual meeting.



Practical Tip:
Webcast the Annual Meeting

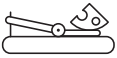
If your company wishes to present a general business update that may include material nonpublic information at its annual meeting, you should make arrangements to webcast the meeting to ensure compliance with Regulation FD. To webcast your annual meeting:

- Issue a press release announcing the meeting and include a notice that the company will webcast the meeting and discuss general business updates;
- Arrange for, and pretest, webcast media facilities at the meeting's site;
- Comply with Regulation G by posting any required GAAP information and reconciliations on the company's website and providing the website address during the presentation;
- Begin the business update with cautionary language on forward-looking disclosures;
- Post any questions and responses in the same manner as after an earnings release; and
- If the presentation includes the first public communication of previously material nonpublic information discussing a historical, completed quarter or year (whether or not it includes non-GAAP financial information), "furnish" this nonpublic earnings information under Item 2.02 of Form 8-K.

See Chapter 5 for a full discussion of webcasts and shareholder or analyst calls and furnishing nonpublic earnings information.

Inspector of Elections. The company should arrange for an inspector of elections to tabulate votes and certify results. Sometimes the inspector is a company employee. More often, the

inspector is a representative of the company's transfer agent, independent auditors or other third-party service provider. Ideally, the inspector is truly independent and unrelated to the company or its regular service providers. The company should be familiar with the inspector's qualifications and be prepared to answer shareholder questions regarding the inspector. In cases of close voting, a well-prepared, well-qualified and independent inspector will provide support for a company if a shareholder later challenges the voting results.



**Trap for the Unwary:
Remember to "8-K" Your Voting Results**

Form 8-K, Item 5.07, requires disclosure of shareholder voting results within four business days of the annual meeting. If your final voting results are not available to meet that deadline, you must file a Form 8-K with preliminary voting results, and amend it within four business days of the date on which you know the final voting results. In addition, remember to disclose your Board's say-on-frequency vote decision, if applicable, in the original Form 8-K to report the voting results or an amendment to the Form 8-K. This amendment must be filed no later than 150 calendar days after the date of the annual meeting and in no event later than 60 calendar days prior to the deadline for the submission of shareholder proposals under Rule 14a-8 for the next annual meeting.

Counsel and Auditors. Representatives from the company's legal counsel and independent auditors usually attend the annual meeting. The independent auditors can field questions regarding the company's financial statements. Legal counsel attend to address any voting, agenda or procedural issues that may arise.

***Board Meeting or Board Consent to Address Matters
Pertaining to the Annual Meeting***

Three to four months prior to the annual meeting, a company's Board should:

- Set the meeting's time, date and place;
- Set the record date(s);
- Determine the mailing date;
- Approve the engagement of a proxy solicitation firm, if one will be used;
- Establish the purposes of the meeting (generally, to elect directors, vote on specified matters and transact other business as may properly come before the meeting);
- Select director nominees;
- Appoint the inspector of elections;
- Designate proxies; and
- Deal with other corporate governance matters such as director independence determinations, committee appointments for the Board and designation of executive officers for purposes of the 1934 Act.

At the same time, the Audit Committee should indicate what firm it has selected as the company's auditors, if it has not done so already. The Audit Committee may also recommend that its appointment of the auditors be submitted to the shareholders for ratification.



Practical Tip:
**Hold a Board Meeting in Connection
with the Annual Meeting**

Most companies hold a meeting of the Board either just prior to the annual meeting, to discuss matters that may be presented at the annual meeting, or just after the annual meeting, when the officers will not be distracted by preparation for the annual meeting. Holding a Board meeting on the annual meeting date helps ensure Board member attendance at the annual meeting, which attendance is required to be disclosed in the proxy statement.

Script, Agenda and Rules of Conduct

Most companies prepare a script, agenda and rules of conduct for the annual meeting. A well-organized script and agenda as well as clear and understandable rules of conduct are essential elements to conducting a successful annual meeting. It is good practice to distribute the agenda and rules of conduct to attending shareholders as they arrive.

Script and Agenda. The script should cover all items on the agenda and all statements that the scheduled speakers will make during the annual meeting, as well as provide draft answers to any questions that management can anticipate. An agenda and script typically include the following:

- Chairperson's opening remarks and call to order;
- Introduction of management, directors and advisors in attendance;
- Establishment of proper meeting notice and quorum;
- Availability of corporate records and the shareholder list;
- Introduction of items to be voted on;
- Voting instructions;

- Opening and closing of polls;
- Report of the inspector of elections and the announcement of voting results;
- Closing remarks and adjournment of formal portion of meeting;
- Management presentations regarding the company's business, if any; and
- Question-and-answer period.

Follow the Script! Regulation FD. The script plays a critical part in complying with Regulation FD by anticipating questions that may call for answers potentially revealing material nonpublic information. The company's investor relations officer should carefully review these areas and either:

- Propose issuing a press release, or using any other dissemination method that is compliant with Regulation FD, prior to the annual meeting to disclose material nonpublic information that can reasonably be expected to be discussed; or
- Flag the topics for the CEO and CFO, and draft a response that does not disclose material nonpublic information.

Speakers will benefit from rehearsing the script before the annual meeting and should pay particular attention to warnings on disclosure of material nonpublic information.

Rules of Conduct. Rules of conduct typically limit shareholders' time to ask questions and address the annual meeting, describe how the company will handle unscheduled proposals, address how to handle unruly shareholders and restrict shareholders' ability to use video or other recording devices during the meeting.



**Practical Tip:
Calming the Contentious Shareholder**

While shareholders have an opportunity to be heard at an annual meeting, a company should take measures to prevent a shareholder from monopolizing other shareholders' time and impeding the meeting's progress. Management can best prepare to calm a contentious shareholder with clear rules of conduct and thorough planning. Rules of conduct should be handed out to the shareholders as they check in to the annual meeting and address basic procedural matters such as recognition by the chairperson before speaking, time limits for each question, etc. The chairperson of the annual meeting should warn a disorderly shareholder whose actions are out of order. If preliminary steps do not restore order, the chairperson should follow a planned course of action to remove the shareholder and, if necessary, adjourn the annual meeting or call for a recess. Companies who typically have high attendance and/or protestors at their annual meetings should consider additional steps, such as hiring outside security personnel.

Materials to Bring to the Annual Meeting

Most companies have an admissions desk staffed with friendly company representatives and materials for the annual meeting attendees. Each attendee will receive the annual meeting agenda and rules of conduct. The company should also have available extra copies of its proxy materials, annual report and Form 10-K for distribution at the request of any attendee. Additionally, the corporate laws of most states require that companies make available to their shareholders a list of shareholders entitled to vote at the annual meeting and that such list be available at the meeting.

Voting and Quorum Requirements

Voting in Person or by Proxy

A shareholder with voting power may vote at the annual meeting by attending in person and casting a ballot or by designating a proxy to act on the shareholder's behalf. In general, a proxy holder has broad discretion to vote the shares covered by the proxy.

Under Delaware corporate law, for example, a proxy generally allows the proxy holder to vote shares in the proxy holder's discretion on any issue that is properly raised at an annual meeting, unless the proxy specifically limits the holder's authority.

Quorum

Before shareholders can conduct business at an annual meeting, a quorum must be present. Quorum requirements generally are governed by state corporate law and the company's articles or certificate of incorporation and bylaws. Usually, a quorum consists of a majority of the shares entitled to vote at the annual meeting. Shares count for quorum purposes if present at the annual meeting either in person or by proxy.

Broker Non-Votes

When a beneficial owner fails to instruct the company or the beneficial owner's nominee how to vote on certain matters deemed to be "routine," the nominee may vote the shares for or against the proposal in its discretion. Matters on which a nominee may vote a beneficial owner's shares in its discretion are known as *discretionary* matters.

Each nominee ultimately sends a proxy to the company containing the cumulative result of beneficial owners' instructions and the nominee's votes on those discretionary matters for which it did not receive instructions. Typically, the only matter that is considered to be "routine" and discretionary is the proposal to ratify the company's independent auditors.

National stock exchanges prohibit brokers and other nominees from voting shares they do not beneficially own with respect to the election of directors, executive compensation proposals and certain other nondiscretionary matters unless they receive specific voting instructions from the beneficial owners. Instead, a beneficial owner must give specific instructions to the nominee to vote on the nondiscretionary matter, or else the shares cannot be voted and a broker non-vote occurs. Broker non-votes are votes that a broker cannot cast with respect to the particular nondiscretionary matter.

Since most matters up for vote at the annual meeting are non-discretionary, companies should consider including at least one annual meeting agenda item that qualifies as “routine” – such as the ratification of the company’s independent auditors – to help achieve a quorum.

Abstentions

A person with voting power (whether as a beneficial owner of shares, a designated proxy holder or a broker with discretionary authority to vote shares) who is present in person or by proxy at an annual meeting has the discretion to abstain from voting.

The Effect of Abstentions and Broker Non-Votes

Each company’s proxy statement relating to an annual meeting must describe how abstentions and broker non-votes count toward the tabulation of each proposal presented at the meeting.

Quorum. Delaware and jurisdictions that follow the Model Business Corporation Act (MBCA) count both abstentions and broker non-votes as “present” for the purpose of establishing a quorum.

Voting. The effect of abstentions and broker non-votes on the outcome of a shareholder vote varies based on:

- The state’s corporate law treatment of abstentions and broker non-votes; and

- The vote required to approve the shareholder action, which may be governed by state corporate law, a company's articles or certificate of incorporation or bylaws, or exchange rules.

Vote Required: Fixed Percentage of Shares Present and Entitled to Vote. Under Delaware corporate law, unless otherwise provided in the company's governing documents, most routine shareholder actions, other than the election of directors, require the affirmative vote of a fixed percentage of the voting shares that are present, either in person or by proxy, and entitled to vote on the matter presented at the annual meeting. Because abstentions are present and entitled to vote on the matter presented at the annual meeting, they have the effect of counting as votes against the proposal – they add to the pool of votable shares without contributing to the affirmative votes required to approve the shareholder action. Broker non-votes, however, while present for purposes of a quorum, are not entitled to vote on the matter presented at the annual meeting. Broker non-votes, therefore, are excluded from the pool of votable shares and have no effect on the outcome of the shareholder vote.

It is important to refer to the corporate law of a company's state of incorporation for its treatment of abstentions and broker non-votes. For example, under New York corporate law, abstentions are treated differently than under Delaware law. In New York, unless the company's shareholders have adopted a bylaw or provided otherwise in the certificate of incorporation, abstentions have no effect on the approval of a proposal other than the election of directors.

Vote Required: Fixed Percentage of Outstanding Shares. Approval of some shareholder actions requires the affirmative vote of a fixed percentage of the company's outstanding voting shares, whether or not such shares are present at the annual meeting. Under Delaware corporate law, mergers, sales of substantially all the company's assets, amendments to the company's certificate of incorporation and dissolutions all require the affirmative vote of a majority of the outstanding voting shares. For these proposals, abstentions and broker non-votes are the same

as votes against the proposal because both are included in the pool of the company's overall voting shares, although they do not count toward the affirmative vote needed to approve the shareholder action. Stock exchanges may also have requirements regarding shareholder votes on certain matters mandated to be approved by shareholders.

Default Vote Required for Election of Directors: Plurality of Votes Cast at a Meeting. The corporate laws of Delaware and the jurisdictions that follow the MBCA require only the affirmative vote of a plurality of votes actually cast at the annual meeting to elect directors and, in jurisdictions following the MBCA, to approve most other shareholder matters, unless a company's governing documents provide otherwise. This means that more votes must be cast in favor of the action than votes cast for any other alternative, whether or not the approving votes constitute a majority or other fixed percentage. Abstentions and broker non-votes do not affect the vote's outcome because they are neither votes cast for nor votes cast against the action.

Majority Voting in Election of Directors. Many larger public companies have moved away from plurality voting and adopted a form of majority voting standard for the election of directors. The majority voting standard for director elections typically requires that, to be elected, a nominee must receive more votes "for" than "against," which may include any votes withheld, depending on the definition of majority. One approach for implementing a majority voting standard is through an amendment to a company's bylaws. As a result, there have been changes to Delaware corporate law and the MBCA to accommodate majority voting bylaw amendments and related matters.

For example, Delaware bylaws may even prohibit directors from unilaterally amending shareholder-approved bylaw provisions implementing majority voting. Delaware law also includes a provision that permits irrevocable director resignations that are effective upon the occurrence of a future event, which could include a director's failure to be elected by a majority vote.

Shareholder Actions by Written Consent in Lieu of an Annual Meeting

In some states, shareholders may act by written consent in lieu of an annual meeting. Although technically permitted, action by written consent in lieu of an annual meeting has little practical value for most public companies, and many public companies have provisions in their governing documents prohibiting or severely limiting the ability of shareholders to act by written consent. Under Delaware corporate law, for example, shareholders may act by written consent to elect directors in lieu of an annual meeting, but only if the consent is unanimous or, if not unanimous, if all directorships to which directors could be elected at an annual meeting held at the written consent's effective time are vacant (by way of resignation or removal) and filled by such written consent. In addition, Section 14(a) of the 1934 Act extends the proxy rules to solicitations of written consents, and exchange rules may also apply.

Chapter 9

NYSE Listing Standards: Governance on the “Big Board”

When a company agrees to list its securities on the New York Stock Exchange (NYSE), it agrees to comply with exchange listing standards and rules designed to achieve a high standard of corporate governance and disclosure. While some of these requirements mirror those imposed by the SEC, these requirements are in fact independent obligations with separate ramifications if not met. An NYSE company and its counsel must ensure that the company satisfies both SEC and NYSE requirements.

This chapter reviews listing standards and rules applicable to companies listed on the NYSE, including:

- Continued listing standards, including mandated corporate governance practices;
- Rules requiring shareholder approval for various corporate actions and events;
- Rules requiring NYSE notification regarding various corporate actions and events; and
- Requirements to publicly disclose specified information in connection with material (or otherwise specified) corporate actions and events.

NYSE Continued Listing Standards

The NYSE requires its listed companies to meet quantitative and qualitative standards on a continuing basis to remain listed on the exchange. Quantitative standards consist of objective financial and share distribution criteria. Qualitative standards relate to companies' corporate governance and ongoing status.

These quantitative and qualitative continued listing standards are set forth in Appendix 4. A company's failure to maintain these standards often triggers NYSE action, which can include initiation of suspension and delisting procedures that may ultimately result in the removal of the company's securities from listing and trading on the NYSE. See the end of this chapter for more information relating to a listed company's failure to comply with listing standards and other requirements.

NYSE Corporate Governance Standards

The NYSE has established corporate governance standards for its listed companies. These governance standards are designed to bolster public confidence in listed companies, promote prompt public disclosure of material events and enhance corporate ethics and democracy. Compliance with these corporate governance standards is an ongoing condition to listing.

A Majority of Directors Must Be Independent

The NYSE requires a majority of Board members of a listed company to be independent directors. For a director to qualify as independent under NYSE standards, a company's Board must affirmatively determine that the director has no material relationship with the listed company (including any parent or subsidiary in a consolidated group). The Board must consider the materiality of the director's direct and indirect relationships as a partner, shareholder or officer of any organization with links to the company (including with its senior management). A material relationship can come in many forms, including commercial, industry-related, banking, consulting, legal, accounting, charitable, private or familial.

Listed companies must report determinations of director independence in their annual meeting proxy statements, together with a description of any direct and indirect transactions, relationships and arrangements between directors and the company considered by the Board in making its independence determinations. Some companies use various general categories of relationships to help determine director independence, and they disclose in the proxy statement whether a director had a relationship that fell into one of the categories without going into much additional detail. We discuss general categories of relationships relating to director independence in Chapter 2.

Practical Tip:
**A “Controlled Company” Is Exempt from
Independence and Certain Committee Requirements**



Does an individual, group or another company hold more than 50% of the voting power for the election of your directors? If so, your company may be a *controlled company* and you may choose to be exempted from various NYSE standards relating to director independence and the existence, composition and duties of your Compensation and Nominating & Governance Committees.

If you opt to use the controlled company exemption, you will need to include in appropriate SEC filings a description of your controlled company status and a statement that you are relying on the controlled company exemption. A controlled company must continue to comply with NYSE’s other corporate governance standards, including the requirements relating to an independent Audit Committee and regular executive sessions of non-management (or independent, as the case may be) directors.

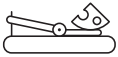
If a company ceases to qualify as a controlled company, it must meet the standard listing requirements within specified periods following its change of status.

What Is Independence? The NYSE Describes What It Is Not

A director who has any of the following relationships is not independent under NYSE standards:

- *Employment Relationship.* A director who is or was within the past three years an employee of the listed company, or who has an immediate family member who is or was within the past three years an executive officer of the company, will not be independent. Employment as an interim chairman, CEO or other executive officer will not by itself disqualify the director from being considered independent following employment.
- *Compensation in Excess of \$120,000.* A director who has, or whose immediate family member has, received more than \$120,000 of direct compensation from the company in any 12-month period within the past three years, other than Board and committee fees and pension or other deferred compensation for prior service (provided the compensation is not contingent on continued service), will not be independent. Compensation that a director receives for past service as an interim chairman, CEO or other executive officer and compensation that an immediate family member receives for service as a nonexecutive employee of the company do not necessarily disqualify the director from being considered independent.
- *Relationships with the Company's Internal or Outside Auditor.* Any of the following auditor relationships will make a director not independent:
 - Being a current partner or employee of the company's internal or outside auditor;
 - Having an immediate family member who is a current partner of the company's internal or outside auditor;

- Having an immediate family member who is a current employee of the company's internal or outside auditor and personally works on the listed company's audit; or
- Having been, or having an immediate family member who was, a partner or employee of the company's internal or outside auditor personally working on the company's audit within the past three years.
- *Interlocking Directorate.* A director will not be independent if the director or an immediate family member is or was within the past three years employed as an executive officer of another company (including a charitable organization) at the same time that a current executive officer of the company served on the other company's Compensation Committee.
- *Significant Business Relationship.* A director will not be independent if the director is a current employee or an immediate family member is a current executive officer of another company that made payments to or received payments from the listed company that exceeded, in any of the past three fiscal years, the greater of \$1 million or 2% of the other company's consolidated gross revenues in the last completed fiscal year.



Trap for the Unwary: Watch Those Charitable Contributions!

Boards must evaluate contributions to charitable organizations as part of the director independence determination process. In addition, a listed company must publicly disclose contributions the company made to any charitable organization in which an independent director serves as an executive officer if, within the past three years, contributions in any single fiscal year exceeded the greater of \$1 million or 2% of the charitable organization's consolidated gross revenues. Some companies adopt a general category of relationships relating to director independence establishing that charitable contributions below a certain dollar amount do not constitute a material relationship for director independence purposes.

Executive Sessions

Listed companies are required to schedule "regular" executive sessions in which non-management directors meet without management participation. Non-management directors exclude company executive officers, but include other directors who may not be independent because of a material relationship or other reason. A listed company may satisfy this requirement by holding regular executive sessions of only its independent directors. However, if a company regularly holds meetings of all non-management directors (and if that group includes any non-independent directors), then it should also hold an executive session of only independent directors at least once a year. We provide practical tips for organizing executive director sessions in Chapter 2.

The non-management (or independent, as the case may be) directors should either appoint a single presiding director for all executive sessions or rotate the presiding director position following a set procedure. Listed companies that have either an independent chair or a lead independent director usually name this person as the presiding director. Companies are required to

publicly disclose the presiding director's name or the procedure used to select the presiding director for executive sessions, as well as a method for all interested parties (not just shareholders) to communicate directly with the presiding director or with the non-management (or independent) directors as a group.

Audit Committee

Composition and Independence. NYSE listing standards generally require that listed companies have an Audit Committee that consists of at least three independent directors and meets SEC requirements. All Audit Committee members must meet two somewhat overlapping independence standards, one established by Sarbanes-Oxley and the other by the NYSE:

- ***Sarbanes-Oxley Criteria.*** An Audit Committee member cannot receive any payment from the company other than for Board or committee service and cannot be an affiliated person of the company or any of its subsidiaries. (We discuss these Sarbanes-Oxley independence requirements in detail in Chapter 2.)
- ***NYSE Criteria.*** An Audit Committee member must be independent under NYSE director independence standards and also must fulfill the Sarbanes-Oxley criteria for Audit Committee independence.

Financial Literacy and Expertise. Each member of the Audit Committee must be, or within a reasonable period of time following appointment must become, financially literate. In addition, at least one member must have accounting or related financial management expertise. The NYSE does not provide detailed definitions for these concepts; a listed company's Board is expected to use its business judgment in interpreting these requirements. For example, the Board can presume that a person who meets the SEC's Audit Committee financial expert standard has the requisite financial expertise to meet this NYSE standard. (We discuss the SEC's Audit Committee financial expert standard in Chapter 2.)

Effectiveness Evaluation of Director's Service on Multiple Audit Committees. Does an Audit Committee member serve on more than three public company Audit Committees? If so, the

Board must decide whether these commitments impair the director's ability to serve as an effective Audit Committee member, and the listed company must publicly disclose the determination. (Many companies' corporate governance guidelines specifically restrict a director from simultaneously serving on more than three public company Audit Committees.)



Practical Tip:
**Have Four Qualified Audit Committee Members
to Ensure Continued Listing Standards Compliance**

As described above, the NYSE requires a company to have at least three qualified independent directors on the Audit Committee. Consider whether it makes sense for your company's Audit Committee to have a fourth independent member so that your company remains compliant with this NYSE listing standard even when a member unexpectedly resigns, no longer qualifies or is removed, without having to scramble to appoint a new member on short notice.

Audit Committee Charter. The NYSE requires a listed company to have a written Audit Committee charter that addresses:

- *Purpose.* The core role of an Audit Committee is to help the Board fulfill its duty of overseeing the company's financial compliance and reporting. Performance of this role is detailed in the Audit Committee report within the annual proxy statement. The Audit Committee's oversight functions cover:
 - The integrity of the company's financial statements;
 - The company's legal and regulatory compliance;
 - The independent auditor's qualifications and independence;
 - The performance of both the internal audit function and the independent auditor; and

- The preparation of disclosures related to Audit Committee interactions with senior management, the Board and the independent auditors.
- *Duties and Responsibilities.* These include, among others (some of which are discussed in Chapter 2):
 - *Review and Evaluation of the Independent Auditor.* Annually reviewing and evaluating the independent auditor’s performance (including that of the lead partner, and the need for rotation of auditor personnel and potentially the independent auditor), qualifications, independence and internal control procedures.
 - *Review of Financial Statements and Earnings Releases.* Reviewing and meeting to discuss quarterly and annual financial statements and disclosures, including MD&A, with management and the independent auditor. Reviewing and discussing earnings releases or guidance to analysts and rating agencies. (The NYSE does not specifically require a pre-release review, instead permitting general guidance regarding releases. However, most Audit Committees, or key members, do preview earnings releases and guidance prior to public release.)
 - *Oversight of Risk Exposure Policies.* Discussing the company’s process for setting policies to govern risk assessment and management, including guidelines, policies and major financial risk exposure.
 - *Holding Executive Sessions.* Holding separate and periodic meetings with management, the internal auditor and the independent auditor.
 - *Review of the Audit Process.* Reviewing audit-related problems or difficulties (and management’s responses) with the independent auditor.
 - *Hiring Policies.* Setting clear hiring policies for employees or former employees of the independent auditor.

- *Informing the Board.* Regularly reporting to the Board on financial statements, compliance with laws and regulations, audit procedures and performance of the independent and internal auditors.
- *Annual Self-Evaluation.* The Audit Committee must annually assess its performance.



Practical Tip:
Audit Committee Should Schedule Additional Meetings or Meet Later in the MD&A Review Process

To comply with NYSE listing standards and governance expectations generally, the Audit Committee must review and discuss a relatively advanced draft of the MD&A to be included in a listed company's SEC filing, instead of simply discussing the MD&A disclosure in general. Accordingly, Audit Committee meetings should be scheduled to allow review of the MD&A disclosure in a form that is almost final. Meetings can be telephonic or in person.

Internal Audit Function. The NYSE requires each listed company to have an internal audit function. A company may out-source this function to a third party other than its independent auditor. The Audit Committee is generally responsible for oversight of the internal auditor.

Compensation Committee

Composition and Independence. NYSE listing standards generally require that listed companies have a Compensation Committee composed entirely of independent directors, but do not prescribe a minimum number of members. In addition, when determining the independence of a director who will serve on the Compensation Committee, the Board must specifically consider all relevant factors regarding whether the director has a relationship to the listed company that is material to the director's ability

to be independent from management with regard to Compensation Committee service, including:

- The source of the director's compensation, including any consulting, advisory or other compensatory fee paid by the listed company to the director; and
- Whether the director is affiliated with the listed company, a subsidiary of the listed company or an affiliate of a subsidiary of the listed company.

Compensation Committee Charter. The NYSE requires a listed company to have a written Compensation Committee charter that addresses:

- *Purpose and Responsibilities.* Each Compensation Committee must at least oversee:
 - *CEO Goals, Performance and Compensation.* The Compensation Committee reviews and approves corporate goals and objectives relevant to the CEO's compensation, evaluates the CEO's performance in light of those goals and objectives, and determines and sets the CEO's compensation level based on its evaluation (either as a committee or with other independent directors as directed by the Board).
 - *Non-CEO Executive Compensation.* The Compensation Committee recommends to the Board non-CEO executive compensation and incentive compensation plans and equity-based plans that are subject to Board approval (although the Board may delegate this authority to the Compensation Committee).
 - *Prepare Disclosure.* The Compensation Committee oversees the preparation of the Compensation Committee report, the CD&A and other related disclosure. (We discuss other duties and responsibilities of the Compensation Committee in Chapter 2.)
- *Annual Self-Evaluation.* The Compensation Committee must annually assess its performance.

- *Advisors.* The Compensation Committee must have the ability to retain or obtain the advice of a compensation consultant, independent legal counsel or other advisor, following an independence assessment of the advisor.

Nominating & Governance Committee

NYSE listing standards generally require that listed companies have a Nominating & Governance Committee composed entirely of independent directors. A minimum number of members is not prescribed. The Nominating & Governance Committee must have a written charter that addresses:

- *Purpose and Responsibilities.* The Nominating & Governance Committee's principal function is to oversee corporate governance, including, at a minimum:
 - Identifying qualified director candidates consistent with criteria approved by the Board;
 - Selecting, or recommending that the Board select, director nominees for the annual shareholders' meeting;
 - Developing and recommending to the Board a set of corporate governance guidelines; and
 - Overseeing the evaluation of the Board and management. (We discuss other duties and responsibilities of the Nominating & Governance Committee in Chapter 2.)
- *Annual Self-Evaluation.* The Nominating & Governance Committee must annually assess its performance.

Corporate Governance Guidelines

The corporate governance guidelines required of each listed company allow the Board and senior management to publicly set

out the key tenets of their company’s governance values. Accessible on the corporate governance page of an NYSE company’s website, the guidelines should address:

- Director independence standards, qualifications, tenure, resignation, succession, responsibilities and compensation;
- Director access to management and independent advisors;
- Director orientation and continuing education;
- Management succession (including selection, review and contingency policies); and
- Annual evaluation of Board and committee functioning and performance.

The NYSE calls for website posting of a listed company’s corporate governance guidelines, code of business conduct and ethics and core committee charters. A listed company must disclose the availability of these materials and the website on which the materials are located in its annual proxy statement (and other SEC filings). Companies use website postings both as a way to publicly communicate the “tone at the top” from the CEO and the Board and as a ready reference for employees, directors and shareholders.

Code of Business Conduct and Ethics

Paired with the corporate governance guidelines is the NYSE-required code of business conduct and ethics – a practical set of ethical requirements for a listed company’s officers, directors and employees. Only the Board or a committee can waive violations of the code by directors or executive officers, and the company must disclose any of these waivers to its shareholders within four business days of the waiver.

An NYSE-compliant code of business conduct and ethics will address, at a minimum:

- Conflicts of interest, corporate opportunities and fair dealing;

- Confidentiality and protection and proper use of company assets;
- Compliance with laws, rules and regulations (including insider trading laws); and
- Proactive reporting of any illegal or unethical behavior (with protections against retaliation).

In reviewing a code of business conduct and ethics, the Board should consider whether the code provides for sufficiently practical and general compliance standards and procedures, so that the Board or a committee is not put in a position of regularly considering waivers.

CEO's Certification of Compliance with Corporate Governance Standards and Company's Annual Written Affirmation Regarding Ongoing NYSE Obligations

A listed company's CEO must annually certify to the NYSE that he or she is unaware of any (not only material) violation of the NYSE's corporate governance standards, or detail any known violation. On an ongoing basis, the CEO must promptly notify the NYSE in writing if any executive officer of the company becomes aware of any noncompliance with the NYSE's corporate governance standards, even if the noncompliance is not material. In addition, a listed company must file a separate annual written affirmation regarding ongoing NYSE obligations, and may have to provide interim affirmations if various triggering events occur.

NYSE May Issue Public Reprimand Letters

The NYSE may issue a public reprimand letter to a listed company that it determines has violated any NYSE listing standard. For companies that repeatedly or flagrantly violate NYSE standards, the reprimand could lead to trading suspension or delisting.

Website Requirements

Listed companies are required to have and maintain a publicly accessible website. To the extent that the NYSE requires

a listed company to make documents available on or through its website, such website must clearly indicate in the English language the location of such documents on the website. Any such documents must be available in printable versions in the English language.

Shareholder Approval

The NYSE believes that good business practice calls for a listed company's management to consider submitting to shareholders those matters that may be important to shareholders, even if submission is not necessarily required by law or by governing documents. If a listed company has questions about submitting a matter to its shareholders, the NYSE urges the company to reach out and discuss the matter with its NYSE representative as appropriate. For the following key corporate actions, however, the NYSE specifically requires shareholder approval:

Equity Compensation Plans

Shareholders must approve any new equity compensation plan (or arrangement), whether or not officers and directors can participate in the plan. Shareholders must also approve any material revision to an existing plan.

For purposes of the NYSE requirements, an *equity-compensation plan* is a plan or other arrangement that may provide equity securities (newly issued or treasury) of the listed company to any employee, director or other service provider as compensation for services.

The NYSE's definition of *material revision* is general, but specifically includes:

- Materially increasing the number of shares available under a plan;
- Expanding the types of awards available under a plan;
- Materially expanding the class of persons eligible to participate in a plan;

- Materially extending a plan's term;
- Materially changing the method of determining the exercise price of options under a plan;
- Repricing options, including where a plan does not permit repricing or changing a plan to permit repricing or lowering the exercise price after grant; and
- Cancelling options as part of an exchange when the exercise price exceeds the fair market value of the underlying security.

Limited exemptions from the NYSE's shareholder approval requirements regarding plan approval include dividend reinvestment or other plans offered to all shareholders, some issuances in connection with mergers and acquisitions, 401(k) and stock purchase plans or similar tax-qualified and parallel nonqualified plans, and equity grants made as a material inducement to a person being newly hired.

If a grant, plan or amendment is exempt from the NYSE's shareholder approval requirements, the Compensation Committee (or a majority of the independent directors) must approve the grant, plan or amendment. In addition, the company must notify the NYSE in writing of the use of an exemption and, for any hiring inducement grant, issue a press release to disclose the material terms of the grant.



Practical Tip:
**Be Timely – Apply for Listing of
Equity Compensation Plan Shares**

It is good practice to file an application with the NYSE for listing of reserved, unissued shares in connection with a stock option, stock repurchase or other remuneration plan prior to securities under those plans being issued.

20% Stock Issuance

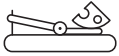
In most cases, shareholders must approve a listed company's new issuance of common stock (or securities convertible into, or exercisable for, common stock) in any transaction (or series of related transactions) that could equal or exceed 20% of the outstanding common stock or 20% of the outstanding voting power before the new issuance. However, a public offering for cash (even if over these 20% limits) generally does not require shareholder approval, nor does a private sale of common stock for cash at a price at or above the common stock's minimum price unless the sale is related to the acquisition of the stock or assets of another company and the related issuance of common stock (and any other issuances of common stock relating to the acquisition) could exceed the 20% limits. The NYSE defines "minimum price" as the lower of (1) the official closing price of the listed company's common stock immediately prior to the signing of the binding agreement to issue the additional common stock; or (2) the average official closing price of the listed company's common stock for the five trading days immediately prior to the signing of the binding agreement.

Issuances with Related Parties

In a non-cash transaction or in a cash transaction at a price less than the minimum price (see above), the NYSE generally requires shareholder approval prior to the issuance of common stock (or securities convertible into, or exercisable for, common stock) of over 1% of the outstanding preissuance common stock or voting power to directors, officers or substantial securities holders. In addition, prior shareholder approval is required if the common stock issuance is related to an acquisition of a company or assets where a related party has a 5% or greater (or related parties collectively have a 10% or greater) direct or indirect interest in the company or assets or the consideration to be paid in the acquisition, and the related issuance of common stock (and any other issuances of common stock relating to the acquisition) could exceed 5% of the outstanding preissuance common stock or voting power.

Issuances in Change-of-Control Transactions

The NYSE generally requires shareholder approval prior to an issuance of securities that would result in a change of control of the listed company.



Trap for the Unwary: Shareholder Voting Rights – Keep It Proportional (Usually, Anyway)!

In general, the voting rights of an NYSE company's current common shareholders cannot be disproportionately reduced or restricted through any corporate action or issuance, such as through capped or time-phased voting plans, issuance of super-voting stock or exchange of common stock for common stock with fewer voting rights per share. It is important to note, however, with regard to issuance of super-voting stock, that this restriction is primarily intended to apply to issuance of new classes of stock, so companies with existing dual-class capital structures generally are permitted to continue to issue any existing super-voting stock without conflict.

That said, an NYSE company (whether dual-class or not) wishing to enter into an arrangement that may disproportionately affect the voting rights of its current common shareholders (through stock issuance or otherwise) should carefully consider consulting with its NYSE representative early in the proposed transaction process, because even shareholder approval of the proposed transaction does not make it permissible without a prior "green light" from the NYSE.

Prior Approval of Related Party Transactions

The NYSE considers related party transactions as those types of transactions potentially required to be disclosed in a company's proxy statement (and some other public filings).

The NYSE requires *advance* review and oversight of related party transactions for potential conflicts of interest by the Audit Committee or another independent body of the Board. For a related party transaction, the Audit Committee or other independent body of the Board must prohibit the transaction unless it determines that the transaction is not inconsistent with the interests of the company and its shareholders.

With this advance review requirement, a company must carefully implement procedures to identify potential related party transactions and approve them before they occur.

The NYSE reviews proxy statements and other public filings disclosing related party transactions, and where such situations continue for several years, the NYSE may remind the listed company of its obligation, on a continuing basis, to evaluate each related party transaction and determine whether it should be permitted to continue.

Additional NYSE Standards

Other critical NYSE standards include:

- *Annual Shareholders' Meetings and Proxy Materials.* Listed companies must generally hold an annual shareholders' meeting during each fiscal year and solicit proxies and provide proxy materials for all shareholders' meetings.
- *Staggered Boards.* If a listed company has a staggered Board, it may be divided into no more than three classes, with each class being approximately the same in number and serving approximately equal terms of no more than three years. (We discuss staggered Boards in Chapter 2.)
- *Quorum for Shareholders' Meetings.* Generally, a listed company will be expected to have a quorum requirement of a majority of outstanding shares for any meeting of shareholders. Nevertheless, the NYSE may permit quorum provisions of reasonably less than a

majority of outstanding shares of common stock if the company agrees to make general proxy solicitations for shareholders' meetings.



**Breaking News:
NYSE to Adopt Listing Standards
That Mandate “Clawback” Policies**

Under the Dodd-Frank Act, the SEC must adopt rules to direct the NYSE and other national securities exchanges to establish rules requiring “clawback” policies. These policies, to be adopted and implemented by listed companies, must be designed to recover certain incentive-based compensation paid to current and former executives in the three years preceding a financial restatement that was made due to material noncompliance with financial reporting requirements. The clawback would apply even in the absence of misconduct on the part of the executive. As of the time this Handbook went to press in 2021, the SEC had proposed but not taken final action regarding adoption of these rules. The NYSE would be required to adopt related rules within a specific period of time following final SEC action.

Communicate! NYSE Notices and Forms

A listed company’s IRO or corporate secretary office should maintain close contact with the company’s NYSE representative. At a minimum, the company will need to notify and provide supporting documentation to the NYSE prior to, or at the time of, a number of corporate actions, including (in addition to those already mentioned) the following:

- Noncompliance with corporate governance standards;
- The listing of additional shares (including potentially through exercise or conversion of nonlisted securities) or a new class of securities;
- Cash dividends or distributions, or stock splits or stock dividends;

- Redemption, retirement or cancellation of a listed security (15 days' advance notice prior to redemption date required);
- A material disposition of assets;
- Rights offerings or changes relating to existing shareholders;
- A change in corporate name (20 days' advance notice of the date set for mailing of shareholders' proxy materials dealing with the matter if required);
- A change relating to the nature of the business;
- A change in directors or executive officers;
- Record date notice (ten days' advance notice prior to the record date required);
- The failure to pay interest on a listed security;
- A change in auditor; and
- A change in transfer agent, trustee, fiscal agent or registrar for listed securities (five business days' advance notice required).

Disclosure of Material News

In making the disclosure decisions discussed in Chapter 5, a listed company must consider the NYSE's requirement calling for prompt release to the public of any material news that might affect the market for the company's securities. This obligation exists side by side with requirements imposed by securities laws and the SEC, and results in an affirmative disclosure obligation for NYSE companies that may not otherwise exist.

Material news consists of news or information that might reasonably be expected to have a material effect – favorable or unfavorable – on the market of a listed company's securities, including information that might affect the value of the company's securities or influence an investor's decision to trade in the company's securities. Events such as earnings announcements, dividend declarations,

mergers and acquisitions, tender offers, major management changes, and significant new products or contracts may all qualify as material news.

Chapter 5 provides a more detailed list of factors that will help in deciding when news or information merits public release.

Exceptions to Required Public Disclosure

The NYSE permits a listed company to refrain from publicly announcing even material news, if necessary, as long as the company can maintain its confidentiality while still keeping all investors on equal footing and allowing no unfair information advantage. However, a company must take extreme care to keep the information confidential and to remind persons who possess the knowledge of their obligation to refrain from trading on insider information.

If a decision is made not to disclose material news, a listed company's IRO and general counsel's office should closely monitor the price and trading patterns in the company's securities and be prepared to make a public announcement if it becomes clear that the information has leaked to outsiders. If the NYSE detects unusual or suspicious trading activity in a company's securities, the NYSE may contact the company, require that the company make the information public immediately or possibly halt trading in the company's securities until the public has time to absorb the information.

**Practical Tip:
Those Pesky Rumors – What to Do?**



Perhaps the greatest threat to the confidentiality of material news is a rumor that indicates the market is aware of the confidential information. In the event of unusual market activity or rumors indicating that investors already know about impending company events – for example, a possible acquisition – your company may be required to make a clear public announcement regarding the state of negotiations or the development of corporate plans relating to the rumored information. This may be required even if the Board has not yet considered the matter.

If rumors do arise, you should first seek to confirm that they did not originate from within the company and, subject to conversations with the NYSE and if considered appropriate, issue the sort of release that we discuss in Chapter 5 (i.e., a release stating that the company’s policy is not to comment on transactional rumors). If the rumors are untrue, you may need to issue a press release publicly denying or clarifying the falsehoods or inaccuracies. It is critical, of course, that you not deny negotiations that are in fact occurring and that the statement be otherwise truthful and in compliance with antifraud laws.

Procedures for Public Disclosure of Material News

The NYSE outlines the following steps a listed company should take when publicly releasing material news (including responding to rumors):

- If the announcement is to be made between 7:00 a.m. and 4:00 p.m. Eastern time (4:00 a.m. and 1:00 p.m. Pacific time), the company must telephone the NYSE’s MarketWatch Group at least ten minutes prior to public announcement and inform the NYSE of the substance and method of distribution of the

announcement. (When the announcement is in written form, the company must also provide a copy of the text to the NYSE via specified web-based means at least ten minutes prior to release of the announcement.) If the announcement is to be made after the close of trading, the NYSE requires that a company wait to make the announcement until the earlier of publication of the day's official NYSE closing price or five minutes (and recommends a company wait 15 minutes) after the official close of trading (except when publicly disclosing material information that was nonintentionally disclosed in order to comply with Regulation FD);

- Broadly disseminate the news by a Regulation FD-compliant method (or combination of methods), and if the information should be immediately publicized, then by the fastest available means. According to the NYSE, this typically requires that the company either (i) include the news in a Form 8-K or other SEC filing or (ii) issue the news in a press release to the major newswire services, including, at a minimum, Dow Jones & Company, Inc., Reuters Economic Services and Bloomberg Business News;
- Prepare an internal question-and-answer script and have someone at the company ready to respond to questions about the material news; and
- Promptly send to the company's NYSE representative via email any press release that may significantly impact trading.

Trading Halts or Delays

The NYSE requires advance notice of potentially material news in part to determine whether the news would justify a trading halt or delay in the listed company's securities. Companies generally may avoid temporary trading halts or delays related to the release of new material news by fully disseminating the information to the public well before trading begins. If the company

believes that it may request a trading halt in connection with the announcement of material news, the company should coordinate closely with the NYSE. Whenever the NYSE decides to halt or delay trading due to pending material news, it will make an announcement to the market to that effect. Once the company releases the material news, the NYSE will monitor the situation and commence trading pursuant to its normal trading procedures. If the pending material news is not released within a reasonable time after the halt, the NYSE will monitor the situation and may reopen trading (often within 30 minutes of the trading halt or delay) and signal that material news is still pending. In addition, when the NYSE believes it is necessary to request from a company information relating to material news, the NYSE may halt trading until it has received and evaluated the information.

Consequences of Noncompliance

The NYSE outlines the following potential consequences for a listed company in the event of noncompliance with its standards and rules:

- *General.* If a company violates the corporate governance standards described above, the NYSE will review the situation and may initially issue a public reprimand letter, which could be followed by suspension or delisting if a violation continues or is repeated by the company.
- *Listing Standards Violation.* If a company falls below the quantitative continued listing standards or fails to comply with other qualitative listing standards, such as maintaining an Audit Committee that conforms with listing requirements, the NYSE will notify the company, generally within ten business days of knowledge, and provide it with an opportunity to present the NYSE with a plan describing action the company has taken, is taking or will take that would bring it into conformity with continued listing standards within 18 months. Such a plan would include quarterly financial projections, details related to any

strategic initiatives the company plans to complete and market performance support. For domestic companies, the company must contact the NYSE within ten days of receipt of notice to confirm that it received the notice, discuss any of the company's financial data that the NYSE may be unaware of, and indicate whether it intends to present a plan. The company then has 45 days from receipt of notice to submit its plan to the NYSE. If the company fails to respond to the notice, fails to comply with certain standards (including regarding financial statements) or fails to present a plan, or if the NYSE does not accept the plan that the company presents, suspension and delisting procedures will commence. The company must file a Form 8-K discussing its failure to meet applicable listing standards and if it does not, the NYSE will issue a press release. At all times, however, the NYSE may suspend trading and apply to the SEC to delist a company's securities if the NYSE deems it necessary for the protection of investors.

- *Failure to File SEC Reports.* If a company fails to file certain reports as required by the SEC, the NYSE will notify the company, and the company must contact the NYSE within five days of the date of notice to discuss the status of the delinquent report. In addition, the company is required to issue a press release discussing the filing delinquency and the anticipated date that the filing delinquency will be cured; otherwise, the NYSE will do so. If the company does not cure the filing delinquency within six months (or another appropriate period of time as determined by the NYSE), suspension and delisting procedures will commence (or the NYSE could provide another six-month cure period at its discretion).

When a company receives notice from the NYSE of any of the circumstances described above, a Form 8-K filing may be required. Companies in these circumstances should discuss with counsel how to best engage with the NYSE to avoid penalties, including potential trading suspension and securities delisting.

Chapter 10

Nasdaq Listing Standards: To Market, to Market

Deciding to list on The Nasdaq Stock Market (Nasdaq) brings with it the agreement to follow listing rules designed to achieve a strong standard of corporate governance, but one that is generally more flexible and accommodating to the needs of less mature companies than that of the NYSE. For example, Nasdaq provides an exceptional and limited circumstances exception permitting a non-independent director to serve on the Audit, Compensation or Nominating & Governance Committee. Larger or more mature Nasdaq companies will still want to be familiar with, and consider generally following, any additional requirements of the NYSE governance standards, as well as the expectations of ISS and other monitors of governance standards.

This chapter presents an overview of Nasdaq's listing and corporate governance standards. Nasdaq's requirements often mirror those imposed by the SEC, but are in fact independent obligations with separate ramifications if not met. Nasdaq companies need to satisfy both sets of requirements.

Continued Nasdaq Listing Standards

Nasdaq requires its listed companies to meet quantitative and qualitative standards on a continuing basis to remain listed on the exchange. Quantitative standards consist of objective financial and liquidity criteria. Qualitative standards relate to companies' corporate governance and ongoing status.

A company that lists its securities with Nasdaq is indexed according to a three-tier classification system: The Nasdaq Global Select Market[®], The Nasdaq Global Market[®] and The Nasdaq Capital Market[®]. The continued listing standards are the same for The Nasdaq Global Select Market and The Nasdaq Global Market and are slightly less burdensome for The Nasdaq Capital Market; these standards are set out in Appendix 5. A company's failure to meet its listing standards over a specified period of time often triggers Nasdaq action, which can include a Nasdaq delisting procedure and the removal of a company's securities from its Nasdaq market or require its move to a different Nasdaq market. See the end of this chapter for more information relating to a listed company's failure to comply with listing standards and rules.



Practical Tip:
Transferring Your Exchange to Nasdaq?
You Have a Little Time to Get Up to Speed

Is your company transferring to Nasdaq from another exchange? If so, you may have a grace period before being subject to some of Nasdaq's corporate governance standards. For a company transferring from another exchange or market (e.g., from the NYSE to Nasdaq), Nasdaq has special rules governing the phase-in period of its corporate governance requirements. Generally, if the exchange or market from which a company is transferring did not have the same requirements as Nasdaq, the transferring company has one year from the date of transfer in which to comply with the applicable Nasdaq requirements. If the exchange or market from which the company is transferring had substantially similar requirements, the company is afforded the balance of any grace period provided by the other exchange or market (other than for Audit Committee requirements, unless a transition period is available under Rule 10A-3 of the 1934 Act).

Nasdaq Corporate Governance Standards

Nasdaq corporate governance standards parallel NYSE standards in many respects, but provide greater flexibility for a less mature company. However, Nasdaq companies find that institutional investors still expect a high standard of corporate governance, sometimes looking with disfavor on companies that, for example, use the exceptional and limited circumstances exception to include a non-independent director on an otherwise independent Compensation Committee.

A Majority of Independent Directors

A majority of the Board members of a Nasdaq company must be independent. The Board itself annually determines independence – specifically, that directors do not have a relationship with the company that would interfere with their exercise of independent judgment in carrying out their director responsibilities. A company lists the independent directors in its annual proxy statement. A Nasdaq director is not independent if the director has one or more of the following relationships:

- *Employment Relationship.* A director who has been employed by the company within the past three years, or who had an immediate family member (as well as anyone residing in the director's home) employed as an executive officer of the company within the past three years, will not be independent. Employment as an interim chairman, CEO or other executive officer for a year or less will not by itself disqualify a director from being considered independent following that employment.
- *Compensation over \$120,000.* A director who has, or whose immediate family member (other than for compensation as a non-executive officer) has, received over \$120,000 in compensation from the company, other than compensation for Board or committee service or for employment as an interim executive officer (for one year or less) or other amounts that are generally non-

compensatory in nature, in any 12-month period within the past three years, will not be independent.

- *Relationships with the Auditor.* A director who is, or who has an immediate family member who is, a current partner of the company's independent auditor, or who was a partner or employee of the company's independent auditor and worked on the company's audit at any time during the past three years, will not be independent.
- *Interlocking Directorate.* A director who is, or who has an immediate family member who is, a current executive officer of another company where, at any time during the past three years, an executive officer of the company has served on the other company's compensation committee, will not be independent.
- *Significant Business Relationship (including Nonprofits).* A director who is, or who has an immediate family member who is, a current partner, executive officer or controlling shareholder of an entity, profit or nonprofit, to which the company made, or from which the company received, payments in the current year or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues or \$200,000, whichever is more (other than payments arising solely from investments in the listed company's securities or payments under nondiscretionary charitable contribution matching programs), will not be independent.

Nasdaq provides a cure period for a listed company's failure to comply with the independent majority requirement if one director ceases to be independent for reasons beyond the director's reasonable control or in the case of a single Board vacancy. The cure period ends on the earlier of the company's next annual shareholders' meeting or the first anniversary of the event that caused the noncompliance. However, if the next annual shareholders' meeting is less than 180 days after the event

that caused the noncompliance, the company will instead have 180 days to regain compliance. The company must notify Nasdaq immediately upon learning of the noncompliance.

Practical Tip:
**A “Controlled Company” Is Exempt from
Independence Requirements**



Does an individual, group or other entity own more than 50% of the voting power of your company’s securities? If so, your company may be a controlled company that does not need to have:

- A Board consisting of a majority of independent directors;
- A Compensation Committee, generally composed of two or more independent members; or
- A Nominating & Governance Committee, generally composed of independent members (or independent directors making nomination decisions).

A controlled company must continue to comply with Nasdaq’s requirement for an independent Audit Committee and other Audit Committee rules. And the independent directors must hold regular executive sessions. Otherwise, Nasdaq’s corporate governance burdens are reduced. A controlled company must disclose its controlled company status in its annual proxy statement, as well as explain the basis for its status.

If a company ceases to qualify as a controlled company, it will need to phase-in its independent Compensation Committee, Nominating & Governance Committee (if a company has such a committee) and majority independent Board in the following manner:

- At least one member of each of the Compensation Committee and Nominating & Governance Committee must be independent at the status change date;



Practical Tip:
**A “Controlled Company” Is Exempt from
Independence Requirements (Cont’d)**

- A majority of each of the Compensation Committee and Nominating & Governance Committee must be independent within 90 days of the status change date; and
- All members of each of the Compensation Committee and Nominating & Governance Committee, and a majority of the Board, must be independent within one year of the status change date.

Mandatory Executive Sessions of Independent Directors

Independent directors must meet “regularly” in executive sessions, without management or other directors present. Nasdaq contemplates that listed companies will hold at least two executive sessions each year. (We discuss executive sessions in further detail in Chapter 2.)



Breaking News:
**Nasdaq Requires Board Diversity
(or Publicly Explain Why Not)**

In August 2021, the SEC approved Nasdaq’s proposed board diversity rule. Generally, listed companies are required to have their Board meet two diversity objectives: (1) at least one director must self-identify as female; and (2) at least one director must self-identify as an underrepresented minority or LGBTQ+. Both diversity objectives cannot be met by only one director.

**Breaking News:
Nasdaq Requires Board Diversity
(or Publicly Explain Why Not) (Cont'd)**



There are a few exceptions to this requirement, including the following:

- Smaller reporting companies can meet the diversity objectives by having two directors who self-identify as female;
- Companies with five or fewer directors can meet the diversity objectives by having at least one director who self-identifies as either female, an underrepresented minority or LGBTQ+; and
- Special purpose acquisition companies (SPACs) are exempt from the board diversity rule.

Nasdaq defines *underrepresented minority* as an individual who self-identifies in one or more of the following groups: Black or African American, Hispanic or Latinx, Asian, Native American or Alaska Native, Native Hawaiian or Pacific Islander, or two or more races or ethnicities.

Listed companies will have a transition period to meet the diversity objectives or explain their reasons for not doing so. The timeframe is based on a company's Nasdaq listing tier:

- Nasdaq Global Select Market and Nasdaq Global Market companies are required to have, or explain why they do not have, one diverse director by August 7, 2023, and two diverse directors by August 6, 2025.
- Nasdaq Capital Market companies are required to have, or explain why they do not have, one diverse director by August 7, 2023, and two diverse directors by August 6, 2026.



**Breaking News:
Nasdaq Requires Board Diversity
(or Publicly Explain Why Not) (Cont'd)**

- Companies with boards of five or less directors, regardless of listing tier, are required to have, or explain why they do not have, one diverse director by August 7, 2023.

If a listed company does not meet its applicable diversity objectives described above, it will need to provide an explanation (in a proxy statement, information statement, Form 10-K or on the company's website) for not doing so, which could include a description of a different approach taken by the company on diversity. Nasdaq will verify that the company has provided an explanation but will not assess the merits of the explanation.

Listed companies subject to the board diversity rule are also required to annually disclose (in a proxy statement, information statement, Form 10-K or on the company's website, depending on timing) the voluntary self-identified gender and racial characteristics and LGBTQ+ status of the Board. This information should be presented in an aggregated matrix format that is the same or substantially similar to the format provided by Nasdaq. Listed companies must disclose the initial matrix in 2022, as follows:

- If a company files its 2022 proxy statement before August 8, 2022, and does not include the matrix, then the company has until August 8, 2022, to provide the matrix.
- If a company files its 2022 proxy statement on or after August 8, 2022, then it must either include the matrix in its proxy statement or post the matrix on its website within one business day of filing its proxy statement.
- If a company does not intend to file a 2022 proxy statement, then the company has until August 8, 2022, to provide the matrix on its website.

Audit Committee

Composition and Independence. Each Nasdaq company must have an Audit Committee consisting of at least three directors, all of whom must be independent. All Audit Committee members must be financially literate and at least one member must be financially sophisticated. (We discuss these requirements later in this chapter.) Directors who have participated in the preparation of the financial statements of the company or any current subsidiary of the company during the past three years cannot serve on the Audit Committee.

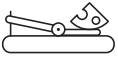
Heightened Independence Requirements for Audit Committee Members. In addition to Nasdaq's general independence requirements discussed above, Audit Committee members must satisfy the Sarbanes-Oxley Audit Committee independence requirements under Rule 10A-3 of the 1934 Act. These requirements provide that Audit Committee members cannot:

- Receive any compensatory payment from the company other than for Board or committee service; or
- Be an affiliated person of the company or any subsidiary. (We discuss these Sarbanes-Oxley Audit Committee independence requirements in Chapter 2.)

Exceptional and Limited Circumstances Exception to Audit Committee Independence Requirements. A director who does not satisfy Nasdaq's general independence standards for directors but who does satisfy the Sarbanes-Oxley Audit Committee independence requirements and is not a current executive officer or employee, or an immediate family member of a current executive officer of the company, can serve on the Audit Committee for up to two years.

The company must disclose in the company's annual proxy statement the nature of the director's relationship and the reasons for the Board's determination that the director's service on the Audit Committee is in the best interests of the company and its shareholders. Only one director may be appointed under

this exception at one time and, if so appointed, may not serve as the Audit Committee chair. The company may rely on this exception without obtaining Nasdaq approval.



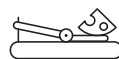
**Trap for the Unwary:
Use Exceptional and Limited Circumstances Exception
from Independence with Great Care**

Nasdaq permits a director who is not independent under Nasdaq criteria to serve on an Audit, Compensation or Nominating & Governance Committee for up to two years under its exceptional and limited circumstances exception, but Boards should be aware of important limits to this exception's usefulness.

First, take the temperature of your shareholders before using this exception. Many institutional investors look with great disfavor on non-independent core committee members, particularly for the Audit and Compensation Committees. These investors may let you know that they will vote against those directors or against an entire Board slate that uses the exception without a very good reason (or at least one they do not agree with).

Second, separate and apart from Nasdaq, various regulations may make it cumbersome to use this exception. For example, Sarbanes-Oxley requires all public company Audit Committee members to be independent under the Sarbanes-Oxley definition. As we detail in Chapter 2, Sarbanes-Oxley has only two criteria for independence (but they do cover many potential relationships): no compensation from the company whatsoever other than for Board or committee service and no affiliate status, that is, a director who controls, is controlled by, or is under common control with the listed company (or an officer or director of another company that is an affiliate of the listed company). Also, regarding the Compensation Committee, the usual desire under the Internal Revenue Code and the 1934 Act to have "outside directors" and "nonemployee directors" approve certain

**Trap for the Unwary:
Use Exceptional and Limited Circumstances Exception
from Independence with Great Care (Cont'd)**



compensation arrangements and option and share grants makes a fully independent Compensation Committee far more practical than having an appropriate subset of the Compensation Committee act on compensation. Further, as we discuss in Chapter 7, a fully independent Compensation Committee gives shareholders additional comfort regarding a company's compensation practices and may help a company avoid an unfavorable say-on-pay shareholder vote on executive compensation.

Companies Can "Cure" Inadvertent Noncompliance with Nasdaq's Audit Committee Composition Requirements. Nasdaq provides a cure period if a company fails to comply with the Audit Committee composition requirements because one director ceases to be independent for reasons beyond the director's reasonable control or because of a single Board vacancy. If reasons beyond the director's reasonable control cause the failure to comply, the cure period ends on the earlier of the company's next annual shareholders' meeting or the first anniversary of the event that caused the noncompliance. If a single Board vacancy causes the failure to comply, then the cure period also ends on the earlier of the company's next annual shareholders' meeting or the first anniversary of the event that caused the noncompliance, except that if the next annual shareholders' meeting is less than 180 days after the event that caused the noncompliance, the company will instead have 180 days to regain compliance. The company must notify Nasdaq immediately upon learning of noncompliance. Nasdaq will excuse only a single noncomplying Audit Committee member from meeting the Nasdaq independence requirements, and the director must at all times meet Sarbanes-Oxley's Audit Committee independence requirements.

Financial Literacy and Sophistication. Audit Committee members must be financially literate, meaning they are able to read and understand fundamental financial statements, including balance sheets and income and cash flow statements, at the time of their appointments. In addition, at least one member of the Audit Committee must have financial sophistication. Past employment experience in finance or accounting, requisite professional certification in accounting or other comparable experience or background, including being or having been a CEO, CFO or other senior official with financial oversight responsibilities, may result in financial sophistication. Although Nasdaq did not expressly adopt the SEC's Audit Committee financial expert standard, any director who meets that standard will meet Nasdaq's financial sophistication standard. (We discuss the SEC's Audit Committee financial expert standard in Chapter 2.)

Audit Committee Charter. A Nasdaq-compliant written charter must detail the membership, structure, processes, responsibilities and authority of the Audit Committee, including those elements established in Rule 10A-3 of the 1934 Act. Nasdaq rules, in conjunction with SEC rules, call for a charter that requires the Audit Committee to:

- ***Oversee Outside Auditors.*** Be directly responsible for the appointment, compensation, retention and oversight of the outside auditors and their independence.
- ***Preapprove Outside Audit Services.*** Preapprove all permissible services provided by the company's outside auditors.
- ***Set Procedures for Financial Whistleblower Complaints.*** Establish procedures for the receipt, retention and treatment of complaints to the company regarding accounting, internal accounting controls or auditing matters and for the confidential, anonymous submission by employees of accounting or auditing concerns.

- *Retain Advisors.* Be authorized to engage, and determine funding for, independent legal counsel and other advisors.
- *Receive Adequate Funding to Meet Responsibilities.* Receive appropriate funding from the company for payment of compensation to auditors, independent legal counsel and other advisors and for ordinary administrative expenses necessary or appropriate to carry out the Committee's duties.
- *Annual Charter Evaluation.* Requires annual assessment of the Committee's charter.

We discuss other common duties of the Audit Committee in Chapter 2.

Audit Committee Review and Oversight of Related Party Transactions

A Nasdaq company's Audit Committee (or a comparable body of independent directors) must review and oversee all related party transactions for potential conflicts of interest on an ongoing basis. To be consistent with SEC disclosure requirements, Nasdaq defines related party transactions as those described in Item 404 of Regulation S-K (which covers the SEC's definition of related person transactions). These transactions include those in which the company is a participant that involve over \$120,000 and in which any director or nominee, executive officer or 5% or more shareholder, or any immediate family member of the foregoing, has a direct or indirect material interest. (We discuss related person transactions in more detail in Chapter 7.)

Compensation Committee

Composition and Independence. Each Nasdaq company must have a Compensation Committee composed of at least two directors, generally all of whom must be independent. In addition, when determining the independence of a director who will serve on the Compensation Committee, the Board must

specifically consider all relevant factors regarding whether the director has a relationship to the listed company that is material to the director's ability to be independent from management with regard to Compensation Committee service, including:

- The source of the director's compensation, including any consulting, advisory or other compensatory fee paid by the listed company to the director; and
- Whether the director is affiliated with the listed company, a subsidiary of the listed company or an affiliate of a subsidiary of the listed company.

In some circumstances, however, a Nasdaq company may avail itself of the exceptional and limited circumstances exception to this independence requirement if the Compensation Committee has three or more members.

Compensation Committee Charter. Nasdaq requires a listed company to have a written Compensation Committee charter that addresses:

- *Scope of Responsibilities.* Provides scope of the Committee's responsibilities and how it carries them out, including structure, processes and membership requirements.
- *CEO and Other Executive Officer Pay.* Details the Committee's responsibility for determining, or recommending to the Board for determination, the compensation of the CEO and other executive officer compensation.
- *Absence of CEO from CEO Compensation Deliberations.* Requires the CEO's absence during voting or deliberation on CEO compensation.
- *Annual Charter Evaluation.* Requires annual assessment of the Committee's charter.
- *Advisors.* Requires the Committee to have the authority to retain or obtain the advice of a compensation consultant, independent legal counsel or other advisor, following an independent assessment of the advisor.

Exceptional and Limited Circumstances Exception to Compensation Committee

Independence Requirements. A director who does not satisfy Nasdaq's general independence standards for directors but who is not a current executive officer or employee, or an immediate family member of a current executive officer of the company, can serve on the Compensation Committee for up to two years, as long as the Committee is composed of at least three members (not the usual minimum of two members).

The company must disclose in the company's annual proxy statement or on the company's website that it is relying on this exemption and explain the basis for the company's conclusion that this exemption is applicable. A director appointed under this exception may not serve longer than two years. The company may rely on this exception without obtaining Nasdaq approval.

Companies Can "Cure" Inadvertent Noncompliance with Nasdaq's Compensation Committee Composition Requirements. Nasdaq provides a cure period if a company fails to comply with the Compensation Committee composition requirements because one director ceases to be independent for reasons beyond the director's reasonable control or because of one vacancy. In either case, the cure period ends on the earlier of the company's next annual shareholders' meeting or the first anniversary of the event that caused the noncompliance, except that if the next annual shareholders' meeting is less than 180 days after the event that caused the noncompliance, the company will instead have 180 days to regain compliance. The company must notify Nasdaq immediately upon learning of the noncompliance.

Limited Requirements for Smaller Reporting Companies. For a company that qualifies as a "Smaller Reporting Company" for SEC filing purposes, Nasdaq provides relief from some of the Compensation Committee requirements. A Smaller Reporting Company must certify that it has, and will continue to have, a Compensation Committee meeting the composition requirement of at least two independent members, as well as a written charter or a Board resolution addressing the Committee's scope of responsibilities generally, the determination of CEO and other

executive officers pay, and that the CEO and other executive officers may not be present during voting or deliberations on their executive compensation. Smaller Reporting Companies may rely on the independence cure period and the independence exception described above.



Practical Tip:
Leaving the Smaller Reporting Company World Behind?
Phase-in Period for Growing Companies

A company exiting Smaller Reporting Company status is given a grace period before being subject to the remaining Compensation Committee requirements from which it was previously exempt. Within six months after ceasing to qualify for Smaller Reporting Company status, the company must certify to Nasdaq that it has adopted a formal written Compensation Committee charter that complies with all Nasdaq requirements and it has complied, or will comply based on the following phase-in schedule, with all Compensation Committee composition requirements.

The company is permitted to phase-in compliance with the composition requirements related to director's compensation and affiliation (but not the requirements related to Compensation Committee size or independence), based on the following schedule:

- Within six months after losing Smaller Reporting Company status, one member of the Compensation Committee must be in compliance with affiliation and compensation requirements;
- Within nine months after losing Smaller Reporting Company status, a majority of members of the Compensation Committee must be in compliance with affiliation and compensation requirements; and
- Within one year after losing Smaller Reporting Company status, all members of the Compensation Committee must be in compliance with affiliation and compensation requirements.

Nominating & Governance Committee (or Nominations by Independent Directors)

The third core independent Board committee of a Nasdaq company is the independent Nominating & Governance Committee. The Board may forgo the Nominating & Governance Committee and choose instead to act on director nominations by a majority of independent directors (through a vote in which only independent directors participate). The Nominating & Governance Committee (or an appropriate majority of independent directors) will select, or recommend to the Board for selection, all director nominations, except for those Board “seats” where a third party has a contractual or other right to nominate a director. The Board may use the exceptional and limited circumstances exception for service by one non-independent director on the Nominating & Governance Committee.

The Board of a Nasdaq company with a Nominating & Governance Committee will need to adopt a formal written charter covering at least the nomination process. If, instead, the Board acts by having an appropriate majority of independent directors make nomination decisions, then a comparable Board resolution should address the nomination process.

Exceptional and Limited Circumstances Exception to Nominating & Governance Committee Independence Requirements. A director who does not satisfy Nasdaq’s general independence standards for directors but who is not a current executive officer or employee, or an immediate family member of a current executive officer of the company, can serve on the Nominating & Governance Committee for up to two years, as long as the Committee is composed of at least three members.

The company must disclose in the company’s annual proxy statement or on the company’s website that it is relying on this exemption and explain the basis for the company’s conclusion that this exemption is applicable. A director appointed under this exception may not serve longer than two years. The company may rely on this exception without obtaining Nasdaq approval.

Code of Conduct

A core component of a Nasdaq company's good governance framework is adoption and public availability of a code of conduct that covers all its directors, officers and employees. Nasdaq requires that the code of conduct comply with the code of ethics mandated by Sarbanes-Oxley. Item 406 of Regulation S-K defines this code of ethics as written standards reasonably designed to deter wrongdoing and to promote honest and ethical conduct and fair and full disclosure. The code of conduct must include enforcement mechanics, and the Board must approve any waivers from the code of conduct for directors or executive officers. Waivers must be disclosed to shareholders within four business days.

Notification of Noncompliance with Nasdaq Corporate Governance Standards

A Nasdaq company must promptly notify Nasdaq if an executive officer of the company becomes aware of any company noncompliance with Nasdaq's corporate governance standards (whether there is an automatic cure period or not).

Shareholder Approval

Nasdaq requires shareholders to approve specified key corporate actions including those below.

Equity Compensation Plans

Nasdaq generally requires that shareholders approve both new equity-based compensation plans or arrangements, whether or not officers and directors can participate, and material amendments to those types of existing plans or arrangements.

Nasdaq defines a material amendment to include:

- Material increase in the number of shares available under the plan, other than increases to reflect reorganizations, stock splits, mergers, spin-offs and similar transactions;

- Material increase in the benefits available to plan participants;
- Material expansion of the class of persons eligible to participate in the plan;
- Any expansion in the types of awards provided under the plan;
- Material extension of the plan's term;
- Reduction in the price at which shares or stock options may be offered; and
- Repricing of stock options, where the plan does not specifically permit the repricing.

There are a variety of special-purpose exemptions to these shareholder approval requirements. These include exemptions for warrants or rights offered generally to all shareholders (poison pills), stock purchase plans available on equal terms to all shareholders (dividend reinvestment plans), some types of awards made in connection with mergers and acquisitions, tax-qualified nondiscriminatory employee benefit plans and parallel nonqualified plans (like 401(k) plans or other ERISA plans), and grants of equity awards made as a material inducement to a person's initial employment with the company. Even when a plan or an arrangement is exempt from shareholder approval requirements, Nasdaq generally still requires that the Compensation Committee (or a majority of independent directors) approve inducement grants and tax-qualified nondiscriminatory employee benefit and parallel nonqualified plans. In addition, the company must promptly disclose in a press release the material terms of inducement grants made in reliance on the shareholder approval exception.

20% Stock Issuance (5% to Affiliates in an Acquisition)

Shareholders of Nasdaq companies have long been required to approve major additional issuances of common stock (or convertible securities). These are the provisions that generally trigger a shareholder vote and proxy solicitation on significant transactions, including stock-for-stock mergers.

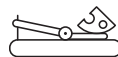
20% Rule. Shareholders must approve any securities issuance (other than in a public offering) that may exceed 20% of the outstanding common stock or the outstanding voting power outstanding before the issuance, if the issuance is priced below the minimum price (sales by officers, directors and 5% shareholders will be combined with the company's securities issuance in determining whether the 20% threshold has been met). Nasdaq defines "minimum price" as the lesser of (1) the official closing price of the listed company's common stock immediately preceding the signing of the binding agreement to issue the additional common stock; or (2) the average official closing price for the five trading days immediately preceding the signing of the binding agreement to issue the additional common stock. Nasdaq also requires shareholder approval for any acquisition that results in the issuance of common stock (or convertible securities) of 20% or more of the outstanding common stock or the outstanding voting power outstanding before the issuance (and this acquisition-related approval triggers a shareholder vote regardless of the price of the Nasdaq purchaser's common stock).

5% Affiliate Acquisition Rule. A Nasdaq acquirer must also seek shareholder approval of an acquisition where a related issuance of securities could result in an increase of over 5% (by number of shares or voting power) of outstanding common stock or voting power, if a director, executive officer or 5% shareholder of the acquirer has a 5% interest (or those insiders together have a 10% interest) in the target company.

Change-of-Control Transactions

Nasdaq requires shareholder approval for issuances or potential issuances of securities resulting in a change of control of the company.

**Trap for the Unwary:
Shareholder Voting Rights –
Keep It Proportional (Usually, Anyway)!**



In general, the voting rights of a Nasdaq company's current common shareholders cannot be disproportionately reduced or restricted through any corporate action or issuance, such as through capped or time-phased voting plans, issuance of super-voting stock or exchange of common stock for common stock with fewer voting rights per share. It is important to note, however, with regard to issuance of supervoting stock, that this restriction is primarily intended to apply to issuance of new classes of stock, so companies with existing dual-class capital structures generally are permitted to continue to issue any existing super-voting stock without conflict.

That said, a Nasdaq company (whether dual-class or not) that wishes to enter into an arrangement that may disproportionately affect the voting rights of its current common shareholders (through stock issuance or otherwise) should carefully consider consulting with its Nasdaq representative early in the proposed transaction process, because even shareholder approval of the proposed transaction does not necessarily make it permissible without a prior "green light" from Nasdaq.

Additional Corporate Governance Standards

Nasdaq companies must comply with a number of additional corporate governance standards. Four critical ones are:

- *Registered Auditor.* Nasdaq requires a company to be audited by an auditor registered with the Public Company Accounting Oversight Board (PCAOB).
- *Annual Shareholders' Meeting.* Nasdaq requires a company to hold an annual shareholders' meeting within one year of its fiscal year-end and to provide

notice to Nasdaq of the meeting (which requirement can be met through SEC filings). At the annual meeting, shareholders must have the opportunity to discuss company affairs with management.

- *Quorums*. Nasdaq prohibits quorum provisions that require less than one-third of all outstanding shares of common voting stock.
- *Solicitation of Proxies*. Nasdaq requires a company to solicit proxies, provide proxy statements for all shareholders' meetings and send copies of the proxy solicitation to Nasdaq (which requirement can be met through SEC filings).



Breaking News: Nasdaq to Adopt Listing Standards That Mandate “Clawback” Policies

Under the Dodd-Frank Act, the SEC must adopt rules requiring Nasdaq and other national securities exchanges to establish rules requiring “clawback” policies. These policies, to be adopted and implemented by listed companies, must be designed to recover certain incentive-based compensation paid to current and former executives in the three years preceding a financial restatement that was made due to material noncompliance with financial reporting requirements. The clawback would apply even in the absence of misconduct on the part of the executive. As of the time this Handbook went to press in 2021, the SEC had proposed but not taken final action regarding adoption of these rules. Nasdaq would be required to adopt related rules within a specific period following final SEC action.

Keep Nasdaq Informed! Notices and Forms

Nasdaq requires listed companies to notify, and provide supporting documentation to, Nasdaq and, in some cases, file a Listing of Additional Shares form or other relevant form, at, prior

to or within specified periods following many corporate actions, including (in addition to those already mentioned) the following:

- Becoming aware of noncompliance with Nasdaq corporate governance standards;
- Establishing or materially amending a stock option plan, purchase plan or other equity compensation arrangement under which stock may be acquired by officers, directors, employees or consultants without shareholder approval;
- Issuing securities that may potentially result in a change of control;
- Issuing common stock or securities convertible into common stock in connection with the acquisition of another company, if any officer, director or 5% shareholder of the issuing company has a 5% or greater interest (or if such persons collectively hold a 10% or greater interest) in the target company or the consideration to be paid;
- Entering into a transaction that may result in the potential issuance of common stock (or convertible securities) greater than 10% of the outstanding common stock or the outstanding voting power on a pre-transaction basis;
- Having an increase or a decrease of 5% of the outstanding listed securities;
- Declaring a dividend or stock distribution;
- Reclassifying or exchanging listed securities or changing the par value;
- Undertaking a reverse stock split;
- Reincorporating;
- Changing the company's general character or nature of business, address of principal executive offices, or corporate name or symbol; or
- Changing the transfer agent or registrar.

At its discretion, Nasdaq may request any additional documentation, public or nonpublic, it finds necessary to consider a company's continued listing.

Disclosure of Material News

Nasdaq, like the NYSE, generally requires a listed company to promptly and publicly disclose any material news or information that might affect the market for the company's securities. This obligation exists side by side with securities law and SEC obligations, and results in an affirmative company disclosure obligation (with a variety of exceptions as discussed below).

Material news includes information that would reasonably be expected to affect the value of a company's securities or influence an investor's decision to trade in the company's securities. Categories of material news are very broad; generally, all significant events affecting the company, including its business, products, management, securities and finances, presumably merit prompt public disclosure consideration.



Practical Tip: What Is Material News?

Nasdaq provides examples of material news, similar to the SEC's list of possible material information that we set out in Chapter 5, that serve as a useful guide for determining whether news merits public disclosure. Nasdaq companies must notify Nasdaq's MarketWatch Department between 7:00 a.m. and 8:00 p.m. Eastern time (4:00 a.m. and 5:00 p.m. Pacific time) (and outside that period, prior to 6:50 a.m. Eastern time/3:50 a.m. Pacific time) at least ten minutes prior to the release of the following types of material information:

- Financial disclosures, including quarterly and yearly earnings, earnings restatements, preannouncements and earnings guidance;



**Practical Tip:
What Is Material News? (Cont'd)**

- Corporate reorganizations and acquisitions, including mergers, tender offers, asset transactions and bankruptcies or receiverships;
- New major product developments or discoveries, or significant developments regarding customers or suppliers;
- Senior management changes of a material nature or a change of control;
- Resignation or termination of independent auditors, or withdrawal of a previously issued audit report;
- Events regarding the company's securities, for example, defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders or public or private sales of additional securities;
- Significant legal or regulatory developments; and
- Any event requiring the filing of a Form 8-K.

Exceptions to Nasdaq's Disclosure Requirements

The exceptions to Nasdaq's disclosure requirements soften the general mandate to always promptly publicly disclose material news. A listed company may delay announcement of material news if it is possible for the company to maintain confidentiality and immediate public disclosure would prejudice the company's ability to pursue legitimate corporate objectives – the delay must not, however, give any investor an unfair information advantage. To take advantage of this exception, a company must keep the information confidential and remind those who possess the information of their obligation to refrain from trading on insider information.

The investor relations department and other responsible officers of a listed company will need to closely monitor the trading of its securities for unusual price or volume movements, and be prepared to make a public announcement if it becomes clear that confidential information has leaked. If Nasdaq detects unusual or suspicious trading activity in a company's securities, Nasdaq's MarketWatch Department may contact the company and require that it promptly and publicly disclose the information. In this case, Nasdaq may require a trading halt in the company's securities until the public has time to absorb the information.



Practical Tip:
Rumors – Where There's Smoke . . .
Don't Get Burned!

A Nasdaq company needs to carefully guard confidential information to prevent circulation of rumors that originate from company sources. Nasdaq specifies that if unusual market activity or rumors indicate that investors are aware of current actions or impending events, your company may be required to make a clear public announcement regarding the state of negotiations or the development of corporate plans in the rumored area. This disclosure may be required even if your Board has not yet taken up the matter for consideration.

If the rumors are untrue, your company may need to issue a press release publicly denying or clarifying the false or inaccurate information. This statement must obviously be truthful and not omit material information necessary to prevent the disclosure from being misleading.

Because a premature public announcement, including one triggered by rumors, can jeopardize proposed plans, careful monitoring of confidential information, and of rumors, can protect a critical corporate initiative.

Procedures for Public Disclosure

Nasdaq permits its listed companies to disclose material information through any, or any combination of, Regulation FD-compliant methods. These methods include a broadly disseminated press release or a Form 8-K, as well as a conference call, press conference or webcast, provided that the public is given adequate prior notice (generally by press release) and access. In addition, with appropriate prior notice and disclosure regarding company public disclosure methods, a company's websites and social media channels may also be adequate tools for public disclosure – although company website and social media disclosures are often coupled with more standard disclosure methods, particularly regarding very significant news. (We provide practical tips for making Regulation FD-compliant disclosures in Chapter 5.)

Nasdaq requires a listed company to notify Nasdaq's MarketWatch Department usually at least ten minutes prior to the release of material information. (See the "What Is Material News?" Practical Tip earlier in this chapter for details on timing and material events.) For material disclosure not in written form (e.g., in a press release, Form 8-K or appropriate company website or social media disclosure), companies should provide prior notice to Nasdaq of the press release announcing the logistics of the future disclosure and a descriptive summary of the information to be announced.

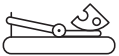
Nasdaq encourages companies to provide prior notice of material news disclosures, even if not mandated, whenever the company believes, based on its knowledge of the significance of the information, that a temporary halt in trading may be appropriate. Nasdaq's MarketWatch Department is required to keep nonpublic information confidential and use it only for regulatory purposes.

Trading Halts

Nasdaq requires advance notice of disclosures in part to help determine whether the material news justifies a trading halt in a

company's securities. A listed company can generally avoid a trading halt by broadly issuing the disclosure to the public with an adequate amount of time before market open.

When an issuer makes a significant announcement during trading hours, the exchange may require a trading halt to allow investors to gain equal access to information, fully digest the material news and consider its impact. A trading halt also alerts the market that material news has been released. Nasdaq determines when a trading halt is necessary and how long it should last, usually permitting trading to resume within 30 minutes after news is fully disseminated.



**Trap for the Unwary:
Nasdaq Disclosure of Golden-Leash
Arrangements for Third-Party Directors**

Nasdaq rules require listed companies to publicly disclose (in a proxy statement, information statement, Form 10-K, Form 8-K, press release or on the company's website, depending on timing circumstances) the material terms of compensation or other payment arrangements provided by third parties to directors or director nominees (e.g., shareholder director representatives being paid additional director fees or equity by a shareholder). Noncompliance with this disclosure requirement may be excused if a company has undertaken "reasonable efforts" to identify all relevant golden-leash arrangements and initially found none, but then later discovered and promptly disclosed such arrangements.

Consequences of Noncompliance

Notice of Deficiency. When Nasdaq has determined that a company does not meet a listing standard, it will notify the company of the deficiency. Based on the type of deficiency, the company may be (1) entitled to an automatic cure or compliance period, (2) entitled to submit a compliance plan for Nasdaq to

review or (3) immediately suspended, delisted or transferred to a different Nasdaq market (a Staff Delisting Determination, described later in this chapter).

Automatic Cure or Compliance Period. As described earlier in this chapter, Nasdaq provides a cure period for a listed company's failure to comply with some of its standards, such as various corporate governance standards related to the composition of the Board or its committees.

Deficiencies for Which a Company May Submit a Plan of Compliance. With some exceptions, Nasdaq may accept and review a plan to regain compliance when there is one or more of the following deficiencies:

- a quantitative deficiency from standards that do not provide a compliance period;
- a corporate governance deficiency regarding standards related to the composition of the Board or its committees where a cure period is not provided;
- a deficiency from various other standards, for example, some regarding shareholder meetings, review of related party transactions, shareholder approvals, a company's code of conduct and shareholder voting rights;
- a failure to make the disclosure required by Nasdaq rules regarding arrangements between any of the company's directors or director nominees and a third party, relating to compensation or other payment in connection with that person's service or candidacy as a director of the company;
- a failure to file periodic financial reports required by the SEC; and
- a failure to meet a continued listing requirement of non-primary equity securities, such as debt securities (other than convertible debt) and exchange traded fund shares (ETFs).

A deficient company must provide the compliance plan generally within 45 calendar days, except for compliance plans with respect to failures to file periodic financial reports required by the SEC, which must be provided generally within 60 calendar days. There are notable exceptions to these time periods regarding compliance plans, including for a company's deficiencies relating to bid price, market makers and market value.

Staff Delisting Determinations and Public Reprimand Letters. Specific types of deficiencies will immediately result in a Staff Delisting Determination, such as failure by a company to timely solicit proxies or if Nasdaq believes continued listing raises a public concern. When Nasdaq determines that a Staff Delisting Determination is an inappropriate sanction for a company that has violated a Nasdaq corporate governance or notification listing standard, it may instead issue a Public Reprimand Letter. This will depend on factors such as whether the violation was inadvertent, whether the violation materially adversely affected shareholders' interests, whether the violation has been cured, whether the company reasonably relied on an independent advisor and whether the company has demonstrated a pattern of violations.

Nasdaq may issue a Staff Delisting Determination or a Public Reprimand Letter at its discretion after a cure or compliance period has expired, after Nasdaq reviews a compliance plan submitted by the company, or if a company does not regain compliance within the time period provided by Nasdaq.

Public Announcement of Notice. A company that receives a notification of deficiency, Staff Delisting Determination or Public Reprimand Letter is required to disclose that notice in a public announcement by (1) filing a Form 8-K (where required by SEC rules), (2) issuing a press release or (3) sometimes both, depending on the deficiency. Both actions are required if the deficiency is due to a failure to file periodic financial reports required by the SEC. The company should make the public announcement promptly and not more than four business days following receipt of the notification. If the company fails to timely make the

required announcement, Nasdaq will halt trading of the company's securities generally at least until the required information has been made public.

Appeals Process. Upon receiving a Staff Delisting Determination or a Public Reprimand Letter, a company may request in writing that the Hearings Panel review the matter in a written or an oral hearing. The Hearings Panel is an independent panel generally made up of two or more persons who have been authorized by the Nasdaq Board of Directors and who are not employees or otherwise affiliated with Nasdaq or its affiliates. After the Hearings Panel has issued a decision, the company may further appeal to the Nasdaq Listing and Hearing Review Council.

Chapter 11

Corporate Structural Defenses to Takeovers

Many private companies aspire to go public. The benefits of going public include the acquisition of capital for growth and the provision of liquidity to shareholders. At the same time, third parties may seize opportunities presented by public capital markets to acquire control of public companies. Vulnerability to unsolicited and sometimes hostile takeover attempts, as well as attempts to influence corporate decision-making, can jeopardize achievement of the company's long-term strategic goals.

Potential acquirers employ a range of techniques to take over public companies. Friendly negotiated acquisitions or hostile takeover attempts can result in a change of control. Some of these techniques essentially coerce shareholders of the target company into accepting the takeover proposal. Hostile takeovers, whether or not accompanied by coercive tactics, result in enormous stress for the target companies and their shareholders.

Although a public company can defeat a takeover attempt after it has begun, a Board should prepare for unsolicited takeover efforts well before these situations arise. Courts have upheld the adoption of takeover defenses that meet the following tests: the Board had reasonable grounds for believing that a hostile action or takeover attempt constituted a danger to the company's corporate policy and effectiveness, and antitakeover protections adopted by the Board was a reasonable and proportionate response to a legitimate corporate threat.

Why Adopt Corporate Structural Defenses?

The Board oversees the development and implementation of the company's business goals and strategies. By equipping the company with tools to withstand hostile takeover efforts, the Board enhances the ability of the company to accomplish its strategic objectives. In particular, the Board may implement appropriate corporate structural defenses by amending the company's certificate or articles of incorporation or bylaws, or by adopting a shareholder rights plan. Although standard takeover defenses will not prevent a well-financed takeover that is in the best interests of shareholders, these defenses will generally provide a target company's Board with sufficient time and negotiating leverage to allow it to:

- Evaluate an offer;
- Communicate with shareholders;
- Negotiate with a potential buyer to preserve the company's long-term objectives and/or achieve the best available price for the company's shareholders;
- Protect a preferred alternative transaction that is consistent with the company's long-term strategic objectives; and
- Otherwise maximize shareholder value.

While our discussion uses concepts from Delaware law, similar defenses are permitted by most other states.

**Practical Tip:
An Ounce of Prevention**



Your Board should consider corporate structural takeover defenses well before the company confronts a takeover attempt. It is important for the Board to consider corporate structural defenses in a reasoned fashion, rather than in the heat of a takeover battle. Implementing some defenses will require shareholder approval, which requires lead time and, as we discuss later in this chapter, may be difficult to obtain after a company has public shareholders. Corporate structural defenses such as a shareholder rights plan that can be put in place after the IPO and even after a takeover attempt has been initiated will, if challenged in court, receive significantly closer judicial scrutiny than defenses established prior to a takeover attempt, although a court reviewing a Board's response to a takeover proposal will consider the impact of all the target's defenses in the aggregate.

Why Not Adopt Corporate Structural Defenses?

Institutional shareholders often object to corporate structural defenses because they view these defenses as entrenching existing management and denying shareholders the benefit of potentially valuable offers for corporate control. Proxy advisory firms such as ISS and other institutions have identified the following provisions that increase the concerns of governance-related risk:

- Dual-class common stock structures with super voting shares;
- Staggered Boards;
- Blank check preferred stock;
- Supermajority shareholder approval of significant business transactions and amendments to certificate or articles of incorporation and bylaws; and
- Nonshareholder-approved shareholder rights plans.

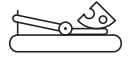
Dual-Class Common Stock Structure with Super-Voting Shares

Dual-class common stock structures are designed to create a new class of super-voting common stock that preserves control in the hands of pre-IPO shareholders – typically founders, executive officers and venture capital investors – for a significant period. Dual-class structures have become more common over the last ten years, particularly among technology companies. Ideally, the bulk of the super-voting shares will be held by founders and executives who are closely involved with the management of the company, allowing the company to focus on remaining innovative and creating value for the long-term, with less concern for short-term market pressures. However, the concentrated control is also a deterrent to hostile takeover attempts as it requires the potential acquirer to negotiate with the controlling group.

A dual-class common stock structure is created through a restructuring, usually prior to or concurrent with an IPO. The restructuring converts the common shares of pre-IPO shareholders into Class B shares with ten votes per share, and creates Class A shares with one vote per share that will be sold in the IPO and used for equity compensation, capital raising and acquisition purposes after the IPO.

- Class A and Class B shares are intended to be equal from an economic perspective with respect to dividends, stock splits and treatment in a change of control.
- Class B shares are not publicly traded and will automatically convert to Class A shares upon a post-IPO transfer or, in some instances, upon the occurrence of one or more trigger events, such as after a fixed period of years following the IPO or when the insiders at the time of the IPO hold below a certain percentage of the company's total outstanding shares.

Trap for the Unwary: Know Your Shareholders



Post-IPO, the interests of holders of Class B shares may diverge. If founders, the Board and executives begin to divest their Class B shares to achieve liquidity, control may shift to one or more pre-IPO investors who are not actively involved in the company's business and whose interests may not align with those of other shareholders. The Board should carefully analyze the pre-IPO shareholder base and the respective liquidity needs and interests of different groups of the company's shareholders before adopting a dual-class structure.

Staggered Boards

A staggered Board, which is discussed in Chapter 2, may impede some takeover attempts. Under Delaware law, shareholders may remove directors of a company with a staggered Board only for cause. If a company has three classes of directors, then, in the absence of cause, shareholders can replace no more than one-third of the directors in any one year.

Staggered Board terms prevent hostile acquirers from taking control of the company by replacing the entire Board at one time. This structure may deter certain types of takeover tactics, including proxy fights and tender offers for less than all of a company's shares. A staggered Board alone will not usually deter an any-and-all cash tender offer – an offer made to all the shareholders to buy all their shares at the same price – because most Board members will not oppose an offeror that has acquired a majority of the company's shares.

Supermajority Removal Provisions

If a company declines to implement a staggered Board, it may otherwise limit shareholders' ability to remove Board members. For example, the company may amend its certificate or

articles of incorporation to stipulate that a director may be removed only for cause and/or to increase the percentage vote of the shareholders required for removal of a director from a simple majority to 75% or 80%.



**Practical Tip:
Build Defenses Ahead of the IPO**

Because many of the most effective corporate structural defenses, such as a dual-class common stock structure or a staggered Board, require shareholder approval, the best time to institute these measures is prior to going public. Advantages of pre-IPO adoption include:

- A Board can thoughtfully implement the takeover measures well in advance of any immediate threat; and
- A company can avoid the problems and uncertainty that tend to arise when a public company seeks shareholder approval of measures that institutional shareholders and their advisors frequently oppose.

However, there are other factors that cause companies to hold off from pre-IPO adoption:

- IPO investors frequently frown on a protection laden IPO;
- The threat of takeover may seem remote in an optimistic IPO environment; and
- Control or venture capital shareholders may seek liquidity and welcome takeover interest.

After the IPO, some institutional investors and their advisors may believe that these defenses should be maintained only if the defenses have been approved by public shareholders. Such investors may mount a “withhold vote” campaign against one or more directors to pressure the Board to seek such approval.

Shareholder Rights (Poison Pill) Plans

A shareholder rights plan, or *poison pill*, can be a powerful takeover defense that encourages acquirers to negotiate with the Board so the Board can either seek to obtain the best value for shareholders in the event of an acquisition or choose to reject an inadequate offer in order to pursue the company's long-term strategic objectives. A rights plan operates by substantially diluting the stock ownership position of a would-be acquirer who buys shares in excess of a set threshold, thereby substantially increasing the cost of a potential takeover.

A standard shareholder rights plan results from a Board's declaration of a special dividend of one right per share of common stock. While differences among plans exist, most shareholder rights plans contain the following common principal features:

- If a bidder acquires a set percentage of the company's stock, usually ranging between 10% and 20% (the Board sets the trigger threshold), the rights allow common shareholders, except the bidder, to purchase shares of a new series of common or preferred stock of the company at a discount. This is called a *flip-in* provision.
- If, after a bidder acquires stock in excess of the trigger threshold, the company merges or sells more than 50% of its assets, the rights allow common shareholders to purchase shares of the acquiring company at a discount. This is called a *flip-over* provision.
- The Board can facilitate a friendly transaction by redeeming the rights at a nominal cost or by waiving the application of the plan to a favored bidder before that bidder crosses the trigger threshold.
- Once an acquiring company crosses the trigger threshold, the Board can exchange each right, except rights held by the bidder, for a specified percentage of the securities issuable on exercise of the rights. Exchange provisions require the reservation of fewer shares of common stock, do not require cash to exercise, and result in automatic and definite dilution.

A company can adopt a shareholder rights plan through Board action at any time if sufficient authorized, unissued preferred stock shares or common stock shares are available under the certificate or articles of incorporation for issuance pursuant to the rights plan. To implement a preferred stock shareholder rights plan, the certificate or articles of incorporation of the company must authorize blank check preferred stock.

Shareholder rights plans are proven and effective tools in defending against takeover attempts and inadequate acquisition offers. However, they are not designed to, and will not, deter all hostile takeover attempts. Specifically, a shareholder rights plan will not prevent a successful proxy contest for control of a company's Board, nor can it override the fiduciary obligations of the Board to consider a fairly priced, any-and-all cash tender offer for the company's shares. A shareholder rights plan will, however, encourage a potential acquirer to negotiate with the company's Board as an alternative to triggering the rights and thereby diluting the interest of the bidder in the target company.

The Delaware Court of Chancery has reaffirmed the validity of shareholder rights plans as a permissible defensive measure for a Delaware corporation faced with a takeover proposal its Board finds inadequate. In *Air Products & Chemicals, Inc. v. Airgas, Inc.*, the court confirmed that while a Board cannot "just say never" to a hostile tender offer, the Board can utilize a rights plan to reject a hostile offer and adhere to its existing strategic plan if the Board is acting in good faith with a reasonable factual basis for its decision.

Developments in Shareholder Rights Plan Implementation

Net Operating Loss Poison Pills

Net operating losses (NOLs) have become significant assets for many companies. If a company experiences an ownership change, Section 382 of the Internal Revenue Code generally limits the company's ability to use its pre-ownership change NOL carryovers to offset taxable income. Under Section 382, an ownership change occurs if one or more 5% shareholders of the

company increase their ownership by more than 50 percentage points in the aggregate over the lowest percentage of the company's stock owned by those shareholders at any time during the preceding three-year period. Public companies with significant NOLs have increasingly chosen to protect their NOL assets by adopting NOL shareholder rights plans. A NOL rights plan operates similarly to a traditional shareholder rights plan, but with lower triggering thresholds, typically 4.9% of the outstanding shares, versus 10% to 20% for a traditional shareholder rights plan.

In *Selectica, Inc. v. Versata Enterprises, Inc.*, Trilogy and its subsidiary, Versata, had offered to acquire some or all of Selectica's business, and were rejected. Trilogy began acquiring Selectica stock, and Selectica then lowered the trigger on its rights plan to 4.99%, allowing existing 5% or more shareholders to acquire up to an additional 0.5% without triggering the rights plan. Trilogy then bought more Selectica shares, exceeding the 4.99% trigger.

The Delaware Supreme Court held that the Selectica Board acted reasonably in determining that the NOL represented a significant business asset worth protecting, and found that the implementation of a NOL rights plan with a 4.99% trigger constituted an appropriate defensive response to the threats represented by Trilogy's actions.

Two-Tiered Poison Pill to Address Creeping or Negative Control by Activists

In *Third Point LLC v. Ruprecht*, the Delaware Court of Chancery found that the possibility of "creeping control" and "negative control" from activist investors posed objectively reasonable threats to justify the adoption by Sotheby's of a two-tiered shareholder rights plan that allowed passive institutional investors (those reporting ownership pursuant to Schedule 13G) to acquire up to a 20% interest in Sotheby's, while permitting all other shareholders to acquire only up to a 10% interest, without triggering the rights plan. In an era of increasing shareholder activism, the court recognized the legitimate concerns of Sotheby's

Board that hedge funds would form a group to acquire a control block of Sotheby's or that a single hedge fund would exercise disproportionate and negative control through a 20% ownership interest, without paying a control premium. Under the circumstances, the court concluded that the adoption of Sotheby's rights plan was a reasonable response to a cognizable threat.

State Antitakeover Statutes

Like virtually every other state, Delaware, the most common domicile of public companies, has adopted an antitakeover statute. State antitakeover statutes are generally based on a control share, business combination or fair price model.

- *Control share statutes* prohibit an acquirer from voting shares of a target company's stock after crossing specified ownership percentage thresholds. The acquirer may proceed if it obtains the approval of the target company's shareholders to cross each ownership threshold.
- *Business combination statutes* prohibit the target company from entering into specified significant business transactions – mergers, sales of assets and other change-of-control transactions – with an acquirer for a three- to five-year period after the acquirer crosses a specified ownership percentage threshold. Under this regime, an acquirer may proceed if it obtains the approval of the target company's Board prior to acquiring its ownership interest.
- *Fair price statutes* protect shareholders from the coercive effects of a two-tier tender offer by requiring approval of a second-stage merger by a supermajority shareholder vote. Alternatives to the shareholder vote include having a disinterested Board approve the transaction or ensuring that second-stage merger consideration equals the consideration paid in the first-stage tender offer, in terms of both amount and type of consideration.

Delaware Section 203: A Business Combination Statute

Section 203 of the Delaware General Corporation Law is a business combination statute. Section 203 limits any investor that acquires 15% or more of a company's voting stock (thereby becoming an *interested shareholder*) from engaging in certain business combinations with the issuer for a period of three years following the date on which the investor becomes an interested shareholder, unless:

- The company's Board has approved, before the acquirer becomes an interested shareholder, either the business combination or the transaction that resulted in the investor's becoming an interested shareholder;
- Upon consummation of the transaction that made the investor an interested shareholder, the interested shareholder owned at least 85% of the voting stock outstanding at the time the interested shareholder began the transaction that resulted in its becoming an interested shareholder (excluding shares owned by persons who are both directors and officers and shares held in employee stock plans that do not provide plan participants with the opportunity to tender shares on a confidential basis); or
- The business combination is approved by the Board and authorized by the affirmative vote of at least 66-2/3% of the outstanding voting stock not owned by the interested shareholder (at a meeting, and not by written consent).

Section 203 defines a *business combination* broadly to include:

- Any merger or sale, or other disposition of 10% or more of the assets of a company, with or to an interested shareholder;
- Transactions resulting in the issuance or transfer to the interested shareholder of any stock of the company or its subsidiaries;
- Certain transactions that would result in increasing the proportionate share of the stock of a company or its subsidiaries owned by the interested shareholder; and

- Receipt by the interested shareholder of the benefit (except proportionately as a shareholder) of any loans, advances, guarantees, pledges or other financial benefits.

A Delaware company may opt out of Section 203:

- If the company's original certificate of incorporation contains a provision expressly electing not to be governed by Section 203; or
- If the company's shareholders approve an amendment to its certificate of incorporation or bylaws expressly electing not to be governed by Section 203. This amendment must be approved by a majority of the outstanding shares entitled to vote, and it is not effective until 12 months after adoption. An opt-out amendment will not apply to any business combination with an investor that became an interested shareholder prior to the adoption of an opt-out amendment.



Practical Tip:
Waive the Statute? Yes – but Use Care

In a friendly acquisition, a buyer may request that a company's Board waive the application of any state antitakeover statutes that could prevent or delay the transaction, while leaving it in place with respect to other bidders. To satisfy their duty of care, directors should take the following actions before granting a waiver:

- Ask management and legal counsel to brief the Board on the application of the antitakeover statute; and
- Consider the waiver request together with any other protections that will be in place to protect the transaction, to be certain that, in the aggregate, the protections are reasonable.

Authorized Common and Blank Check Preferred Stock

A company should maintain sufficient amounts of common stock and blank check preferred stock to retain maximum business and governance flexibility, including in employing corporate structural defenses.

Common Stock

As a general matter, a public company should ensure that it always has an adequate number of authorized shares of common stock, taking into account both outstanding shares and the number of shares issuable upon conversion or exercise of outstanding or anticipated preferred stock, stock options and warrants. The company should maintain sufficient authorized, but unissued and unreserved, shares of common stock for:

- Current and future stock incentive plans;
- Potential stock splits and dividends;
- Strategic acquisitions; and
- Equity financings.

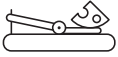
Blank Check Preferred Stock

The company's certificate or articles of incorporation may authorize *blank check* preferred stock – a specified number of shares of authorized but undesignated preferred stock. Authorizing blank check preferred stock gives the Board the authority, without having to seek prior shareholder approval, to designate one or more series of preferred stock out of the undesignated shares and to establish the rights, preferences and privileges of each series.

Taken together, blank check preferred stock and a reserve of authorized but unissued shares of common stock provide target companies the flexibility to:

- Sell shares to a friendly party;
- Use the shares as consideration for a defensive reorganization or acquisition;

- Grant a friendly party a lockup option to acquire the shares; or
- Implement a shareholder rights plan.



**Trap for the Unwary:
The NYSE or Nasdaq May Require Shareholder
Approval of 20% Stock Issuances**

Even if a company has authorized sufficient common stock or blank check preferred stock, NYSE or Nasdaq rules may require shareholder approval of certain large stock issuances. For example, Nasdaq requires shareholder approval of the issuance of common stock (or securities convertible into common stock) equal to 20% of the outstanding common stock or 20% of the voting power prior to the issuance for less than book or market value of the stock. (We discuss this and the NYSE's similar requirement in detail in Chapters 9 and 10.)

Limitations on Shareholders' Meetings and Voting Requirements

Limitations on shareholders' meetings and other shareholder action can slow the efforts of an acquirer to appeal directly to shareholders without negotiating with a target company's Board. For example, if shareholders can act only at annual meetings, an unfriendly third party would be unable to acquire control of the company by soliciting written consents to remove directors and elect a new Board.

Limitations on the Right to Call Special Shareholders' Meetings

A company may defend against coercive takeover attempts by appropriately limiting the power of shareholders to call special shareholders' meetings. Delaware law provides that only the Board and persons authorized in the company's certificate of incorporation or bylaws may call a special meeting of shareholders.

Thus, absent authorizing language in a company's certificate of incorporation or bylaws to the contrary, a Delaware company may entirely eliminate the right of shareholders to call a special shareholders' meeting. In other states, however, a certain percentage of shareholders may have a statutory right to call a special shareholders' meeting. A company incorporated outside Delaware may still increase the default percentage of shareholders required for shareholders' meetings and, in some cases, entirely eliminate this right. Limiting the right of shareholders to call special meetings can ensure additional time to negotiate by preventing a would-be acquirer from electing a class of directors or gaining control of the Board until the company's next annual shareholders' meeting.

Advance Notice Bylaw Provisions

Advance notice bylaw provisions provide that shareholders seeking to bring business before, or to nominate directors for election at, any shareholders' meeting must provide written notice of such action within a specified number of days (usually from 60 to 90 or 90 to 120) in advance of the meeting. Because only business contained in the meeting notice may be conducted at special shareholders' meetings, these bylaw provisions can delay the efforts of coercive acquirers and prevent surprises at shareholders' meetings.

Delaware courts have upheld advance notice bylaw provisions as appropriate mechanisms to give shareholders an opportunity to evaluate shareholder proposals and to give the Board adequate time to make informed recommendations. However, advance notice bylaw provisions may not unduly restrict shareholder rights and must be implemented fairly.



Practical Tip:
**It May Be Time to Revise Your Advance
Notice Bylaw Provisions**

In *JANA Master Fund, Ltd. v. CNET Networks, Inc.* and *Levitt Corp. v. Office Depot, Inc.*, decided by the Delaware Court of Chancery, and in *Hill International v. Opportunity Partners*, decided by the Delaware Supreme Court, the courts narrowly interpreted advance notice bylaw provisions in favor of shareholder activists. In *Hill International*, the court agreed with the activists' reading of the company's bylaws and found that the activists had complied with the advance notice provisions. Although these cases were decided by the Delaware courts, they may influence courts in other jurisdictions interpreting advance notice bylaw provisions.

These decisions highlight the need for public companies to carefully review and, if necessary, clarify and expand the advance notice provisions of their bylaws to eliminate ambiguities and establish procedures shareholders must follow and information they must supply. Among other things, you may wish to:

- Make clear that the advance notice process is separate from and in addition to the requirements under Rule 14a-8 under the 1934 Act (governing shareholder proposals submitted for inclusion in the company's proxy materials). (We discuss Rule 14a-8 shareholder proposals in Chapter 7.)
- Make clear that the process for director nominations is separate from the process for other business to be brought by shareholders.
- Set the advance notice deadline with reference to the date of the previous year's annual meeting, rather than the date proxy materials were released for the previous year's meeting.
- Establish a "no earlier than" date for shareholder proposed nominations and other business.
- Expand required disclosure of ownership information and shareholder interests.

Elimination of Shareholder Action by Written Consent

Under Delaware law, unless otherwise provided in a company's certificate of incorporation, any action required or permitted to be taken by shareholders may be taken by written consent, without a meeting or shareholder vote. A valid written consent sets forth the action to be taken and is signed by the holders of outstanding stock having the requisite number of votes necessary to authorize the action at a shareholders' meeting. The certificate of incorporation may prohibit shareholder action by written consent. Such a prohibition has the effect of confining shareholder consideration of proposed actions to shareholders' meetings. As a result, the holder or holders of a majority of the voting stock of a company may not take preemptive, unilateral action by written consent, and may act only within the framework of a shareholders' meeting.

Supermajority Vote on Merger or Sale of Assets

Delaware law requires shareholder approval for any merger or sale of substantially all the assets of a company. A Delaware company's certificate of incorporation or bylaws may include a supermajority provision requiring more than a simple majority (generally companies choose a percentage between 60% and 80%). A typical provision requires the affirmative vote of 66-2/3% of the voting shares for any merger or sale of substantially all the company's assets if, at the time of the vote, the company has a controlling shareholder (i.e., a shareholder holding a substantial block of stock, such as 10%). A supermajority provision often requires a potential acquirer to obtain a greater number of shares in order to complete the acquisition.

In deciding whether to adopt a supermajority requirement for a merger or sale of substantially all of a company's assets, it is important for a Board to consider the following:

- Too high a standard can allow minority holders to block favorable acquisitions and other transactions; and

- If a company is listed on an exchange, it may be subject to additional restrictions or listing requirements.

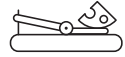
Supermajority Vote on Amendments to Certificate of Incorporation and Bylaws

The default rule under Delaware law provides that a simple majority of a company's voting securities must approve any amendments to a company's certificate of incorporation. A company's certificate of incorporation or bylaws, however, may include so-called *lock-in* provisions that require supermajority voting on specified amendments to a company's charter documents. Lock-in provisions force a hostile acquirer to control a greater number of shares in order to eliminate a company's corporate structural defense provisions by amending the certificate of incorporation or bylaws. However, supermajority voting requirements reduce a company's flexibility to make other desirable changes to its certificate of incorporation or bylaws. As a result, a company may choose to retain a majority approval requirement for amendments to most of the provisions of its certificate of incorporation and bylaws, and to establish a supermajority approval requirement only for amendments to those particular provisions that provide takeover protection, such as provisions dealing with:

- A classified Board;
- Removal of a director for cause;
- The right of shareholders to call special meetings; and
- Supermajority voting provisions for business combinations.

A company may also retain flexibility by providing that the supermajority approval is not required if the amendment is approved by a majority of directors serving before a controlling shareholder acquired its controlling stake in the company.

Trap for the Unwary: Marketing and Disclosure Impact



Every time a public company solicits shareholder approval of amendments to its certificate or articles of incorporation (e.g., to increase the authorized number of shares), it must describe its corporate structural defense provisions in a proxy statement for the shareholders' meeting. The existence of extremely formidable corporate structural defense measures may suggest to shareholders and prospective investors that the company adamantly opposes a change of control. Institutional investors may prefer the short-term returns engendered by hostile takeovers, and are likely to vote against many corporate structural defense provisions. For this reason, public companies should:

- Avoid adopting every possible measure of protection;
- Choose only those defenses best designed to maximize shareholder value; and
- Tailor protections to the company's situation and to its perceived vulnerability to takeover attempts.

Other Actions: Change-of-Control or Golden Parachute Agreements

Change-of-control, or *golden parachute*, agreements are not structural defenses to takeovers, but instead help to incentivize key employees to remain with the company and assist the Board in evaluating an unsolicited acquisition proposal at a time when they might otherwise be concerned about the impact of a takeover on their employment prospects. Nonetheless, ISS and other advisors are often critical of change-of-control agreements, especially if they are adopted in the heat of a takeover contest.

Change-of-control agreements can be stand-alone agreements or severance provisions included in employment agreements. They typically trigger a cash payment (or the automatic

vesting of stock options, restricted stock or other noncash benefits) on the occurrence of a change-of-control event, including a merger, sale of assets or stock, or a change of the constituency of the Board. *Single trigger* agreements result in a severance payment becoming due on the occurrence of a change of control alone. The more common *double trigger* agreements result in a severance payment only if the triggering event is coupled with a significant change in job status or compensation (e.g., termination of employment or decrease in salary or responsibilities).

Best Protections

Corporate structural defenses are not absolute deterrents to takeover attempts. Instead, they are designed to give directors and management time to consider the merits of an offer as well as leverage to negotiate that offer and counteract the coercive tactics that sometimes characterize takeover contests.

Some of the strongest protections against an unfriendly takeover are not special provisions in a company's charter documents, but are, in this order:

- A significant block of stock held by friendly shareholders;
- A high stock price and price/earnings ratio;
- Strong state antitakeover statutes (protections under Delaware law are among the best available); and
- A shareholder rights plan.

Even with these elements in place, in order to keep pace with changes in applicable law, as well as the increasingly refined approach of shareholder activists and institutional shareholders, a Board should also protect the company through its overall efforts to prepare for an unsolicited acquisition proposal. To that end, a Board should periodically (at least annually) review:

- Its fiduciary duties in responding to an unsolicited acquisition inquiry;

- The merger and acquisition environment, in general and in the company's industry;
- The company's existing corporate structural defenses, including its shareholder rights plan; and
- The company's strategic plan, projected financial performance and the composition of its shareholder base.

In advance of any unsolicited acquisition proposal, a Board should also:

- Identify a point person (often the CEO) to respond to takeover inquiries, with Board members instructed to refer inquiries to the point person;
- Identify a response team of key officers, in-house and outside legal counsel, a financial advisor and an investor relations firm; and
- Establish that the point person, and other executives and Board members, may not negotiate with a potential acquirer without seeking direction from the Board.

This advance preparation will put the Board in the strongest position to respond to an unsolicited acquisition proposal in a manner that will serve the best interests of the company's shareholders.

Chapter 12

Follow-On Offerings and Shelf Registrations

An issuer must register each offering of securities to the public on a 1933 Act registration statement unless an exemption from registration is available. Shelf registrations can ease the burden associated with the registration process by allowing one registration statement to register a variety of securities in advance of one or more transactions.

The SEC has adopted a variety of 1933 Act registration forms that require differing levels of disclosure depending on the type of transaction to be registered and the 1934 Act reporting history of the registrant. The most commonly used forms are:

- *Form S-1* – long form typically used for IPOs and sometimes for other primary and secondary sales of securities.
- *Form S-3* – short form typically used for follow-on offerings and public resales of a company's securities by selling shareholders, and available only if eligibility requirements are met.
- *Form S-4* – long form used to register the issuance of securities in a merger or acquisition transaction, to shareholders of the target company and for exchange offers.
- *Form S-8* – short form used to register the issuance of equity securities to employees, officers, directors and various types of consultants under employee compensation plans, including equity incentive plans.

We discuss each of these forms in more detail in this chapter.

Sales under a registration statement may be made only after the registration statement becomes effective. Generally, registration statements on Form S-3 filed by well-known seasoned issuers (WKSIs) and all registration statements on Form S-8 become automatically effective when they are filed. (We discuss WKSIs later in this chapter.)

In most other cases, the SEC has the opportunity to review and comment on a registration statement before effectiveness. In these cases, the SEC takes administrative action, upon a company's written request, to declare a registration statement effective, either when the company is informed that the SEC staff does not intend to review the filing or after the SEC staff is satisfied that the registration statement, as may be amended, adequately addresses the SEC staff's comments. The SEC will post a notice of effectiveness on the company's EDGAR filings index page that indicates the date and time the registration statement was declared effective.

Primary Offerings and Secondary Offerings – What Is the Difference?

Historically, most companies have first gained access to the public capital markets through the IPO process. More recently, however, some companies have also been going public through a direct listing on a securities exchange or through a merger transaction using a special type of acquisition vehicle called a *special purpose acquisition company* (the vehicle, a SPAC; the related merger transaction, a de-SPAC transaction). (See Chapter 1 for further discussion regarding SPACs.)

After a company goes public, it may continue to raise capital through additional public offerings of debt or equity securities. These additional public offerings are sometimes referred to as *follow-on offerings*, as they follow a company initially going public. Follow-on offerings of securities by the company itself, as well as IPOs, are referred to as *primary offerings* to distinguish them from registered offerings of securities on behalf of selling shareholders, which are referred to as *secondary offerings*.

In a secondary offering, selling shareholders, not the company, receive the proceeds from the offering. These offerings provide liquidity to the selling shareholders. For example, shareholders may hold restricted shares purchased from the company in a private financing transaction that cannot be easily or quickly resold except through a registered public offering. In connection with a private financing transaction, a company may agree to register securities for resale and enter into a registration rights agreement for the benefit of the security holders. Another example of a secondary offering is when a company and a shareholder holding a large number of shares choose an underwritten public secondary offering as an orderly and efficient means of liquidating all or part of the shareholder's position.

On occasion, registered offerings involve both primary and secondary offerings.

Shelf Registrations

A shelf registration allows a company to register the offer and sale of securities on a delayed basis (for future use) or on a continuous basis. Often public companies register securities for offer and sale to the public at undetermined future dates to be able to take advantage of favorable market conditions when they occur, although a portion of the securities registered may be offered immediately after effectiveness of the registration statement. Public companies may also use shelf registrations to permit security holders to sell otherwise restricted securities (e.g., securities issued in a private placement) or control securities (i.e., securities held by affiliates) in the public market over a period of time.

Common Types of Shelf Registrations

Three common types of shelf registrations are the universal shelf, the resale shelf and the acquisition shelf.

Universal Shelf. A universal shelf is a registration statement on Form S-3 that typically registers a variety of equity and debt securities that a company may wish to sell in the future. Form S-1 is not available for this kind of registration. A universal shelf

registration statement will typically include some combination of common stock, preferred stock, convertible and nonconvertible debt securities, and warrants to purchase stock (or other securities). In this type of registration statement, a company specifies the aggregate dollar amount of all the securities it intends to offer, rather than specifying the dollar amount of each type of debt security or the number of each type of equity security it is registering. (As we discuss later in this chapter, a WKSI may register securities by specific types or classes on Form S-3 without indicating any dollar amount or number of securities.) The primary advantage of a universal shelf registration statement is that, once effective, a company may offer and sell registered securities (often referred to as a “takedown off the shelf”) without the delay that might result from a review by the SEC staff.

A universal shelf registration statement includes a base prospectus, which often consists of only a section listing the 1934 Act reports and other relevant SEC filings incorporated by reference, a brief overview of the company, an outline of the plan of distribution, a short description of the intended use of the proceeds from a sale of the securities, and, generally, a high-level description of each type of security that is being registered. The 1934 Act reports and other relevant SEC filings incorporated by reference usually satisfy many of the disclosure requirements that apply to this registration statement (including requirements relating to a description of the company’s business, relevant financial statements and MD&A, management, legal proceedings and other matters). A universal shelf registration on Form S-3 also allows a company to forward incorporate future 1934 Act filings to facilitate automatic updating of information required to be included in the base prospectus. In addition to the base prospectus, the registration statement includes other information such as estimated offering expenses (although not required in automatic shelf registrations for WKSI) and required exhibits (many of which can be incorporated by reference from other filings with the SEC).

The base prospectus does not contain pricing information or other details regarding any particular transaction. This additional information is included in a prospectus supplement, which is filed with the SEC when there is an offering of securities, and delivered with the base prospectus to investors. For instance, a prospectus supplement filed in connection with a takedown of debt securities will disclose the aggregate principal amount offered, the public offering price, any discounts and commissions, a detailed description of the terms of the debt securities (including the rate at which interest will accrue, interest payment dates and the maturity date), and more detailed descriptions of the intended use of proceeds and the plan of distribution. The prospectus supplement often includes a description of the risk factors and tax consequences related to the specific offering.

In many cases, underwriters will use a preliminary prospectus supplement (together with the base prospectus) that does not include pricing information, but does include more specificity about a particular transaction for marketing an offering to potential investors. Once an offering is priced, a type of *free writing prospectus* – typically a one-page pricing term sheet – is usually prepared and filed with the SEC. The underwriters then use this pricing term sheet to confirm sales. The pricing term sheet typically provides only the pricing information previously omitted from the preliminary prospectus supplement, including the public offering price of the securities, underwriting discounts and commissions, and, in the case of debt or preferred securities, items such as interest or dividend rates and, if relevant, conversion prices, redemption prices and the like. An issuer then prepares and files with the SEC a final prospectus supplement (together with the base prospectus) that includes the pricing information from the pricing term sheet and any other final changes to the prospectus supplement.

Resale Shelf. Companies typically use a resale shelf registration statement on Form S-3 to register the resale to the public, from time to time, of securities held by an affiliate of the issuer or securities that were issued in a private placement. The prospectus included in a resale shelf registration statement on

Form S-3 tends to be very short (particularly when the securities registered are shares of common stock). It usually includes a section listing the company's 1934 Act reports and other relevant SEC filings incorporated by reference, a section on risk factors, a list of the selling shareholders (including the name, address and number of securities each holder plans to sell) and descriptions of their related transactions with the company, and a section describing the manner in which the securities are expected to be distributed. Typically, the plan of distribution is drafted to provide significant flexibility relating to the types of transactions in which the registered securities may be sold. Many of the details relating to selling shareholders (including their identities and the number or amount of securities they may sell) may be omitted from an automatically effective resale shelf registration statement filed by a WKSI and, under certain circumstances, from a standard resale shelf filed by a non-WKSI issuer. The initially omitted details are later added to the registration statement by means of a prospectus supplement, post-effective amendment or 1934 Act report, depending on the circumstances.

If a company is not eligible to use Form S-3, the company could file a resale shelf registration statement on Form S-1. Keeping a resale shelf registration statement on Form S-1 updated is, however, much more time-consuming and expensive than with Form S-3. Unlike with Form S-3, Form S-1 does not allow forward incorporation by reference to a company's 1934 Act reports. As a result, a company would have to continually update a resale registration statement on Form S-1 by filing prospectus supplements and post-effective amendments to reflect material developments and updated financial information.

**Practical Tip:
Your Company Must Pay Special Attention to Its
Disclosure Obligations When It Has a Resale Shelf
Registration Statement on File**



An effective resale shelf registration statement typically permits selling shareholders to sell securities from time to time at their discretion. When selling shareholders have the ability to sell at any time, your company has to be particularly attuned to whether the registration statement (including the prospectus contained therein) remains up-to-date. Sales made at a time when the registration statement omits material information or includes materially inaccurate or misleading information could expose your company (and your officers and directors) to liability to purchasers of the securities under Rule 10b-5 under the 1934 Act. Accordingly, during the period in which the resale shelf registration statement is effective, ensure that an appropriate person at the company is tasked with continually monitoring and, if necessary, updating the information included or incorporated in the prospectus to keep it accurate and complete. Because a prospectus related to a shelf registration on Form S-3 is automatically updated through incorporation by reference of subsequently filed 1934 Act reports, it will typically be kept up-to-date through the filing of those reports. However, officers should maintain a heightened awareness of any non-public developments and, where material, disclose the developments on a Form 8-K.

Agreements to file resale shelf registration statements can form an important part of a venture or private equity fund's exit strategy. When a fund invests in a privately held company, the company often agrees at the time of the investment to file for the fund one or more shelf registration statements after the company has completed its IPO. This arrangement provides a way for the fund to eventually obtain liquidity for its investment.

Sometimes companies also use resale shelf registrations after issuing securities in an acquisition transaction. For instance,

when acquiring a privately held company, a public company may issue its shares to the shareholders of the target company in an unregistered transaction pursuant to an exemption from registration such as Rule 506 or Section 4(a)(2). Often, the shareholders of the target company will require the acquirer to register the shares received in the acquisition by filing a resale shelf registration statement on Form S-3 soon after the closing of the acquisition. This allows the shareholders to start selling the shares they received in the transaction sooner than they otherwise would under Rule 144 under the 1933 Act (which we discuss in Chapter 6) and, in the case of target company shareholders who become affiliates of the acquiring company, in amounts exceeding the volume limits under that rule.

Companies may also file resale shelf registration statements in connection with PIPE (private investment in public equity) transactions. In a PIPE transaction, a public company typically agrees to sell shares of its common stock or convertible preferred stock (and sometimes warrants) to institutional and other accredited investors in a private placement, usually at a discount to the market price, with an agreement to file a resale shelf registration statement on Form S-1 or S-3 shortly after closing. The benefit to the company of a PIPE transaction is that the company is able to obtain the proceeds from the sale much faster than if it were to instead launch a registered public offering, which would be subject to the SEC review and comment process.

Companies typically agree to keep their resale shelf registration statements *effective* (meaning that the prospectus will be kept up-to-date and shareholders will be allowed to sell under the registration statement) for a prescribed period of time, usually until the time at which shares become freely transferable under Rule 144. This allows holders of restricted securities to have some control over the timing of their resales. To deregister, a company would file an amendment to the resale registration statement deregistering any remaining unsold securities, which terminates the effectiveness of that registration statement.

Acquisition Shelf. An acquisition shelf provides for the issuance of equity securities as consideration in future acquisitions.

An acquisition shelf registration statement is usually filed on Form S-4 and cannot be filed on Form S-3. (We discuss acquisition shelf registration statements in greater detail later in this chapter.)

Registration Statements on Form S-1

A company usually uses Form S-1 just once – for its IPO. Companies that are not eligible to use Form S-3, as described below, also use Form S-1 to register follow-on or secondary offerings. For example, a company that conducts an offering less than a year after its IPO will use Form S-1 due to its limited 1934 Act reporting history.

Form S-1 is the most comprehensive of the registration statements. The Form S-1 prospectus requires complete information regarding the company and the transaction. If the company has filed all required 1934 Act reports and has filed at least one annual report on Form 10-K, it may be eligible to incorporate the previously filed 1934 Act reports by reference. Form S-1 does not, however, permit forward-looking incorporation by reference to 1934 Act reports filed after the effective date of the registration statement.

Registration Statements on Form S-3

Form S-3 is more cost-effective and efficient than Form S-1 for registering follow-on and secondary offerings, particularly for shelf offerings. Form S-3 allows a company to satisfy many disclosure requirements through incorporation by reference into the registration statement of some of the company's previously filed 1934 Act reports, and to update that disclosure in the future through forward incorporation of subsequently filed 1934 Act reports. This "evergreen" feature means that a company generally will not need to file any post-effective amendments to the registration statement to update company-related disclosure. Post-effective amendments for public companies other than WKSIs are potentially subject to SEC review – a time-consuming and potentially expensive proposition.

Companies often use Form S-3 registration statements for shelf registrations, as we described in more detail earlier in this chapter. A key advantage of a shelf registration is that once the Form S-3 registration statement becomes effective, a takedown from the shelf typically does not require SEC approval. This expedites issuance of securities and reduces overall costs. A company can use its shelf registration statement on Form S-3 for most types of offerings for three years. After the three years, a company can roll over any SEC fees related to unsold securities to a new shelf registration statement.

Eligibility Restrictions on Use of Form S-3

To be eligible to use the very convenient Form S-3 registration statement, companies must meet both registrant and transaction eligibility requirements.

Registrant Requirements. To qualify for use of Form S-3, a company must have been required to file 1934 Act reports for at least 12 calendar months since the effectiveness of its first registration statement under the 1933 Act (e.g., Form S-1) or 1934 Act (e.g., Form 10). For a company that went public through a merger with a SPAC, the SEC staff generally interprets this period to commence when the de-SPAC transaction occurred, meaning that the company resulting from a merger with a SPAC cannot rely on the SPAC's pre-combination reporting history for Form S-3 eligibility purposes. Additionally, the company must have timely filed all required 1934 Act reports and information during the previous 12 months and any portion of the month in which the Form S-3 is actually filed. Finally, since the end of the fiscal year covered by its most recent annual report on Form 10-K, the company must not have failed to pay any dividend or sinking fund installment on preferred stock or experienced any default on debt or a long-term lease that is material to the company's financial position.

Transaction Requirements. Companies that meet the registrant requirements may use Form S-3 only to register offerings that fall within one or more of Form S-3's permitted transaction categories.

Offerings by Issuers with a Minimum Public Float. A qualified registrant that has a public float of at least \$75 million may use Form S-3 to register any primary or secondary offering of debt or equity securities for cash. The term *public float* refers to the aggregate market value of the voting and nonvoting common equity held by nonaffiliates of the registrant. It is determined by reference to the closing price (or average of the bid and asked price) of the registrant's common equity on its principal trading market as of any date selected by the registrant within the 60-day period preceding the filing of the Form S-3. This permitted transaction category is significant because it allows a registrant to conduct a primary offering of common stock without limitation on the amount offered.

Transactions That Do Not Require a Minimum Public Float. A qualified registrant that does not have a public float of at least \$75 million may nonetheless use Form S-3 to register certain qualified transactions, including the following:

- Secondary offerings, provided the class of securities to be offered is listed on a national securities exchange (such as the NYSE or Nasdaq);
- Primary offerings of nonconvertible securities, other than common equity, if the company is a wholly owned subsidiary of a WKSJ or if the company as of a date within 60 days prior to filing the registration statement has:
 - Issued at least \$1 billion in aggregate principal amount of nonconvertible securities (other than common equity) in registered primary offerings for cash in the past three years; or
 - Outstanding at least \$750 million in aggregate principal amount of nonconvertible securities (other than common equity) that were issued in registered primary offerings for cash;
- Securities to be offered upon the exercise of outstanding rights under a dividend or interest reinvestment plan or upon the conversion or exercise of outstanding convertible securities, including options and warrants; and

- Primary offerings of securities for cash by a company (other than a shell company) listed on a national securities exchange, so long as the aggregate value of securities sold by the registrant during any 12-month period (including the potential offering) does not exceed one-third of the company's public float.

See below for more information about these offerings.

Unique Flexibility for WKSIs

The 1933 Act provides companies with varying degrees of flexibility in conducting securities offerings. This flexibility depends on membership in one of four issuer categories based on a company's reporting history under the 1934 Act and its equity market capitalization or fixed income issuance history. One of these four issuer categories is the WKSI category. Companies meeting the WKSI criteria can access the markets more quickly and with less expense than companies that do not qualify as WKSIs.

To qualify as a WKSI, a company (including an emerging growth company) generally must:

- Meet the registrant eligibility requirements of Form S-3, including having timely filed all required 1934 Act reports and information during the previous 12 months;
- Within 60 days of the WKSI determination date, either have at least \$700 million of public float outstanding or have issued in aggregate \$1 billion of nonconvertible securities, other than common equity, in registered primary offerings for cash, during the previous three years;
- Not be an ineligible issuer – generally, companies that are not current in filing 1934 Act reports, blank check companies, shell companies (including SPACs), penny stock issuers, some limited partnerships, and companies that have filed for bankruptcy, have been the subject of

refusal or stop orders, or have violated the antifraud provisions of the federal securities laws during the previous three years; and

- Not be a registered investment company or an asset-backed issuer.

WKSI's have additional flexibility in using shelf registration statements. WKSI's may file shelf registration statements on Form S-3 that are automatically effective upon filing. These shelf registration statements are not subject to review and comment by the SEC prior to their use. This means that an offering under one of these registration statements can begin immediately after it (along with an appropriate prospectus supplement) is filed with the SEC. In contrast to other Form S-3 filers, a WKSI does not have to include any of the following information in a shelf registration statement on Form S-3:

- Amount of securities to be offered;
- Allocation of the registered securities between primary and secondary securities;
- Description of the securities (other than the name or class of securities); or
- Outline of the plan of distribution.

A WKSI can essentially make unlimited sales off its shelf registration statement and provide the required information omitted from the prospectus filed on Form S-3 in a prospectus supplement used at the time of the offering. If the WKSI chooses, it can file the required disclosure at the time of the offering in a 1934 Act report, such as a current report on Form 8-K, which would be automatically incorporated by reference into the registration statement. A WKSI can also pay SEC registration fees on a "pay-as-you-go" basis, rather than at the time of initial filing.

A WKSI's ability to use Form S-3 as an automatically effective shelf registration statement depends on how the company qualifies as a WKSI:

- *\$700 Million Public Float.* A company that qualifies as a WKSI based on public float (\$700 million or more) is

eligible to conduct an offering for any kind of security on an automatically effective shelf registration statement using Form S-3.

- *\$1 Billion of Nonconvertible Securities.* A company that qualifies as a WKSI based on the aggregate value of issuances of its nonconvertible securities (other than common equity) in registered offerings for cash during the three previous years (\$1 billion or more) may use Form S-3 as an automatically effective shelf registration statement only to register nonconvertible securities (other than common equity). If, however, the value of the company's common equity held by nonaffiliates is at least \$75 million, it may also register any other securities using Form S-3 as an automatically effective shelf registration statement.

A company's status as a WKSI is generally determined at the time of the initial filing of the registration statement and at the time of the filing of any amendment to the registration statement, as well as annually at the time of its Form 10-K filing. Consequently, it is possible for a company that qualified as a WKSI at the time of its initial filing of an automatic registration statement to lose its WKSI status before the end of the customary three-year period for the automatic shelf registration statement (if, for example, the company did not meet the public float requirement at any time within the 60-day period of a later-filed Form 10-K). In that event, the company may still, however, be able to use the shelf registration statement after it no longer qualifies as a WKSI, if it can take specific steps outlined by the SEC regarding those registration situations.

Use of Form S-3 by Small Public Companies

Many public companies that do not meet the \$75 million public float test may offer and sell a limited amount of securities pursuant to Form S-3 in primary offerings for cash. Specifically, the amount of securities offered during any 12-month period using Form S-3 may not exceed one-third of the company's public float. To determine whether an offering is permissible under

this limitation, the amount of the proposed offering together with the amount of securities sold within the last 12 months in other offerings registered on Form S-3 pursuant to the one-third public float rule must not exceed one-third of the company's public float as of a date within 60 days of the intended sale. A small public company discloses in each Form S-3 prospectus an updated calculation of its public float and the amount of securities offered, including those in the intended sale, in the 12-month period ending on the date of the prospectus.

Only small public companies that have a class of common equity securities listed on a national securities exchange (such as NYSE or Nasdaq) may take advantage of these relaxed Form S-3 eligibility requirements. Small companies whose equity securities are traded only over the counter (e.g., on various OTC markets) are not eligible. Any company that is a shell company at the time of the offering, or that was a shell company at any time in the previous 12 months, is not eligible to benefit from these relaxed Form S-3 eligibility requirements. The term *shell company* means a company, other than an asset-backed issuer, that has no or nominal operations and any one of the following applies:

- The company has no or nominal assets;
- The company's assets consist solely of cash and cash equivalents; or
- The company's assets consist of any amount of cash and cash equivalents and nominal other assets.

Form S-4: The M&A Registration Statement

Companies can use Form S-4 to register securities to be issued in merger and acquisition transactions that involve an offer and sale of securities to the shareholders of the target company. Generally, an offer and sale of securities is deemed to be involved when the target company's shareholders are asked to vote on, or consent to, a plan or agreement for a reclassification, merger, consolidation or transfer of assets. The context in which this most frequently arises is when a public company acquires another company by way of merger or consolidation and will

issue its own stock as consideration to be paid to shareholders of the target company. Companies can also register securities on Form S-4 that they plan to issue in exchange for their outstanding securities or outstanding securities of another entity.

Form S-4 is unique in that it is a single document that satisfies both the 1933 Act registration requirements and, where shareholders of either the registrant or the target company are required to vote on the transaction, the 1934 Act proxy solicitation and information requirements. The core disclosure document in a Form S-4 serves as the proxy or information statement of the target company for purposes of soliciting shareholder approval of the transaction. It also serves as the prospectus of the acquiring company for purposes of offering its securities in connection with the transaction. Once the acquiring company's Form S-4 is declared effective by the SEC, the target company can file the same document as its proxy materials in definitive form as a Schedule 14A.

Unless a company uses Form S-4 as an acquisition shelf (which we discuss later in this chapter), this registration statement requires extensive disclosure of the terms of the transaction, including discussion of the background and reasons for the transaction and any fairness opinions provided by financial advisors, as well as a comparison of the rights of shareholders of the two companies.



Practical Tip:
“Dear Diary . . .”

The “Background of Merger” section is the heart of the disclosure of any merger proposal a company submits to its shareholders. During your negotiations, designate a team member to keep a brief but accurate timeline of critical dates of meetings, due diligence requests, draft documents, telephone calls and other interactions between the target company and the potential acquirer or acquirers. This timeline usually provides the outline for the “Background of Merger” section.

Information about the company filing the Form S-4 and information about any target company may be incorporated by reference in certain cases, depending on whether (and on what basis) the companies are eligible to use Form S-3. A Form S-4 that incorporates information by reference must be sent to shareholders at least 20 business days prior to the date of the shareholders' meeting or, if no shareholder vote is required, at least 20 business days prior to the date of the closing.

Shareholders of the target company who receive securities in a transaction registered on a Form S-4 can generally resell their securities immediately after the closing of the transaction. Usually, affiliates of the target company in a business combination transaction will not have resale limitations on their shares under the 1933 Act's business combination rules. However, significant target company shareholders who become affiliates of the acquiring company will have to sell their acquiring company securities under Rule 144. (We discuss Rule 144 in Chapter 6.) Additionally, if the acquiring company is a SPAC, the business combination rules may impose certain limits on resales by affiliates of the target company.

Acquisition Shelf

One motivation for a rapidly expanding private business to become a public company is to be able to use its stock as currency for private acquisitions. The Form S-4 acquisition shelf registration statement is a flexible and potentially speedy corporate finance vehicle designed for a series of stock-for-stock acquisitions of privately held target companies by a public company expected to take place over the ensuing few years.

The two methods to place freely transferable shares into the hands of a private target company's shareholders are:

- A stand-alone registration on Form S-4 for a business combination transaction (as described in more detail above); and
- An acquisition shelf on Form S-4, which registers shares for issuance in connection with future business acquisitions.

(A third alternative can sometimes achieve essentially the same goal in a business acquisition or combination setting. A company may potentially issue the shares pursuant to a private placement exemption, such as Rule 506, and then file a resale shelf registration on Form S-3 that allows target company shareholders to resell shares without having to comply with Rule 144.)

To use an acquisition shelf registration statement, a company should fit the following profile:

- It is eligible to incorporate by reference 1934 Act reports into the Form S-4;
- It is considering the acquisition of one or more private companies (including subsidiaries or assets of a public company) in the next two years; and
- It is likely to use stock as a significant portion of acquisition consideration.

The acquisition shelf registration statement will not describe a particular transaction, but will be available for any of a broad range of private company acquisitions. These acquisitions may be effected by merger, consolidation, acquisition of assets or stock-for-stock exchange. The number of shares that may be registered on an acquisition shelf may not exceed the amount that the company reasonably expects to use for acquisition transactions in the two years following the filing of the registration statement.

If an acquisition is material to the acquiring company, the Form S-4 will need to be updated after the acquisition before the acquiring company can use the Form S-4 for a subsequent acquisition. This may require the filing of a post-effective amendment (including potentially extensive financial statement information), although companies that are eligible to use Form S-3 should be able to rely on incorporation by reference of 1934 Act reports into the acquisition shelf (including a Form 8-K disclosing a material acquisition) for this purpose.

Registration Statements on Form S-8

Form S-8 is available for 1934 Act reporting companies to register securities offered to employees, directors and certain consultants under an employee benefit plan, such as an equity incentive plan. The requirements for the use of Form S-8 are much simpler than for other registration forms. Additionally, a registration statement on Form S-8 is not reviewed by the SEC before it becomes effective – it is effective immediately upon filing. Like Form S-3, Form S-8 allows a company to incorporate by reference all current and future 1934 Act reports filed by the company. In the IPO context, the company's prospectus included in its Form S-1 is typically incorporated by reference into the Form S-8. An IPO company usually will file a Form S-8 immediately after the effectiveness of its registration statement on Form S-1.

Practical Tip:
File Your Form S-8 Immediately After Going Public!



The securities laws for granting equity awards to your employees change after your IPO. Private companies typically grant stock options or other compensation-related equity to employees pursuant to the exemption from registration under Rule 701 under the 1933 Act, while public companies register the shares to be issued under an equity incentive plan with the SEC on a Form S-8. Stock acquired by an employee under Rule 701 (e.g., by exercise of a stock option) may generally be sold 90 days after your IPO.

However, if your company registers outstanding pre-IPO awards (such as options) on a Form S-8 immediately after the IPO, employees can resell shares acquired under those awards without the 90-day waiting period. To take advantage of that benefit, file your Form S-8 immediately after your IPO, registering both outstanding pre-IPO awards and the shares available for future grant under your company's plan. Shares that an employee acquires or purchases under Rule 701 before the Form S-8 is filed cannot be registered on a Form S-8.

Unlike Form S-3, however, Form S-8 does not require the company to file a prospectus with the SEC, but merely to provide employees with a prospectus containing specified information, including a description of the material terms and tax consequences of the equity incentive plan.

Registrant Requirements

To be eligible to use Form S-8, a company must:

- Be subject to the 1934 Act reporting requirements immediately prior to filing the Form S-8;
- Have filed all 1934 Act reports required to be filed during the preceding 12-month period (or for such shorter period that the company has been subject to 1934 Act reporting requirements);
- Not be a shell company and not have been a shell company for at least 60 days before filing the Form S-8; and
- If the company was at any earlier time a shell company, have filed current Form 10 information with the SEC reflecting that the company is no longer a shell company, at least 60 days before filing the Form S-8. A business combination-related shell company may, however, use Form S-8 as soon as it ceases to be a shell company and files its current Form 10 information with the SEC.

Transaction Requirements

A company that meets Form S-8's requirements can use Form S-8 to register securities offered to employees under any written option, purchase, savings, bonus, appreciation, profit-sharing, thrift, incentive, pension or similar employee benefit plan, or a written compensation contract. (We discuss the special meaning of the term *employee* for purposes of Form S-8 later in this chapter.)



**Practical Tip:
Beware of Restricted Stock**

A company may register shares underlying stock options at any time before the options are exercised, either before or after the options are granted. However, for restricted stock (i.e., stock subject to forfeiture restrictions that lapse over time), the Form S-8 must be effective before the company grants and issues the restricted stock.

Definition of Employee

In general, Form S-8 is available only to register securities offered to employees. The term *employee* for Form S-8 purposes includes any employee, director, general partner or officer of the company. Former employees (as well as any executors authorized by law to administer the estates or assets of former employees) are also employees, but only for the following purposes:

- Exercising stock options and subsequent sales of securities to the extent permitted by the relevant plan; and
- Acquiring securities pursuant to intraplan transfers among plan funds to the extent permitted by the relevant plan.

Employees also include consultants and advisors who are natural persons and who provide bona fide services to the company. Their services cannot, however, be in connection with an offer or sale of securities in a capital-raising transaction or for promoting or maintaining a market for the company's securities.

Transferable Options

Form S-8 registration permits the exercise of employee stock options by any family member who has acquired the options from an employee through a gift or a domestic relations order. Form S-8 is not available for the exercise of stock options that have been transferred for value.

Filings Relating to Employee Benefit Plan Amendments

From time to time, a company may choose to amend an employee benefit plan for which it has filed a registration statement on Form S-8. Some points to consider when amending a plan covered by an effective Form S-8 include the following:

- If a plan amendment increases the number of shares available for issuance under the plan, the company may register the additional shares using an abbreviated Form S-8 filing. (This would be a new registration statement, not a post-effective amendment to the Form S-8 originally registering the plan.) The abbreviated Form S-8's exhibits would include a new legal opinion and accountant's consent.
- If a plan amendment decreases the number of shares available for issuance under the plan, the company should file a post-effective amendment deregistering that number of shares. The company would not need to file a new legal opinion or accountant's consent for this filing.
- If a plan amendment changes the terms of the plan without changing the number of shares available for issuance under the plan, a post-effective amendment would generally not be necessary. Instead, the Form S-8 would self-update by incorporating by reference a 1934 Act report (e.g., a Form 8-K or 10-Q) that describes the amendment or files the amendment as an exhibit.



Breaking News: The SEC Looks to Simplify Form S-8 Requirements

The SEC proposed amendments in November 2020 to simplify Form S-8 requirements, including in connection with plan amendments and extending consultant eligibility for equity awards under a Form S-8. As of the time this Handbook went to press, the SEC had not approved adoption of these rules.

Chapter 13

Securities and Corporate Governance Litigation

A public company and its management face litigation risks as a result of issuing public securities. Securities holders may bring claims under the federal securities laws for alleged disclosure violations. Shareholders may bring corporate governance claims, such as derivative claims for breaches of fiduciary duty by management or the Board of Directors. The SEC or the company's securities exchange may conduct investigations and bring enforcement proceedings against the company or management for disclosure violations. Criminal prosecutors may investigate and prosecute criminal violations of the securities laws.

Although these risks are real, there are ways to mitigate them and provide increased protection to directors and officers. This chapter summarizes some of the most common litigation risks facing public companies and their officers and directors, and provides practical tips for managing these risks.

Liability Under the 1934 Act – Section 10(b) and Rule 10b-5

The most common cases brought by public company securities holders are private securities actions under the 1934 Act, a federal law governing the securities markets. Section 10(b) of the 1934 Act and the related SEC Rule 10b-5 make it unlawful for a company or a person, in connection with the purchase or sale of a security, to:

- Make any untrue statement of a material fact; or

- Omit to state a material fact necessary to make a statement made, in light of the circumstances under which it was made, not misleading.

In practical terms, a company or a person violates Rule 10b-5 by making an intentional or reckless misrepresentation or omission of fact that influences the price of a public company's stock. Rule 10b-5 applies to virtually any type of statement by a public company, officer or director, including statements in periodic reports, press releases and analyst calls. Purchasers or sellers of publicly traded stock can sue even if they did not see, hear or rely on the alleged misstatement in deciding to trade in a company's stock. These purchasers and sellers rely on the *fraud-on-the-market* presumption, which allows them to allege that they relied on the integrity of the market price for the stock to reflect all publicly available material information. Rule 10b-5 imposes liability even when the defendant was not a party to a securities transaction, such as when an investor buys stock via a transaction on a stock exchange.

A company, its officers and directors, and any other person who makes a false or misleading statement may be directly liable for damages under Rule 10b-5. Any individual who disseminates material misstatements with the intent to defraud may also be held liable under Section 10(b) and Rule 10b-5. Those who control the company may be liable as well – even if they did not personally make any false or misleading statements.

Although liability under Rule 10b-5 is broad, there are some important limitations. A company or person is not liable for mere negligence. Instead, Rule 10b-5 imposes liability only on a defendant who acts with *scienter*, which means with knowledge of or reckless disregard for the falsity of a statement or the materiality of an omission. In addition, a defendant is liable only for economic losses actually caused by the alleged misrepresentation or omission. In light of these limitations, defendants often assert a multipronged defense to claims under Rule 10b-5, arguing the following:

- The statement was not false or misleading, or the omission was not material;

- The defendants did not know or recklessly disregard the fact that the statement was false or misleading; and
- The alleged misrepresentations or omissions did not cause the economic losses allegedly suffered by the plaintiffs.

**Practical Tip:
If You Speak, Speak the Whole Truth!**



Rule 10b-5 does not impose an affirmative duty to disclose all material information about your company's business. But when you do speak, you must do so truthfully and completely. For example, while your company may have no obligation to disclose the development of a new product, if you choose to announce the new development, your statements must be accurate and complete.

Liability Under the 1933 Act – Sections 11 and 12(a)(2)

In some circumstances, public company shareholders may also bring claims under a second federal law, the 1933 Act, which governs securities offerings. Claims under the 1933 Act are limited to false or misleading statements made in connection with a registered offering of securities. Claims under the 1933 Act, however, can pose even greater risks than claims under Rule 10b-5 because plaintiffs asserting 1933 Act claims need to allege little in the way of actual misconduct in order to defeat a motion to dismiss those claims and proceed to take discovery. The risk of legal claims under the 1933 Act provides a powerful incentive to issuers and their agents to ensure the accuracy of registration statements and prospectuses.

Two sections of the 1933 Act, Sections 11 and 12(a)(2), impose liability for misstatements in registration statements and prospectuses. Those sections often overlap, but they are not identical. They have different elements and provide for recovery of different types of damages.

Section 11 – Liability for Misrepresentations in a Registration Statement

Section 11 of the 1933 Act permits shareholders to recover damages for misstatements or omissions of material fact in a registration statement – including the prospectus. With limited exceptions, Section 11 does not require a plaintiff to prove that he or she relied on the alleged misstatement, nor that the defendant acted with scienter (the requirement of knowledge or reckless disregard that a statement was false or misleading for claims under the 1934 Act). To state a claim under Section 11, a plaintiff generally must allege only the following:

- The registration statement or prospectus misrepresented or omitted a material fact at the time it became effective;
- The plaintiff bought securities traceable to that registration statement; and
- The plaintiff suffered damages (typically a loss due to a decline in the price of a security).

A shareholder may bring a Section 11 claim against, among others:

- The company issuing the securities;
- Any director of the company at the time of the offering;
or
- Any person who signed the registration statement.

Other potential Section 11 targets include any person who controls these primary defendants, as well as underwriters and accountants.

Directors and officers of the company (but not the company itself) and some other defendants may assert an affirmative defense of reasonable care. In addition, all defendants may have available the following affirmative defenses:

- The plaintiff knew the truth when he or she purchased the securities; and

- The misstatement or omission, if it occurred, did not cause the plaintiff's damages.

Section 12(a)(2) – Seller's Liability

Section 12(a)(2) of the 1933 Act provides shareholders with a right to sue for a misstatement or omission of material fact in a prospectus or oral communication used to offer or sell securities to the public. Any investor who purchases a security in a public offering can assert a Section 12(a)(2) claim against any person who offers or sells the security. Section 12(a)(2) applies only to sales of securities in public offerings, not to trading in the secondary market or to private sales of securities. It also applies only against those considered to be offerors or sellers of the securities at issue. Within those parameters, Section 12(a)(2) imposes relatively few requirements on a plaintiff. A plaintiff need not prove reliance, scienter or that the misstatement or omission caused the purchase. To recover, a plaintiff must prove only that:

- The defendant offered or sold securities;
- By the use of any means of interstate commerce (e.g., an interstate mailing or electronic communication);
- Through a prospectus or oral communication;
- Which included a misstatement or omission of material fact; and
- The plaintiff was ignorant of the truth.

A defendant may assert an affirmative defense of reasonable care, i.e., the defendant did not know, and in the exercise of reasonable care could not have known, of the misstatement or omission.

A successful plaintiff who still holds the security is entitled to rescission and may recover the consideration paid for the security, minus any income. Where the plaintiff has sold the security, he or she may recover rescissory damages, generally the difference between the purchase price and the resale price, plus interest, and minus any income or return of capital on the security.

Special Situations Under the 1933 and 1934 Acts

Several situations relevant to claims under the 1933 and 1934 Acts warrant special consideration.

Forward-Looking Statements

Forward-looking statements, such as forecasts of earnings or revenues, have historically served as the basis for private claims under the 1933 and 1934 Acts. To encourage companies to make forward-looking statements, Congress created, in the Private Securities Litigation Reform Act of 1995, a safe harbor defense against federal securities law claims for forward-looking statements. Under this safe harbor, a forward-looking statement cannot be the basis for liability if the company:

- Properly identifies the statement as a forward-looking statement; and
- Accompanies the statement with meaningful cautionary statements that identify important factors which could cause actual results to differ materially from those forecast in the forward-looking statement.

A company does not need to identify all important factors, or even the factor that ultimately causes actual results to differ from those forecast in the forward-looking statement, as long as it issues the most complete cautionary statements possible in the circumstances. (We provide practical guidance on this safe harbor in Chapter 5.)

Liability for Endorsing Third-Party Statements

A company or person may be liable for false or misleading statements made by stock analysts or other third parties if that company or person:

- Gives false or misleading information to the analyst or third party;
- Expressly or implicitly adopts a third-party statement as its own; or

- Endorses or adopts a third-party statement after publication, such as by distributing the statement to the public.

**Practical Tip:
How to Avoid Liability
for Endorsing an Analyst's Report**



Your company can take three basic steps to minimize the risk of liability for statements in a stock analyst's report:

- Enforce your company's policy of neither endorsing nor adopting statements made by analysts;
- Do not provide links to analysts' reports on the company's website or otherwise distribute analysts' reports to shareholders or other members of the public; and
- Comply with Regulation FD. (We explain how in Chapter 5.)

Duty to Correct and Duty to Update

A company has a duty to correct a material statement of historical fact that the company discovers to have been untrue when made. The company must correct the prior statement within a reasonable time after learning that the original statement of historical fact was not true when a failure to correct would affect the total mix of information available for investors to use to make informed investment decisions. In contrast, there is no general duty to update statements that were true when made. The federal courts disagree on exactly when a historic statement requires updating. At the least, some courts have held that the duty to update applies to prior statements that are forward-looking in nature and still "alive" in the minds of investors at the time of some conflicting or contradictory development, or that relate to a fundamental transaction, such as a merger. In addition, one federal circuit has held that a company must update prior disclosures which, while still technically accurate, were diminished in importance and value due to new information.

Frequently, the passage of time causes a forward-looking statement, although reasonable when made, to become outdated or, if viewed as a current statement, to be materially misleading. Because it may be difficult to determine when an earlier statement has become materially misleading in light of developments, the best practice is to:

- identify statements as accurate only on and as of the date they are made, and
- explicitly disclaim any intention or obligation to update them.

If it is not clear whether updating a prior disclosure is necessary, it may be prudent to consult with internal or external counsel about the circumstances and current applicable law.

Shareholder Class Actions

Plaintiffs often bring claims under the 1933 and 1934 Acts as *shareholder class actions*. A shareholder class action is a lawsuit brought by a purchaser or seller, or a relatively small group of purchasers or sellers, on behalf of all investors who purchased or sold the securities during a specified time, known as the class period. Plaintiffs and their lawyers often file shareholder class actions when a company's negative public announcement triggers a drop in the company's stock price.

Defendants often move to dismiss a shareholder class action complaint on the ground that it fails to allege facts which satisfy the relevant legal standards. If the court grants that motion, the court dismisses the case either:

- *With prejudice*, meaning that plaintiffs are not entitled to amend and refile a complaint making the same legal claims based on the same alleged misconduct (such a decision may be subject to appeal); or
- *Without prejudice*, meaning that plaintiffs have an opportunity to correct any defects in the complaint and file an amended complaint making legal claims based on the same alleged misconduct.

If the court denies the motion to dismiss, the case proceeds to the discovery phase. Because most securities lawsuits allege misconduct implicating an extended time period and multiple aspects of a company's operations and financial condition, discovery is often broad, costly and time-consuming. Once the plaintiffs obtain access to extensive internal records of the company, the plaintiffs' allegations of misconduct, including what was not properly disclosed, often change and expand.

**Practical Tip:
Named in a Shareholder Class Action?
Take These Four Steps**



As soon as a plaintiff names you or your company in a shareholder class action, you should promptly take these four basic steps:

- Consult your insurance broker and give timely notice of the lawsuit, including a copy of the complaint, to the company's D&O insurance carriers.
- Research and retain outside legal counsel experienced in securities litigation. Choose qualified counsel with good practical judgment.
- Work with legal counsel to preserve documents relating broadly to the subject matter of the lawsuit. Preserve both paper documents and electronic documents and data, and document those preservation efforts in writing.
- Develop strategies for defending the lawsuit. The first step in nearly all securities lawsuits is to move to dismiss the complaint. But plan beyond the motion to dismiss, because the case may begin to move quickly if the court denies the motion.

CEO/CFO Certifications

A public company's CEO and CFO are required to certify their company's periodic reports. The certification requirement itself does not appreciably increase the potential liability of a CEO or CFO in securities class actions. However, plaintiffs have used the certifications to allege that, based on the CEO's and CFO's required review of a periodic report, they knew, or were reckless in not knowing, that the periodic report contained material misrepresentations or omissions. The SEC uses certifications in enforcement proceedings and related litigation. (We discuss practical tips for compliance with the certification requirements in Chapter 4.)

Retention and Destruction of Documents

Accountants are required to retain a broad range of documents relating to audits or reviews of a company's financial statements, including audit and review work papers, for seven years from the end of the fiscal period in which the audit or review was conducted. In addition, Sarbanes-Oxley imposed criminal liability on any person – not only an auditor – who “corruptly” alters, destroys, mutilates or conceals a document or other record with the intent to impair its integrity or availability for use in an official proceeding.

These statutory provisions, along with court decisions regarding spoliation of evidence, have elevated the importance of companies' document management practices.



Practical Tip: Creating a Document Management Policy

To protect your company and your employees, your company's document management and retention policy should include four elements:

- A document *creation* policy: Encourage professionalism and professional language in email and other



Practical Tip:
Creating a Document Management Policy (Cont'd)

written communications. Encourage face-to-face discussion to resolve issues. You do not have to manage a misleading or unduly embarrassing document that was never created.

- A document *retention* policy: Identify which documents to retain, the retention period for different categories of documents, and the procedures to follow. Consult with tax, regulatory affairs, legal and other personnel to determine the appropriate retention period for each category of documents. Retained documents should include both important business records and documents necessary to satisfy governmental requirements. In identifying the types of documents subject to the retention policy, consider the various forms of electronic communications used by the company's directors, officers and employees.
- A document *destruction* policy: Set out procedures for destroying documents that do not need to be retained, such as personal correspondence, non-essential emails, drafts of documents and records that have passed their retention dates.
- Clear standards for suspending document destruction practices and preserving records, along with clear responsibilities for compliance: When litigation (or an investigation or other official proceeding) commences, or is reasonably foreseeable, preserve all relevant documents. Destroying relevant documents under those circumstances – or under any other circumstance that might suggest an intent to make the documents unavailable in the lawsuit,



Practical Tip:
Creating a Document Management Policy (Cont'd)

investigation or other official proceeding – may subject the company and its employees to sanctions for destroying evidence or even criminal charges for obstruction of justice. There is no bright-line test, so err on the side of caution.

Whistleblower Incentives and Protection

The Dodd-Frank Act created an SEC whistleblower program to help the Division of Enforcement discover and prosecute securities law violations. The SEC whistleblower program's three key elements are (1) providing financial awards to a successful whistleblower, (2) protecting the whistleblower against retaliation and (3) maintaining the anonymity of the whistleblower. The SEC makes financial awards to individuals who voluntarily provide original information that leads to successful SEC enforcement actions resulting in monetary sanctions exceeding \$1 million. These awards range from 10% to 30% of the sanctions the SEC collects.

The Dodd-Frank Act shields from retaliation any employee who participates in proceedings alleging violations of selected federal securities laws, if he or she has a reasonable belief that a securities violation has occurred, is in progress or is about to occur.

ERISA Claims

Widely known as ERISA, the Employee Retirement Income Security Act of 1974 is a federal law that governs employee benefit plans. Because many public companies have ERISA plans that allow participating employees to invest in the employer's stock, a decline in the company's stock price can trigger claims under ERISA similar to claims under the federal securities laws.

Plaintiffs often include ERISA claims in addition to, or file ERISA actions simultaneously with, federal securities law claims. These claims are often referred to as “ERISA stock-drop” litigation. Plaintiffs in ERISA stock-drop litigation typically allege that the plan fiduciary (generally a management committee that may include company executives) violated a duty of prudence by failing to act on non-public information to prevent losses in the plan fund which holds the company’s stock. Based on a 2014 U.S. Supreme Court decision, plaintiffs must be able to plausibly allege (1) an alternative action the plan fiduciary could have taken that would have been consistent with securities laws, and (2) that a prudent fiduciary in the same circumstances could not have viewed such alternative action as more likely to harm the plan fund than to help it. This has proven to be a very high, but not insurmountable, pleading standard for plaintiffs.

Most ERISA litigation involving the company’s stock, whether or not specific to an alleged stock-drop, focuses on whether the defendants in fact breached fiduciary duties owed to the plan participants. A person or entity generally is considered a fiduciary for purposes of ERISA if:

- Exercising any discretionary authority or control with respect to management or disposition of assets of an ERISA plan;
- Providing investment advice for a fee; or
- Exercising any discretionary authority or responsibility in the administration of an ERISA plan.

A plan fiduciary who is found to have breached fiduciary duties owed to the ERISA plan may be held personally liable to plan participants for the plan’s losses resulting from the fiduciary’s breach. Other equitable remedies are also available under ERISA.



Practical Tip:
Consider Engaging an Independent Fiduciary

To assist with managing the risk of ERISA stock-drop litigation, sponsors of ERISA plans may choose to engage an independent fiduciary. The key practical implication of such engagement is that the independent fiduciary then assumes responsibility for managing the company's stock in the plan (consistent with plan objectives), which may include communicating with plan participants, limiting plan allocations in the company's stock and even removing the company's stock from the plan. While engaging an independent fiduciary may not avoid claims and liability altogether, it likely restricts the potential claims available to plaintiffs and, as a result, the exposure of the plan sponsor.

Corporate Governance Litigation

In addition to claims under the federal securities laws, directors and officers of a public company may also face claims in connection with the corporate governance issues that we discuss in Chapters 2, 9 and 10. Corporate governance litigation often involves alleged conflicts of interest. (We discuss ways to manage conflict-of-interest situations in Chapter 2.)

Change-of-Control Transactions

Change-of-control transactions are especially fraught with potential conflicts of interest for directors and are a common source of litigation, whether brought by frustrated potential acquirers or by shareholders dissatisfied with the terms or outcome of a transaction. For example, shareholder plaintiffs often allege that directors have approved a merger or other change-of-control transaction to entrench themselves or to obtain benefits for themselves or a favored shareholder. The duty of the Board in a change-of-control transaction is fairly clear, at least in theory:

- The Board must act in the best interests of the company and all of its shareholders; and

- If the Board decides to sell the company, it generally must take reasonable steps to obtain the best available price and cannot unduly favor a lower-valued transaction.

**Breaking News:
Litigation Accompanies (Almost)
Every Public M&A Deal**



Shareholder litigation challenging merger and acquisition transactions has become routine:

- Investors have come to litigate approximately four out of five public company merger and acquisition transactions of \$100 million or more. Most settlements of this type of merger and acquisition litigation provide for additional disclosures about the transaction to shareholders and nothing else. It is extremely rare for a settlement to provide additional merger consideration to shareholders. Because of a landmark 2016 decision by the Delaware Court of Chancery signaling that court's willingness to reject the typical non-monetary, disclosure-only settlements of these lawsuits, the majority of recent M&A litigation has been filed in federal courts rather than state courts.
- These M&A lawsuits usually take the form of a class action on behalf of the target company's shareholders. The typical suit alleges that the target company's Board of Directors violated its fiduciary duties by conducting a flawed sale process, not maximizing shareholder value, and failing to disclose to shareholders all material information about the transaction.

In order for directors' decisions in a change-of-control transaction to be protected under the deferential business judgment rule described in Chapter 2, directors must agree to the

transaction offering the best value reasonably available for the company's shareholders. Use the three methods that we describe in Chapter 2 for dealing with conflicts of interest in a change-of-control transaction to help protect the directors from liability. If the business judgment rule does not apply, courts will employ an enhanced level of scrutiny when reviewing directors' behavior in the face of a takeover threat.

The sale of a company will generally trigger dissenters' rights pursuant to provisions in the governing corporate statute that allow for judicial review of price. The company must carefully comply with the statute's provisions. Doing so can protect against claims for money damages in favor of a litigated statutory appraisal process. (The statutory dissent process will not preempt claims for injunctive relief or claims for fraud, misrepresentation or other serious impropriety.)

Shareholder Derivative Lawsuits

Plaintiffs frequently pursue corporate governance claims through shareholder derivative lawsuits. In a derivative lawsuit, a shareholder sues on behalf of the company, seeking relief for alleged claims that belong to the company but that the company has not asserted for itself. A derivative plaintiff cannot recover damages personally; instead, any damages or injunctive relief are solely for the benefit of the company. A company's officers and directors are the most common targets of derivative claims, although plaintiffs may also target major shareholders and third parties.

A derivative plaintiff must comply with strict procedural requirements, including:

- The plaintiff must be a shareholder at the time of the alleged wrong and must remain a shareholder throughout the litigation;
- The plaintiff must be an adequate representative of the company's other shareholders;
- The company usually must be made a party to the litigation, generally as a nominal defendant; and

- Before bringing suit, the plaintiff must make a demand on the Board that the company take steps to assert the claim.

Some states (but not all) permit a plaintiff to proceed without first making a demand on the Board if the plaintiff can demonstrate that such a demand would be futile. Futility can be demonstrated by establishing a reasonable doubt that:

- The directors acted disinterestedly and independently; and
- The directors exercised valid business judgment in authorizing the challenged transaction.

A company may assume control of derivative litigation by appointing a *Special Litigation Committee* of the Board to investigate the claims asserted by a derivative plaintiff and to determine whether pursuing the claims is in the company's best interests. A Special Litigation Committee will have the power to terminate, settle or pursue the litigation, and may decide to permit the existing plaintiff to continue the suit. The Board should appoint disinterested independent directors to the Special Litigation Committee and give the Special Litigation Committee full authority to accomplish its investigation and to implement its decisions. Courts will often grant motions to stay derivative suits, including burdensome discovery, pending the outcome of a Special Litigation Committee investigation. Any decision by a Special Litigation Committee to terminate the litigation will be subject to judicial review, and a party challenging the termination decision may pursue limited discovery into the independence and good faith of the Special Litigation Committee's investigation.

Alternatively, the Board may ask an advisory committee of independent directors to conduct an investigation and report the results to the full Board. The full Board will then determine how best to respond to the derivative litigation based on the independent committee's recommendations. The risk of this approach is that, to the extent a derivative plaintiff has alleged that the full Board has some interest or involvement in the alleged miscon-

duct or lacks independence, courts are less likely to defer to the independent committee's recommendations and the full Board's review than to a Special Litigation Committee composed of independent directors authorized to act independently on the results of an investigation.



**Practical Tip:
The Lonely Life of the One-Member
Special Litigation Committee**

A Special Litigation Committee (or any other special Board committee) must be composed of directors who are disinterested and independent. In many Model Business Corporation Act states, a minimum of two directors may be required, but in Delaware and some other states, a committee may be composed of only one director. In the words of one court, “[i]f a single member committee is to be used, the member should, like Caesar’s wife, be above reproach.” As a practical matter, the independence of a single-member committee may come under more rigorous scrutiny than would otherwise be applied to individual members of a larger committee.

Once a plaintiff has initiated a derivative action, the parties will need court approval to settle or dismiss it. In most derivative cases, notice of a settlement must be provided to the shareholders, and the court will convene a hearing to determine whether the settlement is fair and adequate. Attorneys’ fees may be awarded to plaintiff’s counsel – either out of the proceeds of the settlement or from the company itself – if the court determines that counsel’s efforts conferred a substantial benefit upon the company.

Shareholder Access to Corporate Books and Records

Statutes in numerous states, including Delaware, permit shareholders of public corporations to inspect some of a company’s books and records upon request to the company with

sufficient advance notice. The statutes of the state in which the company is incorporated govern these inspections. In most cases, a shareholder must express a *proper purpose* for a books and records inspection request. Courts have generally upheld as *proper purposes* a shareholder's desire to:

- Investigate possible wrongdoing or mismanagement by the company's executive officers;
- Appropriately value shares of the company's stock; and
- Communicate with other shareholders regarding proposals for shareholders' meetings.

States vary in the type of corporate books and records that they permit shareholders to access, but they usually include at least the company's certificate or articles of incorporation, bylaws and minutes of shareholders' meetings. Shareholder inspection demands are often simply the prologue to a later event, such as shareholder derivative litigation, a request for a meeting with directors for the purpose of discussing proposed reform, preparation of shareholder resolutions or a proxy fight.

Foreign Corrupt Practices Act

The Foreign Corrupt Practices Act (FCPA) is a common basis for government investigations of public companies. The FCPA has two key components. First, anti-bribery provisions prohibit public and private companies from paying bribes or giving anything of value to influence a foreign official. Second, books and records provisions mandate that public companies maintain books and records in sufficient detail to be "reasonable" to a prudent manager of the business. Promising, offering or authorizing someone to pay a bribe or to give something of value to a foreign official may all violate the FCPA. The FCPA goes beyond cash to include goods, services, rights, contracts and benefits. A foreign official may include any representative of a foreign governmental party or of a public international organization, a candidate for public office or an employee of a government-owned business. Violation of the FCPA can

result in criminal penalties, including prison terms for individuals, as well as monetary fines. FCPA enforcement is consistently a top priority for the U.S. Department of Justice and the SEC, who jointly enforce the statute.



**Practical Tip:
Help Your Employees to Steer Clear –
and Record It!**

Follow these four key practices to keep your company FCPA compliant:

- Maintain a robust compliance program designed to scrutinize requests for reimbursement for gifts by employees or consultants who engage in foreign business for your company.
- Include appropriate third-party reviews in your record. Monitor suppliers, resellers, distributors and agents and document your efforts to ensure their compliance.
- Have a rigorous due diligence process for any acquisition that involves doing business abroad.
- Enhance and test a robust whistleblower system. Tie it to internal training!

Regulatory Investigations and Enforcement

A variety of regulators actively enforce the securities laws.

SEC

Each year the SEC brings hundreds of civil enforcement actions against companies and individuals that are alleged to have violated the federal securities laws. The SEC seeks sanctions, including prohibiting directors and officers from serving for public companies, fines and disgorgement, for these types of misconduct:

- Insider trading;

- Accounting fraud;
- Disclosure violations; and
- Aiding and abetting violations.

The SEC will often first seek an immediate injunction against defendants to prohibit unlawful acts and practices. It may then seek disgorgement, monetary penalties and other sanctions against the alleged wrongdoers. While the SEC does not have the authority to pursue criminal actions, it may refer criminal matters to the Department of Justice.

Typically, the SEC pursues initial investigations through an informal inquiry, interviewing potential witnesses and examining brokerage records, trading data or company documents to determine whether further investigation is warranted. Following the preliminary investigation, if the SEC issues a formal order of investigation, the SEC staff may issue subpoenas compelling witnesses to testify and produce books, records and other relevant documents to assist the SEC in its investigation. The SEC can authorize its staff to file a case in federal court or to bring an administrative action against individuals and companies.

Market Regulations

In addition to the SEC's civil enforcement authority, securities markets have established self-regulatory organizations to govern the conduct of their members. The Financial Industry Regulatory Authority (FINRA) is involved in virtually all aspects of the securities business, including registering and educating industry participants, examining securities firms, rulemaking, enforcing its own rules as well as the federal securities laws, and administering a dispute resolution forum for investors and registered firms. The NYSE and Nasdaq also have their own regulatory, investigation and enforcement divisions.

FINRA investigates potential securities violations and, when appropriate, brings formal disciplinary actions against firms and their associated persons. If it appears that rules have been violated, FINRA Enforcement will determine whether the conduct

merits formal disciplinary action, via either a negotiated settlement or a litigated proceeding. FINRA Enforcement also brings disciplinary cases on behalf of the securities exchanges with which it has entered into Regulatory Services Agreements. FINRA and exchange investigations are serious and may merit the assistance of qualified counsel.

Department of Justice and State Securities Regulators

The Department of Justice is also active, bringing criminal cases for alleged corporate fraud.

State securities regulators regularly conduct securities-related investigations and initiate enforcement actions in an effort to enforce state securities laws and return money to harmed investors.



Practical Tip: Create and Monitor an Effective Compliance Program

Companies can be criminally liable for crimes that employees commit in connection with their employment. In determining whether to charge a company for an employee's wrongdoing, prosecutors and regulators often ask: Did the company have an effective compliance program to detect and prevent violations of law?

Protect your company with a compliance program that:

- Includes clear written standards and procedures;
- Names a single person or small team responsible for overseeing the compliance program;
- Expects the CEO and senior management to set the appropriate tone at the top;
- Provides appropriate training at all levels, including the Board and senior management;

**Practical Tip:
Create and Monitor an Effective
Compliance Program (Cont'd)**



- Monitors, audits, evaluates and promotes the reporting of potential and actual violations, including a confidential or anonymous reporting mechanism;
- Protects attorney-client privileged communications; and
- Holds employees accountable for violations of policy or law.
- When a possible violation occurs, take prompt and reasonable steps to investigate, remedy or, as appropriate, report the violation.

The Important Role of D&O Insurance

Companies often purchase D&O insurance to protect directors and executive officers (as well as the company itself) from the types of claims and investigations described above. D&O insurance helps provide companies, directors and officers with the resources to defend and resolve such cases. D&O insurance also protects directors and officers from the risk that the company will be unable or unwilling to pay for a defense, settlement or judgment, such as when the company is insolvent or the claims are not subject to indemnification. For these reasons, D&O insurance is an essential element of any strategy to mitigate the litigation risks confronted by public companies and their directors and officers. There are three common types of D&O insurance. We provide a simple visual guide to D&O insurance in Appendix 3.

- *Side A* coverage typically covers claims against officers and directors that are not indemnified by the company. Directors and officers can think of this as

“worst case” coverage, which will be available to protect them if the company is unwilling or unable to make good on its indemnification obligations.

- *Side B* coverage typically reimburses the company for indemnified costs incurred in connection with claims against directors and officers. Because most solvent companies indemnify their directors and officers from such claims, policy payouts often involve this type of coverage.
- *Side C* coverage typically applies to claims against the company itself and is limited to securities claims.

D&O insurance policies routinely cover defense costs. These D&O insurance policies are wasting policies in which the amounts paid for ongoing defense costs in litigation or investigations reduce the total insurance proceeds remaining for settlement or for payment of a judgment or related expenses. D&O insurance policies are almost always claims-made policies, meaning that coverage is provided for claims made during the policy period, rather than for conduct occurring during that period. As a result, it is essential that the company and the insured directors and officers provide their D&O insurance carriers with prompt notice of any claims that might be covered. Any delay in providing notice could result in a loss of coverage.



Practical Tip:
Be Vigilant: Actively Manage Your Company’s D&O Insurance Program

Ensure that your company’s D&O insurance program provides protection, not only for the company, but also for the company’s directors and officers. Then:

- Review your company’s D&O insurance program annually with your broker and counsel to ensure that the program provides appropriate types and amounts of coverage.

Practical Tip:
**Be Vigilant: Actively Manage Your Company's
D&O Insurance Program (Cont'd)**



- Ask how the policies will cover gaps in D&O insurance coverage layers that follow one insurer's insolvency. Ask how the policy will apply in unusual situations, such as when the company becomes bankrupt or during a governmental investigation.
- Ask for pricing on a Side A-only D&O insurance program. An insurer offering Side A-only D&O insurance will often be willing to allow its policy to "drop down" to fill a gap caused by the insolvency of an insurer providing a lower layer of insurance.
- Consider purchasing smaller insurance layers so that your company can fill any small gaps in coverage caused by the insolvency of an insurer.
- Ask counsel to brief you on the order-of-payment language in any D&O insurance policy. Does it provide that if directors, officers and the company all have simultaneous claims on the policy that exceed the liability limits, the directors and officers are entitled to payment before the company? This can ensure that the policy will not be seen as a company asset in the event that the company enters bankruptcy.
- Ask for confirmation that the policy has appropriate severability language that protects innocent directors and officers in the event one executive officer engages in wrongdoing. Be sure that the policy cannot be rescinded simply based on fraud or misconduct of the CEO or CFO.

Chapter 14

Tiring of the Public Eye? Delisting, Deregistration and Going Private

At some point in their corporate life cycles, many companies delist, deregister or go private and cease making periodic filings with the SEC.

Delisting and Deregistration

Exchange Delisting (Section 12(b))

A public company registered under Section 12(b) of the 1934 Act can delist its securities voluntarily by application in accordance with the rules of its exchange. However, as long as the company has 300 or more shareholders (or in the case of a bank, a savings and loan holding company or a bank holding company, 1,200 or more shareholders), it will remain subject to the 1934 Act under Section 12(g) (companies of a certain size).

Size Criteria Delisting (Section 12(g))

A company can voluntarily terminate its registration of securities under Section 12(g) of the 1934 Act by filing a Form 15 certifying that either:

- The registered class of securities is held of record by fewer than 300 persons (or in the case of a bank, a savings and loan holding company or a bank holding company, 1,200 persons); or

- The registered class of securities is held of record by fewer than 500 persons and the total assets of the company have not exceeded \$10 million on the last day of each of the company's three most recent fiscal years.

The company's duty to file periodic and current reports is immediately suspended upon filing the Form 15, and its registration under the 1934 Act terminates 90 days after filing. The suspension will terminate if the company crosses the Section 12(g) size thresholds as of the end of any future fiscal year. The suspension applies only to the duty to file periodic (Forms 10-K and 10-Q) and current (Form 8-K) reports. As long as the company is registered under Section 12(g), it will remain subject to the other obligations that attach to being registered (e.g., proxy rules and Section 16 reporting obligations) until 90 days after filing Form 15 when the company's Section 12(g) registration is terminated.

Suspension After Filing 1933 Act Registration (Section 15(d))

A company that issues equity or debt securities to the public in an offering registered under the 1933 Act must file annual, quarterly and current reports with the SEC pursuant to Section 15(d) of the 1934 Act. This reporting requirement applies even though the company does not list the securities on a national securities exchange or market and the company has not crossed the size thresholds triggering 1934 Act registration. Unlike registration under Section 12 of the 1934 Act, a company can never terminate its reporting obligations under Section 15(d) – those obligations may only be suspended. A company's periodic reporting obligations under Section 15(d) are automatically suspended for a fiscal year, other than a fiscal year in which a 1933 Act registration statement became effective, if at the beginning of that year the registered securities are held of record by less than 300 persons (or in the case of a bank, a savings and loan holding company or a bank holding company, 1,200 persons). A company must file a Form 15 with the SEC as a notice of the automatic suspension within 30 days after the beginning of the fiscal year in which the suspension is effective. If a company has one or more effective Form S-3 and/or Form S-8 registration

statements, in order to rely on the Section 15(d) automatic reporting suspension, it must deregister any remaining unsold securities from those registration statements prior to filing its annual report on Form 10-K for the prior fiscal year. Otherwise, the Form 10-K serves as a post-effective amendment, rendering the automatic suspension under Section 15(d) unavailable.

A company may file a Form 15 under Rule 12h-3 under the 1934 Act to suspend its Section 15(d) reporting obligations at any time if it meets either of the record holder thresholds previously identified for the termination of its Section 12(g) registration. However, like the Section 15(d) automatic reporting suspension, a company generally cannot rely on Rule 12h-3 to suspend its Section 15(d) reporting obligations for the fiscal year in which a 1933 Act registration statement becomes effective or is updated by Section 10(a)(3) of the 1933 Act (e.g., by filing a Form 10-K). Moreover, if a company is relying on the fewer than 500 record holders and \$10 million in assets threshold, it cannot rely on Rule 12h-3 to suspend its Section 15(d) reporting obligations for (i) the fiscal year in which a 1933 Act registration statement becomes effective or is updated by Section 10(a)(3) of the 1933 Act and (ii) the two succeeding fiscal years. (In limited circumstances in connection with the completion of a merger or an abandoned IPO, a company may rely on Rule 12h-3 to suspend its Section 15(d) reporting obligations, even if a registration became effective or was updated in the same year.)

Going Private Transactions: Flying Below the Radar

In a going private transaction, a significant shareholder group (often insiders) offers to purchase all or most of the company's equity securities held by the general public. The company then files a Form 15 to deregister under the 1934 Act and will no longer have its stock publicly traded.

The Board of a public company may determine that a going private transaction is in the best interests of shareholders and the company for a number of reasons:

- *Small Float for Orphan Company.* A company with a small public float and little or no analyst coverage sometimes is unable to realize the benefits of being a public company. Stock prices for these types of companies, sometimes referred to as orphan public companies, may be undervalued and shareholders may have limited liquidity.
- *Management Focus.* The management team at a public company may feel market pressure to favor short-term gains over the pursuit of long-term strategies or objectives.
- *No Third-Party Purchasers.* The company may have sought and failed to find a third-party purchaser to maximize shareholder value.
- *Weary Outside Shareholders.* Outside shareholders may be prepared to liquidate their investment, while significant shareholders and management may not be ready to sell.
- *Liquidity.* A going private transaction can provide public shareholders with an opportunity to sell their shares at a premium to recent market prices.
- *Elimination of 1934 Act Reporting Obligations.* Going private relieves a company of the expenses and burdens of preparing and filing 1934 Act reports with the SEC and complying with proxy requirements and stock exchange or market rules.

There are downsides to going private, including:

- *Cost, Decreased Liquidity and Loss of Public Profile.* Future cost savings may be offset by other considerations, such as:
 - The cost to complete the going private transaction;

- Decreased liquidity for remaining shareholders;
 - The loss of the public markets as a source for equity and debt financing;
 - A potentially heavy debt burden (if the transaction is financed); and
 - A loss of public profile or prestige compared to status as a public company.
- *Conflicts of Interest.* Going private transactions raise special concerns because the proponent typically has a conflict of interest. The proponent is frequently represented on the company's Board and has a fiduciary duty to the other shareholders, while it is in the proponent's personal financial interest to pay the minimum purchase price for the company.

Process of Going Private

A going private transaction may take many forms, but the ultimate result is that the proponent acquires all or most of the outstanding stock, and the selling shareholders receive cash, redeemable preferred stock or debentures for their shares. The two most common transaction types are a self-tender and a proxy solicitation to propose a merger.

Self-Tender. A company self-tender that buys out the general public will leave the proponent shareholder group holding a majority of the company's outstanding equity. The self-tender is followed by a second-step merger transaction in which all shareholders other than the proponent group are squeezed out.

Friendly Merger/Proxy Solicitation. Alternatively, the company can solicit shareholder proxies to merge the target company with an insider entity or an acquirer entity controlled by a third party. As with a self-tender, the proponent group will be left with a majority of the shares, and selling shareholders will receive cash or other consideration.

If any Board member has a conflict of interest in the transaction, the company's Board will often appoint a Special Committee of independent directors to review the proposal, negotiate

with the proponent and make recommendations to the full Board. The Special Committee may retain independent counsel and a financial advisor to evaluate the proposed transaction and opine on the fairness of the transaction. If the acquirer in a going private transaction is a controlling shareholder, the shareholder will likely condition its offer at the outset on approval by both (i) the Special Committee of independent directors empowered to select its own advisors and definitively say “no” to the transaction and (ii) an informed, uncoerced majority of the unaffiliated minority shareholders. (We discuss how to manage conflicts of interest in Chapter 2.) If the Board is unable to cleanse a conflict of interest, or a controlling shareholder fails to implement adequate procedural protections for the minority shareholders, the transaction will be subject to entire fairness review, which includes demonstrating fair dealing and a fair price. If a controlling shareholder can show that the transaction was *either* approved by a properly empowered and functioning Special Committee of independent directors, *or* approved by an informed vote of a majority of the minority shareholders, the shareholder can shift the burden of persuasion to the challenging shareholder.

Rule 13e-3

Rule 13e-3 under the 1934 Act governs going private transactions and imposes significant disclosure requirements on a public company going private. Among other items, the company must disclose in the proxy statement or tender offer document filed with the SEC:

- The purpose of the transaction;
- Alternatives considered and reasons for their rejection;
- Reasons for the structure of the transaction and for undertaking it at that particular time;
- Reasons the issuer believes the transaction is fair;
- A discussion of the analysis underlying a financial advisor’s fairness opinion;

- Any firm offers made by any third party for the company during the past two years; and
- Extensive financial information.



Practical Tip:
Key Players in a Going Private Transaction

Special Committee. A going private transaction often involves a conflict of interest between an insider proponent that may control the company and the other shareholders. The Board will want to ensure that a Special Committee is selected and granted broad authority. The Special Committee will have the ability to choose its own financial, legal and accounting advisors and will become the voice of the Board in the transaction. The first significant act of the Special Committee is to choose its outside financial advisor.

Financial Advisor. The financial advisor will advise the Special Committee on the financial structure of the going private transaction and on strategic alternatives to the transaction. The Special Committee will also request that the financial advisor deliver a fairness opinion to the Special Committee. A fairness opinion is a statement by the financial advisor that the consideration or financial terms of the transaction are fair, from a financial point of view, to the company and its shareholders. Obtaining a fairness opinion is an important step in establishing that the Board has satisfied its fiduciary duty of care.

Information Agent. Even before the going private transaction begins, an information agent, typically a proxy solicitation or consulting firm, will provide an analysis of the company's shareholder base and, based on that, help give strategic advice on the structure of the transaction. Following the commencement of the offer, the information agent will handle the distribution of tender offer documentation (if the transaction is structured as a self-tender) and will field questions from shareholders about the offer or procedures for tendering their shares.



Practical Tip:
Key Players in a Going Private Transaction (Cont'd)

Dealer Manager. The dealer manager (typically an investment banking firm retained by the company) will solicit tenders or consents and communicate generally regarding the transaction with brokers, dealers, commercial banks and trust companies. In smaller deals, the information agent plays this role.

Depositary. In a self-tender transaction, the depositary, typically a company's transfer agent, receives tenders of shares and provides daily updates to the company on the number of shares tendered.

Outside Counsel. Outside counsel will prepare the transaction documents and handle filings and communications with the SEC. It will also advise the Board (and Special Committee if the Special Committee does not retain separate counsel) on the legal aspects of the transaction and on the fiduciary duties of the directors. The Special Committee may wish to retain independent counsel.

Chapter 15

Foreign Private Issuers

Many companies that issue securities in the United States are based outside the country. U.S. securities laws apply to these companies, but their U.S. reporting obligations vary widely. Non-U.S. companies may become subject to the SEC's periodic reporting requirements:

- If they have assets of over \$10 million and over 2,000 shareholders of record worldwide (or 500 shareholders who are not accredited investors), of whom over 300 are in the United States;
- By issuing securities in the United States in an SEC-registered offering; or
- By listing securities on a national securities exchange (usually the NYSE or Nasdaq).

These non-U.S. reporting issuers can benefit from relief from several key SEC reporting requirements and securities exchange rules if they qualify as "foreign private issuers." Non-U.S. reporting issuers that do not meet the very specific SEC definition of foreign private issuer generally must comply with U.S. securities laws as if they were based in the United States.

What Is a Foreign Private Issuer?

A *foreign private issuer* is a company that is organized under the laws of a jurisdiction outside the United States and for which:

- *Non-U.S. Shareholders.* At least half of its outstanding voting securities are owned, directly or indirectly, by non-U.S. residents; or
- *Based and Managed Outside the United States.* If it fails the non-U.S. resident ownership test, each of the following applies:
 - A majority of its directors and a majority of its executive officers are not U.S. citizens or residents;
 - Over half of its assets are located outside the United States; and
 - The business is not managed principally in the United States.

If a company is able to show that it has less than 50% U.S. ownership or, even if it has over 50% U.S. ownership, that it is not located or managed in the United States, or managed by U.S. personnel, then the entity will be a foreign private issuer and be entitled to the benefits of less stringent reporting and governance requirements than U.S.-based companies.

A foreign private issuer tests its continuing status as a foreign private issuer at least annually on the last business day of its second quarter. If it no longer meets the test, it generally must comply with U.S.-company registration and reporting obligations on the first day of its upcoming fiscal year.

Benefits of Being a Foreign Private Issuer: The Notable Nine

A foreign private issuer benefits from at least nine significant areas of relief from SEC reporting and governance obligations. Canadian and certain other foreign private issuers may be subject to separate home country requirements that limit the benefits otherwise generally available to foreign private issuers.

The nine principal benefits are:

1. *No Quarterly or Current Reports.* Foreign private issuers need not file quarterly reports on Form 10-Q or current reports on Form 8-K. However, for those foreign private issuers listed on the NYSE, the NYSE requires the filing of semiannual unaudited interim financial information covering the company's first two fiscal quarters.
2. *Section 16 Reporting and Short-Swing Relief.* Insiders of foreign private issuers are not subject to 1934 Act Section 16(a) reporting of their securities transactions. In addition, Section 16(b)'s "short-swing" profit disgorgement requirements do not apply.
3. *SEC Proxy Rule Exemption.* The SEC's proxy statement disclosure requirements and proxy solicitation rules do not apply to foreign private issuers, which are governed by home country proxy rules.
4. *Dodd-Frank Act Exemptions.* Several key corporate governance reforms of the Dodd-Frank Act do not apply to foreign private issuers, including those related to proxy statement matters, such as say-on-pay and golden parachute disclosure, and voting and disclosure relating to chair/CEO overlaps and performance-to-pay ratios.
5. *GAAP Flexibility.* In preparing its financial statements to be provided to the SEC, a foreign private issuer can choose among U.S. GAAP, non-U.S. GAAP (with a reconciliation to U.S. GAAP) or the International Financial Reporting Standards.
6. *Reduced Executive Compensation Disclosure.* Foreign private issuers may provide significantly reduced executive compensation disclosure compared to U.S. companies, including in most cases by providing aggregate rather than individual disclosure of executive compensation.
7. *No Accelerated Filing.* A foreign private issuer using a Form 20-F annual report may file the report up to 120 days after the end of the fiscal year.

8. *Exemption from Regulation FD.* Regulation FD expressly exempts foreign private issuers from its requirements. As a result, Regulation FD does not mandate foreign private issuers to make simultaneous or prompt public disclosure of material nonpublic information. However, many foreign private issuers comply with Regulation FD as a “best practice,” even though they are exempt. To do otherwise could be the basis for liability for violation of U.S. and foreign securities law – not under Regulation FD but under the long-standing principles that form the basis of the regulation.
9. *NYSE and Nasdaq Corporate Governance Exemptions.* Foreign private issuers listed on the NYSE or Nasdaq are generally exempt from most of the exchanges’ corporate governance rules, other than SEC Audit Committee requirements, to the extent not required by the issuer’s home country laws. The exemptions cover independence determinations, Compensation and Nominating & Governance Committees, and other matters, including certain shareholder approval requirements relating to equity-based compensation plans and issuances of shares in various situations otherwise requiring shareholder approval. Foreign private issuers are required to disclose how their corporate governance rules materially differ from those of U.S. companies.

In spite of these benefits, some foreign private issuers voluntarily become subject to all, or selectively adopt some, general SEC and NYSE/Nasdaq requirements due to potential market or investor preferences.

Rule 12g3-2(b) Exemption

Rule 12g3-2(b) under the 1934 Act exempts foreign private issuers from any obligation to register a class of securities under the 1934 Act if the company and the applicable class of securities have a primary trading market outside the United States and meet certain requirements. A foreign private issuer can take advantage of the Rule 12g3-2(b) registration exemption without submitting a written application to the SEC as long as it continues to meet these requirements.

Qualifying foreign private issuers can use the Rule 12g3-2(b) exemption in establishing an *unlisted* American Depositary Receipts (ADR) program.

SEC 1934 Act Reporting and Disclosure Requirements

A foreign private issuer's primary 1934 Act disclosure obligations are to file an annual report with the SEC and to disclose certain material information by furnishing to the SEC any required reports on Form 6-K. Nearly all SEC disclosures are required to be in English. An issuer's failure to timely file an annual report will restrict the issuer's ability to use a Form F-3 or S-3 "short form" registration statement for offerings of its securities.

Annual Report: Form 40-F (for Canadians) or 20-F (for All Others)

Most foreign private issuers subject to reporting obligations under the 1934 Act file an annual report on Form 20-F rather than Form 10-K. Canadian companies meeting specific criteria may file on Form 40-F, which essentially includes a U.S. wrapper around the company's Canada-required annual reporting materials. Form 20-F is due 120 days after the end of the company's fiscal year and includes broad disclosure that generally is similar to that of a Form 10-K, subject to notable exceptions, such as streamlined executive compensation disclosure.

Reports on Form 6-K

Foreign private issuers "furnish" to the SEC supplementary reports on Form 6-K. The timing and content of these reports is less demanding than are counterpart Forms 10-Q and 8-K for U.S. companies. A foreign private issuer must "promptly" furnish a Form 6-K to the SEC to disclose certain material information that the foreign private issuer:

- Makes public in accordance with the laws of its home country;

- Files with any exchange on which its securities are traded and which information the exchange makes public; or
- Distributes or is required to distribute to its security holders.

The limited nature of the triggers above results in relatively few mandatory Form 6-K filing requirements, although many foreign private issuers file additional Form 6-Ks to voluntarily disclose additional information to the market.

Other Ongoing SEC Filing and Disclosure Requirements

Holders of 5% or more of applicable securities of a foreign private issuer must file with the SEC statements of beneficial ownership on Schedule 13D or 13G. (We discuss Schedules 13D and 13G in Chapter 6.)

The NYSE and Nasdaq Exchange Requirements

A public company generally must register its securities, including ADRs if applicable, under the 1934 Act before it may list the securities on a U.S. national securities exchange. The company must also qualify and apply for listing with the exchange. Foreign private issuers may qualify for listing on the NYSE under U.S. domestic listing standards or alternative listing standards for non-U.S. issuers. The NYSE and Nasdaq listing standards include quantitative and qualitative standards, including ongoing standards for continued listing.

Corporate Governance Standards

Foreign private issuers listed on the NYSE or Nasdaq are generally exempt from most of the exchange's corporate governance rules to the extent compliance with those rules is not required by the issuer's home country laws. However, the NYSE and Nasdaq require the foreign private issuer to disclose the significant differences in its corporate governance practices from those practices required of U.S. companies under the exchange's

corporate governance rules. This can be a brief general summary of any significant differences included in annual reports on Form 20-F. Foreign private issuers not using Form 20-F may include the “significant difference” disclosure on their websites in English or in their annual reports to shareholders.

Neither the NYSE nor Nasdaq exempts foreign private issuers from rules governing the composition and independence of Audit Committees. In addition, the NYSE and Nasdaq require certain notifications, certifications and affirmations relating to compliance with corporate governance rules.

Appendix 1

Annual 1934 Act Reporting Calendar (SEC Reporting and Annual Shareholders' Meeting)

The following sample form of an Annual 1934 Act Reporting Calendar for SEC Reporting and Annual Shareholders' Meeting purposes provides a starting point for creating your company's checklist and timetable for the tasks associated with SEC periodic reporting obligations and the annual shareholders' meeting. Tailor the Calendar to reflect your company's specific requirements and timing. Work closely with your company's internal reporting teams (legal, finance, investor relations, human resources, etc.), Disclosure Practices Committee, outside legal counsel and independent auditors to ensure compliance with each of: (a) the 1934 Act requirements and other federal securities law requirements; (b) state law requirements (the Calendar assumes a company incorporated in Delaware); (c) the company's charter, bylaws, reporting and governance policies and Board committee charters; and (d) applicable NYSE or Nasdaq listing standards. For simplicity, the Calendar assumes that your company is a U.S. company and a large accelerated filer with a December 31 fiscal year-end and a May 15 annual meeting date, that no proposal to be considered at the annual meeting will require the filing of a preliminary proxy statement with the SEC, and that earnings releases are issued and quarterly reports are filed generally around the same time.

Date*	Item	Responsibility
December 1	Schedule insider trading "blackout" periods for upcoming year <i>(Generally begins two to four weeks prior to quarter-end, and ends after the second full business day following company's earnings release for that quarter, although timing will depend on company policy)</i>	Company
	Schedule reminders to be sent to officers and directors on the first day of every month to remind them to give prior notice to and obtain preclearance	Company

* Dates will change depending on the calendar year. Generally, if the last filing day relating to an SEC filing requirement falls on a weekend or holiday, then the last filing day relating to such filing shall extend to the next business day.

Date*	Item	Responsibility
	<p>from company with respect to securities transactions to be made during that month at least two business days prior to a transaction</p> <p><i>(Form 4s must be filed with SEC within two business days after the transaction requiring reporting on Form 4 is executed)</i></p>	
December 1 – 6	Coordinate with auditors regarding Q4 and year-end audit	<i>Company/ Auditors</i>
December 1 – 9	Meetings of internal reporting teams, including meeting of Disclosure Practices Committee regarding, among other things: planning for Q4 and year-end earnings release; Form 10-K and proxy season reporting; disclosure/materiality issues relating to public disclosures; review of disclosure controls and procedures and internal control over financial reporting; and CEO/CFO certifications for Form 10-K	<i>Company</i>
December 1 – 10	Schedule appropriate meetings for actions to be taken by Audit, Compensation, Nominating & Governance, and other Board Committees, and Disclosure Practices Committee and other management committees for upcoming year	<i>Company</i>
December 5 – 9	Determine whether company or any intermediaries will use SEC “householding” rules regarding delivery of annual meeting materials	<i>Company/ Legal Counsel</i>
December 5 – 16	Review Regulation FD policy, provide training sessions for applicable personnel and confirm a response team is prepared to act upon unintentional disclosures	<i>Company</i>

Date*	Item	Responsibility
December 19 – 23	Determine whether preliminary proxy statement will be required; if so, revise schedule accordingly, including accelerating initial filing of proxy statement	<i>Company/ Legal Counsel</i>
	Determine whether company will elect to use “notice-only” or “full-set delivery” proxy solicitation model, or a combination of both, and revise schedule accordingly <i>(Companies using the notice-only option, including in combination with full-set delivery, must post proxy materials on website and send Notice of Internet Availability at least 40 calendar days before the date of the annual meeting, and some intermediaries have indicated that they require companies to furnish information required for Notice of Internet Availability as much as 47 calendar days before the date of the annual meeting)</i>	<i>Company/ Legal Counsel</i>
December 23 – 26	Determine printing and mailing logistics for the Notice of Internet Availability <i>(Notice must be sent in paper to each shareholder and beneficial owner unless affirmative consent to electronic delivery has previously been given)</i>	<i>Company</i>
	Select provider for web hosting of proxy materials	<i>Company</i>
	Confirm whether company is a “large accelerated filer” or “accelerated filer” under SEC rules and revise schedule if needed (<i>See Chapter 4</i>)	<i>Company</i>
	Determine whether a proxy solicitor will be used	<i>Company</i>
	Select printer(s) for proxy materials, Form 10-K and annual report to shareholders (as well as determine if annual report to shareholders will have special graphics or photography)	<i>Company</i>

Date*	Item	Responsibility
	Determine record date, agenda, location, time and date of annual meeting; if company will be holding “virtual-only” or “hybrid” annual meeting, consider whether any control numbers to be used on Notices of Internet Availability and proxy cards will comply with provider requirements for shareholders to attend and vote at virtual meeting	<i>Company</i>
December 26 – 30	Distribute D&O Questionnaires (including Audit Committee financial expert/independence materials and Compensation Committee independence materials) relating to annual proxy statement, Form 10-K and Form 5s	<i>Company/ Legal Counsel</i>
December 31	End of Q4 and reporting year	
January 2 – 4	Planning meeting to review and update business section, MD&A and risk factors in Form 10-K	<i>Company/ Legal Counsel/ Auditors</i>
January 3 – 10	Begin closing books and compiling information for financial statements and notes for Q4 and year-end; continue coordinating with auditors regarding Q4 and year-end audit; draft financial statements and notes for Q4 and year-end; draft Q4 earnings release	<i>Company/ Auditors</i>
January 5 – 23	Draft Form 10-K, including financial statements and notes	<i>Company</i>
	<p>In connection with iXBRL reporting requirements:</p> <ul style="list-style-type: none"> • If self-tagging data in iXBRL, begin selecting or extending taxonomy, then map each line item to the correct iXBRL element • If not self-tagging, contact third-party service provider to determine date on which financial statements must be submitted for tagging 	<i>Company</i>

Date*	Item	Responsibility
<p>January 8 – 15 <i>(assuming company will file its definitive annual proxy materials between March 29 and April 5)</i></p>	<p>Final date company may file with SEC no-action requests regarding shareholder proposals for annual proxy statement <i>(Rule 14a-8 under the 1934 Act requires filing no-action requests no later than 80 calendar days prior to filing of definitive proxy materials with SEC)</i></p>	<p><i>Company/ Legal Counsel</i></p>
<p>January 9 – 11</p>	<p>Schedule quarterly notifications to be provided to insiders regarding the opening of the insider trading windows <i>(Generally notify insiders two or three weeks before quarterly earnings release, although timing will depend on company policy)</i></p>	<p><i>Company</i></p>
<p>January 11</p>	<p>Completed D&O Questionnaires due back to company</p>	<p><i>Company</i></p>
<p>January 15 <i>(assuming prior year's annual meeting was held on May 15 and advance notice provision of company's bylaws provides that shareholder nominations and other proposals must be made no earlier than 120 days prior to the anniversary of the prior year's annual meeting date. Note: company's bylaws may provide for different period)</i></p>	<p>First date for receipt of shareholder's director nominations and other shareholder proposals that may be brought before annual meeting if not otherwise included in company's proxy statement pursuant to Rule 14a-8 under the 1934 Act</p>	<p><i>Company/ Legal Counsel</i></p>
<p>January 24</p>	<p>Distribute complete Form 10-K and Q4 earnings release to legal counsel and auditors for initial review</p>	<p><i>Company</i></p>

Date*	Item	Responsibility
January 30	Initial comments due back to company from legal counsel and auditors on complete Form 10-K and Q4 earnings release	<i>Legal Counsel/ Auditors</i>
February 1 – 6	Senior management initial review of Form 10-K and Q4 earnings release	<i>Company</i>
February 1 – 7	Prepare Board resolutions relating to annual meeting and reporting actions for February 20 – 21 Board meeting, together with related Board Committee resolutions	<i>Company/ Legal Counsel</i>
February 1 – 14	Prepare first draft of annual proxy statement, proxy card and notice, including Audit Committee Report, Compensation Discussion & Analysis (CD&A), compensation tables and Compensation Committee Report	<i>Company</i>
	Confirm “Named Executive Officers” for proxy statement	<i>Company</i>
February 6 – 10	Revise Form 10-K and Q4 earnings release	<i>Company</i>
February 10	Distribute revised Form 10-K and Q4 earnings release per management’s review to legal counsel and auditors for review	<i>Company</i>
February 12	Comments due back to company from legal counsel and auditors on Form 10-K and Q4 earnings release	<i>Legal Counsel/ Auditors</i>
February 13 – 14	Disclosure Practices Committee Meeting regarding review of, and issues relating to, Q4 earnings release and Form 10-K, and disclosure controls and procedures and internal control over financial reporting, and conducting follow-up Q&A with business unit managers and other employees relating to Form 10-K and CEO/CFO certifications	<i>Company</i>

Date*	Item	Responsibility
February 14	Hold diligence session regarding CEO/CFO certifications for Form 10-K and management's report on internal control over financial reporting to, among other things, review Disclosure Practices Committee report and review disclosure controls and procedures and internal control over financial reporting	<i>Company</i>
	Form 5s due at SEC regarding securities transactions made in prior reporting year relating to securities transactions not disclosed in Form 4 filings for prior reporting year <i>(Required to be filed with SEC on or before the 45th day following the end of the reporting year)</i>	<i>Company/ Legal Counsel</i>
	Deadline for eligible shareholders to file reports or amendments on Schedule 13G <i>(Required to be filed with SEC on or before the 45th day following the end of the calendar year)</i>	<i>Shareholders</i>
	Communicate with transfer agent, proxy solicitor (if engaged) and printer regarding: <ul style="list-style-type: none"> • Proxy solicitation timetable • Record date • Annual meeting date • Annual proxy statement and related materials • Name and address of financial printer • Request for shareholder lists as of the record date • Instructions as to ordering and printing of mailing and return envelopes and proxy cards • Confirmation of availability of post office box for return of proxies, if applicable • Electronic voting and dedicated website for e-proxy 	<i>Company</i>

Date*	Item	Responsibility
February 14 – 16	<p>Communicate with banks, brokerage processing servicer and the Depository Trust Company (DTC), informing them of record date and the annual meeting date <i>(SEC regulations require that these communications be done at least 20 business days prior to the record date)</i></p>	<i>Company</i>
<p>February 14 <i>(assuming prior year's annual meeting was held on May 15 and advance notice provision of company's bylaws provides that shareholder nominations and other proposals must be made no later than 90 days prior to the anniversary of the prior year's annual meeting date. Note: company's bylaws may provide for different period)</i></p>	<p>Final date for receipt of shareholder's director nominations or other shareholder proposals that may be brought before annual meeting if not otherwise included in company's proxy statement pursuant to Rule 14a-8 under the 1934 Act</p>	<i>Company</i>
February 15	<p>Distribute substantially final draft of Form 10-K (and in case of Board and Committees, other relevant Board and Committee materials) to Board, Committees, key senior management, legal counsel and auditors for final review</p>	<i>Company/ Legal Counsel/ Auditors</i>
	<p>Distribute complete proxy statement and related materials, including Compensation Committee and Audit Committee Reports, to legal counsel for initial review</p>	<i>Company</i>
February 15 – 17	<p>Obtain CEO and CFO certifications and applicable subcertifications for Form 10-K</p>	<i>Company</i>

Date*	Item	Responsibility
February 20 – 21	Nominating & Governance Committee Meeting to: <ul style="list-style-type: none"> • Review and recommendation of slate of director nominees • Review Board and Committee compensation for recommendation to Board 	<i>Company</i>
	Compensation Committee Meeting <ul style="list-style-type: none"> • Approve prior year executive bonuses, as needed • Review draft of CD&A for proxy statement 	<i>Company</i>
	Audit Committee Meeting to: <ul style="list-style-type: none"> • Review Q4 and year-end financial results, including Q4 earnings release • Review Disclosure Practices Committee report relating to Q4 and year-end financial results • Review final audited financial statements with company and auditors, recommend audited financial statements for inclusion in Form 10-K, and review other applicable parts of Form 10-K, including MD&A • Review auditors' and management's reports and discuss issues relating to disclosure and internal control over financial reporting • Review auditors' report on all critical accounting policies and practices; alternative GAAP-compliant accounting treatments available for material items, including impact of different treatments; and any material written communications between auditors and management, including the management letter 	<i>Company</i>

Date*	Item	Responsibility
	<p>Board Meeting to, among other things, and as necessary:</p> <ul style="list-style-type: none"> • Approve annual meeting date, time, location and record date • Approve business to be transacted at annual meeting • Approve inspectors of election with power of substitution • Appoint officers to vote proxies with full power of substitution • Determine slate of director nominees and recommendation of slate to shareholders (including any shareholder nominations) • Approve Form 10-K in substantially the form presented to Board • Approve Board and Committee compensation • Review any reports from Audit Committee, including any reports regarding financial reporting and internal control over financial reporting <p><i>(Notify applicable exchange of annual meeting and record dates per exchange requirements)</i></p>	<p><i>Company</i></p>
	<p>Obtain signature pages and powers of attorney from Board members for Form 10-K</p>	<p><i>Company</i></p>
<p>February 21</p>	<p>Release Q4 and year-end numbers in earnings release; conference call regarding Q4 and year-end financial results</p> <p><i>(Make applicable financial information available on website and applicable report filing with SEC)</i></p>	<p><i>Company</i></p>
	<p>Initial comments due back to company from legal counsel on complete proxy statement and related materials, including Compensation Committee and Audit Committee Reports</p>	<p><i>Legal Counsel</i></p>

Date*	Item	Responsibility
February 22 – 26	Senior management initial review of proxy statement and related materials, including Compensation Committee and Audit Committee Reports	<i>Company</i>
February 22 – 23	Obtain executed report for audited financial statements and consents from auditors for filing as an exhibit to Form 10-K, including auditors' attestation report on management's report on internal control over financial reporting	<i>Company/ Auditors</i>
February 23 – March 1	File Form 10-K with SEC <i>(SEC regulations require that large accelerated filers file Form 10-K with SEC via EDGAR within 60 days of end of reporting year; accelerated filers are required to file Form 10-K within 75 days after end of reporting year; all other registrants are required to file 10-K within 90 days after end of reporting year. See Chapter 4.)</i>	<i>Company</i>
February 27 – March 6	Company must provide shareholders whose Rule 14a-8 shareholder proposals will be accompanied by a Board Opposition Statement in annual proxy statement with a copy of the Board Opposition Statement <i>(Generally must be sent to applicable shareholders 30 calendar days prior to distribution of definitive annual proxy materials)</i>	<i>Company/ Legal Counsel</i>
February 27 – March 3	Revise proxy statement and related materials, including Compensation Committee and Audit Committee Reports	<i>Company</i>
March 4	Distribute revised proxy statement and related materials, including Compensation Committee and Audit Committee Reports per management's review to legal counsel for review	<i>Company</i>

Date*	Item	Responsibility
March 6	Comments due back to company from legal counsel on proxy statement and related materials, including Compensation Committee and Audit Committee Reports	<i>Legal Counsel</i>
March 6 – 8	Prepare meeting admission guidelines and assign annual meeting responsibilities for: <ul style="list-style-type: none"> • Hosts (to direct seating, distribute and collect ballots) • Welcoming committee (officers assigned to greet shareholders and guests) • Arbiters (legal counsel or corporate secretary's staff who will handle difficult questions or complicated situations with regard to admission to the meeting) • Coordinating physical layout, security, audio/visual arrangements and webcast of the meeting, if applicable 	<i>Company</i>
March 10	If company has not already done so, notify applicable exchange of annual meeting date and record date pursuant to applicable exchange requirements <i>(Generally must be done at least 10 business days prior to record date)</i>	<i>Company</i>
	Distribute proxy materials and substantially final draft of annual report to shareholders or Form 10-K wrap (and in case of Board and Committees, other relevant Board and Committee materials) to Board, Committees, key senior management and legal counsel for review	<i>Company/ Legal Counsel</i>
March 15	Compensation Committee Meeting to: <ul style="list-style-type: none"> • Approve Compensation Committee Report and CD&A for inclusion in the annual proxy statement 	<i>Company</i>

Date*	Item	Responsibility
	<p>Nominating & Governance Committee Meeting to:</p> <ul style="list-style-type: none"> • Recommend Committee assignments 	
	<p>Audit Committee Meeting to:</p> <ul style="list-style-type: none"> • Review auditors' relationship with company, including the lead partner's performance • Review auditors' annual report on its internal quality control procedures, including any issues raised through its internal review, and the assessment of auditors' independence • Appoint independent auditors (including review and applicable preapproval and approval of services and fees and such policies) • Review and approve Audit Committee Report for proxy statement • Recommend financial expert(s) • Review audit fees to be listed in the proxy statement 	<i>Company</i>
	<p>Board Meeting to, among other things, and as necessary:</p> <ul style="list-style-type: none"> • Approve proxy materials and annual report to shareholders in substantially the form presented to Board • Approve independence determinations of directors • Appoint Committee members • Appoint financial expert(s) • Review Audit Committee and Compensation Committee Reports for proxy statement 	<i>Company</i>
March 16 – 19	Finalize annual proxy statement and related materials	<i>Company/ Legal Counsel</i>
	Deliver draft of proxy card to website host and transfer agent; work with	<i>Company/ Legal Counsel</i>

Date*	Item	Responsibility
	website host on draft Notice of Internet Availability	
March 20 – 21	Send annual proxy statement and related materials, including proxy card, to printer	<i>Company/ Legal Counsel/ Printer</i>
	Send annual report to shareholders (or Form 10-K wrap) to printer <i>(This may be done earlier depending on formatting/ substance of annual report to shareholders)</i>	<i>Company/ Printer</i>
March 22 – 24	Blueline of annual proxy statement and related materials, including proxy card, to be reviewed and comments sent to printer; finalize annual proxy statement and related materials, including proxy card	<i>Company/ Legal Counsel</i>
	Blueline of complete annual report to shareholders delivered for review	<i>Company/ Legal Counsel/ Printer</i>
	Transfer agent ships preaddressed proxy cards to printer	<i>Company/ Transfer Agent</i>
March 26 – 31	Printer sends printed annual proxy materials and annual report to shareholders to transfer agent	<i>Company/ Printer/ Transfer Agent</i>
	Send required information to intermediaries for preparation of Notice of Internet Availability and posting of proxy materials on website <i>(If company elects notice-only model, some intermediaries have indicated that they require companies to furnish information required for Notice of Internet Availability as much as 47 calendar days before the date of the annual meeting)</i>	<i>Company</i>
March 26	RECORD DATE <i>(Depending on company bylaws and state law, generally set between 10 days and 60 days prior to the annual meeting date)</i>	<i>Company</i>

Date*	Item	Responsibility
	Ask transfer agent to confirm number of voting shares and supply certified list of record date shareholders	<i>Company/ Transfer Agent</i>
March 29 – April 5	File definitive proxy materials with, and send copies of annual report to shareholders to, SEC <i>(Copies of the definitive proxy statement, proxy card, Notice of Internet Availability and any other solicitation materials must be filed with SEC via EDGAR no later than the date such materials are first sent to shareholders. If company elects to use the notice-only model, the proxy materials must be filed at least 40 calendar days before the date of the annual meeting.)</i>	<i>Company/ Legal Counsel/ Printer</i>
	Send Notice of Internet Availability to shareholders concurrently with or after posting the proxy materials on company website <i>(If company elects to use the notice-only model, the notice must be sent at least 40 calendar days before the date of the annual meeting) (Notice must be sent in paper form unless shareholders have given affirmative consent to electronic delivery) (References to a “company website” include a third-party website that complies with SEC rules; note that SEC rules prohibit use of the SEC EDGAR website to satisfy website posting requirements)</i>	<i>Company</i>
	If company elects to use the full-set delivery model, mail annual proxy statement and related materials, including proxy card, to all shareholders; each annual proxy statement must be accompanied or preceded by an annual report to shareholders, which needs to include audited financial statements <i>(Depending on state law and company bylaws generally, written notice of the</i>	<i>Company/ Transfer Agent</i>

Date*	Item	Responsibility
	<i>annual meeting must be given not less than 10 nor more than 60 days before the date of the meeting to each shareholder entitled to vote at such meeting. Mailing must occur at least 20 to 30 days before annual meeting to timely receive brokers' votes)</i>	
	Distribute proxy statement and annual report to option holders and other applicable benefit plan participants	<i>Company/ Transfer Agent</i>
	If company elects to use the notice-only model for any portion of distribution, send copies of proxy materials to record holders and beneficial owners upon request <i>(Until the date of the annual meeting, copies requested must be sent within three business days of the shareholder request via first-class mail or equivalent)</i>	<i>Company</i>
March 31	End of Q1	
April 3 – 7	Meetings of internal reporting teams, including Disclosure Practices Committee, regarding Q1 financial statements, Form 10-Q, disclosure controls and procedures and internal control over financial reporting, and CEO/ CFO certifications for Form 10-Q	<i>Company</i>
April 7 – 19	Draft and review Form 10-Q, including financial statements and notes; coordinate with auditors regarding financial statements	<i>Company/ Auditors</i>
April 10 – 14	Complete annual meeting arrangements for preparation of: <ul style="list-style-type: none"> • Ballots • Programs • Agenda • Meeting script • Q&A book • Inspectors' reports 	<i>Company/ Legal Counsel</i>

Date*	Item	Responsibility
April 12 – May 1	Prepare and submit periodic reports on proxy returns to management; determine whether another proxy mailing is required	<i>Company/ Transfer Agent/ Proxy Solicitor</i>
April 14 – 19	Draft Q1 earnings release	<i>Company</i>
April 19	Distribute draft Form 10-Q, including financial statements and notes, and Q1 earnings release, to legal counsel and auditors	<i>Company</i>
April 19 – 24	Legal counsel and auditors review and provide comments on Form 10-Q and Q1 earnings release	<i>Legal Counsel/ Auditors</i>
April 22 – 26	Review annual meeting script, speeches, audio/ visual requirements, microphone requirements, catering arrangements, displays, parking requirements, security, procedure for checking in shareholders, coordination with news media and analysts and mechanics for webcast of the meeting, if applicable	<i>Company/ Legal Counsel</i>
April 25	Comments due back on draft Form 10-Q, including financial statements and notes, and draft Q1 earnings release from legal counsel and auditors	<i>Legal Counsel/ Auditors</i>
April 25 – May 1	If desirable, begin contacting by telephone those major shareholders who have not responded to proxy solicitation	<i>Company/ Transfer Agent</i>
	Confirm attendance of legal counsel and auditors at annual meeting	<i>Company</i>
April 25 – May 2	Revise Q1 financial statements, Form 10-Q and Q1 earnings release	<i>Company/ Legal Counsel/ Auditors</i>
April 28	Disclosure Practices Committee Meeting regarding issues relating to Q1 earnings release, disclosure controls and procedures and internal control over financial reporting, and	<i>Company</i>

Date*	Item	Responsibility
	conducting Q&A with business unit managers and other employees, relating to Form 10-Q, and CEO/CFO certifications	
April 30	Deadline for filing proxy materials with SEC if Form 10-K incorporates information by reference from the proxy materials; file amendment to Form 10-K on Form 10-K/A if proxy statement is not filed by this date	<i>Company</i>
May 2	Distribute Q1 financial statements, Form 10-Q, Q1 earnings release and other materials to Audit Committee	<i>Company</i>
May 3 – 4	Hold CEO/CFO Form 10-Q certifications diligence session with Disclosure Practices Committee to review Form 10-Q, review disclosure controls and procedures and internal control over financial reporting, and obtain CEO and CFO certifications and applicable subcertifications for Form 10-Q	<i>Company</i>
	Prepare script and management for earnings release conference call	<i>Company</i>
May 4	Have shareholder list open for examination <i>(The officer (usually the corporate secretary) in charge of the stock ledger must prepare and make available, at least 10 days before every annual meeting, a complete list of the shareholders entitled to vote at such meeting. Such list must be open to examination by any shareholder at the meeting place and, during ordinary business hours, for at least 10 days prior to the meeting at corporate headquarters. It must also be produced and kept at the time and place of the meeting during the whole time thereof, including on the virtual meeting website if the meeting is held virtually. The specifics and availability will depend</i>	<i>Company/ Transfer Agent</i>

Date*	Item	Responsibility
	<i>on company bylaws and state law requirements.)</i>	
May 8	Audit Committee Meeting to: <ul style="list-style-type: none"> • Review Q1 financial results, including the earnings release • Review Form 10-Q • Review Disclosure Practices Committee report relating to Q1 • Review auditors' report on all critical accounting policies and practices; alternative GAAP-compliant accounting treatments available for material items, including impact of different treatments; and any material written communications between auditors and management, including the management letter 	<i>Company</i>
May 8 – 10	Release Q1 numbers in earnings release; conference call regarding Q1 financial results <i>(Make applicable financial information available on website and applicable report filing with SEC)</i>	<i>Company</i>
	File Form 10-Q for Q1 with SEC	<i>Company</i>
May 13 – 14	Review meeting admission guidelines, "disruptive person" guidelines, proxy acceptance guidelines and any other applicable guidelines for annual meeting	<i>Company/ Legal Counsel</i>
	Senior management briefing regarding annual meeting	<i>Company</i>
	Final revisions to management reports to be made at annual meeting and any accompanying presentations	<i>Company</i>
	Set up annual meeting headquarters at meeting site; rehearsals and final briefings	<i>Company</i>

Date*	Item	Responsibility
May 14 – 16	ANNUAL MEETING OF BOARD AND BOARD COMMITTEE MEETINGS	<i>Company</i>
May 15	ANNUAL MEETING OF SHAREHOLDERS <i>(Notify applicable exchange of any changes in directors or executive officers as required)</i>	<i>Company</i>
	Complete Oath of Inspector of Election	<i>Company/ Inspector of Election</i>
May 16 – 19	Obtain final shareholder voting numbers in order to disclose results of annual meeting of shareholders on Item 5.07 of 8-K <i>(Information required to be filed within four business days after the end of the annual meeting; if annual meeting includes a say-on-frequency vote, company must file an amendment to the previously filed 8-K disclosing, in light of the Say-on-Frequency vote, company's decision on how frequently it will hold say-on-pay votes no later than 150 calendar days after the date of the annual meeting, but in no event later than 60 calendar days prior to the deadline for the submission of a Rule 14a-8 shareholder proposal for the subsequent annual meeting)</i>	<i>Company/ Legal Counsel</i>
May 17 – 24	If applicable, send to exchange any required certifications or affirmations consistent with applicable exchange rules <i>(NYSE rules require the submission of a CEO Written Affirmation within 30 days of annual meeting)</i>	<i>Company</i>
May 31	If applicable, file Form SD with SEC	<i>Company</i>
June 30	End of Q2	

Date*	Item	Responsibility
July 3 – 7	Meetings of internal reporting teams regarding Q2 financial statements, Form 10-Q, disclosure controls and procedures and internal control over financial reporting, and CEO/CFO certification for Form 10-Q	<i>Company</i>
July 7 – 19	Draft and review Form 10-Q, including financial statements and notes; coordinate with auditors regarding financial statements	<i>Company/ Auditors</i>
July 14 – 19	Draft Q2 earnings release	<i>Company</i>
July 19	Distribute Form 10-Q, including financial statements and notes, and Q2 earnings release to legal counsel and auditors	<i>Company</i>
July 19 – 24	Legal counsel and auditors review and provide comments on Form 10-Q and Q2 earnings release	<i>Legal Counsel/ Auditors</i>
July 20	Board and Committee Meetings <ul style="list-style-type: none"> • Annual review of committee charters and governance policies • Annual Board and Committee self-evaluations 	<i>Company</i>
July 25	Comments due back on Form 10-Q, including financial statements and notes, and Q2 earnings release from legal counsel and auditors	<i>Legal Counsel/ Auditors</i>
July 25 – August 1	Revise Q2 financial statements, Form 10-Q and Q2 earnings release	<i>Company/ Legal Counsel/ Auditors</i>
July 28	Disclosure Practices Committee Meeting regarding issues relating to Q2 earnings release, disclosure controls and procedures and internal control over financial reporting, and conducting Q&A with business unit managers and other employees, relating to 10-Q and CEO/CFO certifications	<i>Company</i>

Date*	Item	Responsibility
	Distribute Q2 financial statements, Form 10-Q, Q2 earnings release and other materials to Audit Committee	<i>Company</i>
August 2 – 3	Hold CEO/CFO Form 10-Q certifications diligence session with Disclosure Practices Committee to review Form 10-Q, review disclosure controls and procedures and internal control over financial reporting, and obtain CEO and CFO certifications and applicable subcertifications for Form 10-Q	<i>Company</i>
	Prepare script and management for Q2 earnings release conference call	<i>Company</i>
August 8	<p>Audit Committee Meeting to:</p> <ul style="list-style-type: none"> • Review Q2 financial results, including the earnings release • Review Form 10-Q • Review Disclosure Practices Committee report relating to Q2 • Review auditors’ report on all critical accounting policies and practices; alternative GAAP-compliant accounting treatments available for material items, including impact of different treatments; and any material written communications between auditors and management, including the management letter 	<i>Company</i>
August 8 – 10	<p>Release Q2 numbers in earnings release; conference call regarding Q2 financial results</p> <p><i>(Make applicable financial information available on website and applicable report filing with SEC)</i></p>	<i>Company</i>
	File Form 10-Q for Q2 with SEC (including, if necessary, notice requirements regarding shareholder proposals for next year’s proxy)	<i>Company</i>

Date*	Item	Responsibility
September 20	Board Meeting and Committee Meetings	<i>Company</i>
September 30	End of Q3	
October 2 – 6	Meetings of internal reporting teams regarding Q3 financial statements, Form 10-Q, disclosure controls and procedures and internal control over financial reporting, and CEO/CFO certification for Form 10-Q	<i>Company</i>
October 6 – 18	Draft and review Form 10-Q, including financial statements and notes; coordinate with auditors regarding financial statements	<i>Company/ Auditors</i>
October 13 – 18	Draft Q3 earnings release	<i>Company</i>
October 18	Distribute Form 10-Q, including financial statements and notes, and Q3 earnings release to legal counsel and auditors	<i>Company</i>
October 18 – 23	Legal counsel and auditors review and provide comments on Form 10-Q and Q3 earnings release	<i>Legal Counsel/ Auditors</i>
October 24	Comments due back on Form 10-Q, including financial statements and notes, and Q3 earnings release from legal counsel and auditors	<i>Legal Counsel/ Auditors</i>
October 24 – 31	Revise Q3 financial statements, Form 10-Q and Q3 earnings release	<i>Company/ Legal Counsel/ Auditors</i>
October 27	Disclosure Practices Committee Meeting regarding issues relating to Q3 earnings release, disclosure controls and procedures and internal control over financial reporting, and conducting Q&A with business unit managers and other employees, relating to Form 10-Q and CEO/CFO certifications	<i>Company</i>

Date*	Item	Responsibility
October 31	Distribute Q3 financial statements, Form 10-Q and Q3 earnings release to Audit Committee	<i>Company</i>
November 1	Prepare and distribute time and responsibility schedule for next year's annual proxy statement and annual reporting season to management, legal counsel and auditors	<i>Company</i>
November 1 – 2	Hold CEO/CFO Form 10-Q certifications diligence session with Disclosure Practices Committee to review Form 10-Q, review disclosure controls and procedures and internal control over financial reporting, and obtain CEO/CFO certifications and applicable sub-certifications for Form 10-Q	<i>Company</i>
	Prepare script and management for Q3 earnings release conference call	<i>Company</i>
November 6	<p>Audit Committee Meeting/Conference Call to:</p> <ul style="list-style-type: none"> • Review Q3 financial results, including the earnings release • Review Form 10-Q • Review Disclosure Practices Committee report relating to Q3 • Review CEO/CFO reporting and disclosure philosophy and internal communications and reporting design to set “tone at the top” for preparation of Form 10-K and financial statements • Review auditors’ report on all critical accounting policies and practices; alternative GAAP-compliant accounting treatments available for material items, including impact of different treatments; and any material written communications between auditors and management, including the management letter 	<i>Company</i>

Date*	Item	Responsibility
November 6 – 9	Release Q3 numbers in earnings release; conference call regarding Q3 financial results <i>(Make applicable financial information available on website and applicable report filing with SEC)</i>	<i>Company</i>
	File Form 10-Q for Q3 with SEC	<i>Company</i>
November 14	Board Meeting and Committee Meetings	<i>Company</i>
November 29 – December 6 <i>(assuming definitive annual proxy materials for last annual meeting were distributed to shareholders between March 29 and April 5)</i>	Final date for receipt of Rule 14a-8 shareholder proposals to be included in annual meeting proxy statement for upcoming year <i>(Rule 14a-8 under the 1934 Act generally requires that shareholder proposals be received by company at corporate headquarters no later than 120 days prior to the date of distribution of previous year's proxy materials if upcoming annual meeting is scheduled to be held within 30 days of previous year's annual meeting; if not, then the last day for Rule 14a-8 shareholder proposals is a "reasonable" time before printing proxy materials for upcoming annual meeting)</i>	<i>Company</i>

Appendix 2

Form 8-K Reportable Events and Filing Deadlines

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Entry Into a Material Definitive Agreement (or a Material Amendment of a Material Definitive Agreement)*	Item 1.01	Within four business days	Generally, agreements required to be filed as exhibits to Form 10-K or 10-Q under Item 601 of Regulation S-K will trigger Form 8-K disclosure, other than executive compensation agreements. Companies are encouraged, but not required, to file copies of the agreements as exhibits to Form 8-K. If not filed with Form 8-K, the agreements will be filed as exhibits to the company's periodic report for the period in which the agreement was entered or the next applicable registration statement.
Termination of a Material Definitive Agreement*	Item 1.02	Within four business days	Triggered only if termination is material to the company. No disclosure required if agreement terminates by expiration on its stated termination date or upon the parties' completion of their obligations under the agreement, or if the company believes in good faith that the agreement has not been terminated, unless the company has received notice of termination pursuant to agreement terms.

*These Items are subject to a limited safe harbor from public and private claims under Section 10(b) of the 1934 Act, and Rule 10b-5 under the 1934 Act for a failure to timely file a Form 8-K. The safe harbor extends only until the due date of the next periodic report for the relevant period in which the Form 8-K was not timely filed. In addition, failure to timely file these Items will not impair eligibility to use short-form registration statements on Form S-3 so long as the required Form 8-K is filed on or before the date of filing of the Form S-3 and otherwise meets the safe harbor requirements.

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Bankruptcy or Receivership	Item 1.03	Within four business days	Triggered by appointment of a receiver in federal or state bankruptcy proceeding or by entry of an order confirming a plan of reorganization, arrangement or liquidation.
Mine Safety-Reporting of Shutdowns and Patterns of Violations	Item 1.04	Within four business days	Triggered by receipt of specified orders or notices with respect to a coal or other mine of which the company or a subsidiary is an operator.
Completion of Acquisition or Disposition of Assets	Item 2.01	Within four business days	Report acquisition or disposition of a significant amount of assets other than in the ordinary course of business. Specific guidelines are provided for determining what is deemed to be a significant amount of assets.
Results of Operations and Financial Condition	Item 2.02	Within four business days To take advantage of the conditional exemption from filing for an earnings call, related earnings release must be accepted by the SEC prior to, and within 48 hours of, the call	Triggered by public announcement/release of material nonpublic information (or update of such information) regarding financial results/condition for a completed fiscal year or quarter (other than in Form 10-Q or 10-K). A quarterly earnings release will be furnished under this Item. Disclosure under this Item is deemed to be "furnished" and not "filed," unless the company provides that information is to be deemed "filed."

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Creation of a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement*	Item 2.03	Within four business days	<p>Triggered by:</p> <ul style="list-style-type: none"> • Entering into an enforceable agreement under which a material direct financial obligation will arise or be created. If no agreement, then triggered by closing or settlement of the transaction under which the direct financial obligation arises or is created. • Becoming directly or contingently liable for an obligation that is material arising out of an off-balance sheet arrangement. If the company or an affiliate is not party to the transaction or agreement creating a contingent obligation arising under the off-balance sheet arrangement, the four-business-day period for filing the Form 8-K begins on the earlier of (a) the fourth business day after the contingent obligation is created or arises and (b) the day on which an executive officer becomes aware of the contingent obligation. • Entering into an agreement, transaction or arrangement that comprises a facility, program or similar arrangement that creates or may give rise to direct financial obligations in connection with multiple transactions. <p>A <i>direct financial obligation</i> is a long-term debt obligation, capital lease obligation, operating lease obligation or short-term debt obligation arising other than in the ordinary course of business.</p>

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Triggering Events That Accelerate or Increase a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement*	Item 2.04	Within four business days	Triggered by the occurrence of an event of default, an event of acceleration or a similar "triggering" event that accelerates or increases a direct financial obligation or an obligation under an off-balance sheet arrangement with consequences material to the company.
Costs Associated with Exit or Disposal Activities*	Item 2.05	Within four business days	Triggered when the Board or an authorized officer commits the company to an exit or disposal plan, or otherwise disposes of a long-lived asset or terminates employees under a plan of termination, under which the company will incur a material write-off or restructuring charge.
Material Impairments*	Item 2.06	Within four business days	Triggered when the Board or an authorized officer concludes that a material charge for impairment to one or more assets, including impairments of securities or goodwill, is required under GAAP (except if conclusion is in connection with the preparation, review or audit of financial statements included in a timely filed periodic report).

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
<p>Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing</p>	<p>Item 3.01</p>	<p>Within four business days</p>	<p>Triggered by:</p> <ul style="list-style-type: none"> • Receipt of notice from the NYSE, Nasdaq or other domestic exchange of failure to satisfy continued listing standards, or that the exchange has taken delisting action; • Notice by the company to the NYSE, Nasdaq or other exchange of any material noncompliance with a continued listing standard; • Receipt of public reprimand letter or similar communication from the NYSE, Nasdaq or other exchange of a violation of a continued listing standard; or • Definitive Board or authorized officer action to withdraw listing from the NYSE, Nasdaq or other exchange.
<p>Unregistered Sales of Equity Securities</p>	<p>Item 3.02</p>	<p>Within four business days</p>	<p>Triggered by <i>sale</i>, but only if the securities sold, in the aggregate since the company's last report under this Item or its last periodic report, constitute 1% or more of the number of shares outstanding (5% or more for a smaller reporting company). <i>Sale</i> occurs when the company enters into an enforceable agreement under which equity securities are to be sold. If there is no written agreement, sale occurs on the date of closing or settlement of the sale. <i>Shares outstanding</i> include only actual shares outstanding (not convertible securities). Any disclosure not required to be reported under this Item on Form 8-K – because it does not meet Form 8-K size threshold – will continue to be required to be reported on Forms 10-Q and 10-K.</p>

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Material Modification to Rights of Security Holders	Item 3.03	Within four business days	Triggered by material modification to instruments (like articles of incorporation) that define the rights of shareholders or other security holders, or by the issuance or modification of any other securities that has a material adverse impact on those rights.
Changes in Certifying Accountant	Item 4.01	Within four business days	Triggered by resignation or dismissal of accountant or its refusal to stand for reappointment and, as a separate reportable event, by the engagement of a new accountant.
Nonreliance on Previously Issued Financial Statements*	Item 4.02(a)	Within four business days	Triggered when the Board, a Board Committee or an authorized officer concludes that any previously issued financial statements should no longer be relied on because of an error in those financial statements.
Nonreliance on Previously Issued Audit Report or Completed Interim Review	Item 4.02(b)	Within four business days	Triggered when the company is advised by its independent accountant that the company should make disclosure or take action to prevent further reliance on a previously issued audit report or interim review related to previously issued financial statements.
Changes in Control	Item 5.01	Within four business days	Triggered when the Board, a Board Committee or an authorized officer has knowledge that a change in control of the company has occurred.

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Departure of a Director as a Result of a Disagreement or Removal for Cause	Item 5.02(a)	Within four business days	Triggered when a director resigns or refuses to stand for reelection because of a disagreement with the company's operations, policies or practices, and that disagreement is known to an executive officer. If the director furnishes the company with any written correspondence concerning the circumstances surrounding the director's departure, the company must file the correspondence as an exhibit to Form 8-K. The company must also provide the Form 8-K disclosure to the director – not later than the day it is filed – and give the director an opportunity to furnish a letter stating whether the director agrees with the company's disclosures. If provided, the director's response letter must be filed as an exhibit by amendment to the previously filed Form 8-K within two business days of receipt by the company.
Any Other Departure of a Director or Any Departure of a Principal Officer or Named Executive Officer	Item 5.02(b)	Within four business days	Triggered by notice of a decision to resign, retire, refuse to stand for reelection or termination (or demotion in responsibilities or duties), except, with respect to a director, in circumstances covered by Item 5.02(a). Whether communications represent discussion or consideration, on the one hand, or notice of a decision, on the other, is a "facts and circumstances" determination. Principal officers include the company's principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer or any person performing similar functions. The named executive officers are those listed in the most recent proxy statement.

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Appointment of a New Principal Officer	Item 5.02(c)	Within four business days	Triggered on the date of appointment. However, if the company intends to make the first public announcement of the appointment other than by means of a Form 8-K after an applicable Form 8-K would otherwise be due, the company may file the Form 8-K on the day on which the company first publicly announces the appointment.
Election of a New Director Other Than by Shareholder Vote	Item 5.02(d)	Within four business days	Form 8-K is not required if the election is by vote of the shareholders at an annual meeting or a meeting called for that purpose.
Entry into or Amendment of Material Compensation Arrangement*	Item 5.02(e)	Within four business days	Applies to principal executive officer, principal financial officer and named executive officers. A termination should be disclosed if it constitutes a material amendment or modification.
Salary and Bonus Omitted from Summary Compensation Table	Item 5.02(f)	Within four business days	If a company omits from the Summary Compensation Table in its annual report or proxy statement, as applicable, the value of the salary or bonus earned by a named executive officer because it cannot calculate the value prior to filing its annual report or proxy statement, this Item requires the company to file a Form 8-K to report this information as soon as the amounts are calculable in whole or in part.
Amendments to the Company's Articles of Incorporation or Bylaws Other Than by Shareholder Vote	Item 5.03(a)	Within four business days	Form 8-K is not required if the amendments were adopted by the shareholders pursuant to a previously filed proxy statement.

Form 8-K Reportable Events and Filing Deadlines

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Change in Fiscal Year Other Than by Shareholder Vote	Item 5.03(b)	Within four business days	Form 8-K is not required if the change is approved by a shareholder vote through the solicitation of proxies or is effected through an amendment to the company's articles of incorporation or bylaws.
Temporary Suspension of Trading Under Company's Employee Benefit Plans	Item 5.04	Within four business days	Triggered by receipt of notice from the plan administrator of a pension fund trading blackout period. If notice is not received, then triggered by a Regulation BTR notification from the company to an affected officer or director of a pension fund trading blackout period. (We discuss Regulation BTR in more detail in Chapter 6.)
Amendment to the Company's Code of Ethics or Waiver of a Provision of the Code of Ethics	Item 5.05	Within four business days	Form 8-K filing is not required if the company provides the required disclosure on its website within four business days, and the company disclosed in its most recently filed Form 10-K its website address and intention to provide disclosure in this manner. This information must remain on the company's website for 12 months. (A company need not disclose technical, administrative or other non-substantive amendments to its code of ethics.) A waiver must be disclosed only when it relates to a material departure from a provision of the company's code of ethics.
Change in Shell Company Status	Item 5.06	Within four business days	If a company that was a shell company (other than a shell company related to a business combination) completes a transaction that effectively causes the company to cease being a shell company, then the material terms of the transaction need to be disclosed under this Item.

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Submission of Matters to a Vote of Security Holders	Item 5.07	Within four business days, beginning with the day on which the meeting ended	<p>Preliminary voting results must be disclosed within four business days if final voting totals are not available; if preliminary results are filed, final voting results must be filed as an amended report on Form 8-K.</p> <p>No later than 150 days after the end of a meeting at which shareholders vote on the frequency of the say-on-pay vote, the company's decision in light of that vote as to how frequently the company will include the say-on-pay vote in its proxy materials must be disclosed by amendment to the original Form 8-K disclosing the meeting's voting results, unless such decision was disclosed in the original Form 8-K.</p>
Shareholder Director Nominations	Item 5.08	Within four business days after the company determines the anticipated meeting date	<p>If a registrant is required to include shareholder director nominees in its proxy materials pursuant to applicable law or its governing documents, then the company must disclose the date by which a nominating shareholder must submit the notice on Schedule 14N required to be filed pursuant to Rule 14a-18 under the 1934 Act.</p> <p>The SEC has not provided any guidance on this Item, but it appears that the intended meaning is that this Item is triggered only if the company's advance notice bylaw does not provide a deadline for submission of shareholder director nominees, and the company did not hold an annual meeting the previous year or the date of this year's annual meeting has been changed by more than 30 days from the date of the previous year's meeting.</p>

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Events Related to Asset-Backed Securities	Items 6.01 – 6.06	Within four business days	Require the reporting of various events applicable to asset-backed securities, including the filing of informational and computational materials, change of servicer or trustee, change in credit enhancement or other external support, failure to make a required distribution, significant change (5% or more) in the asset pool relating to an offering of asset-backed securities, and static pool information.
Regulation FD Disclosure	Item 7.01	Comply with Regulation FD timing requirements	This Item can be used to comply with Regulation FD disclosure requirements. Disclosure under this Item is deemed to be “furnished” and not “filed,” unless the company provides that information is to be deemed “filed.”
Other Events	Item 8.01	No specific timing requirement If filing under this Item to disclose nonpublic information required to be disclosed by Regulation FD, comply with Regulation FD timing requirements	This Item can be used for voluntary disclosure of any events, with respect to information not otherwise required by Form 8-K, that the company deems of importance to shareholders. The company may file a report under this Item disclosing the nonpublic information required to be disclosed by Regulation FD. Unlike a filing under Item 7.01, disclosure under this Item is deemed to be “filed,” not “furnished.”

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Financial Statements and Exhibits	Item 9.01	<p>Financial statements required by Item 9.01 will be filed with initial Item 2.01 Form 8-K report (or by amendment not later than 71 calendar days after the date that initial Form 8-K is due)</p> <p>Other required exhibits are filed as required by the relevant Form 8-K Item.</p>	Requires filing of financial statements and pro forma financial information for certain business acquisitions required to be described under Item 2.01 of Form 8-K. Also calls for filing of other exhibits required by the relevant Form 8-K Item or Item 601 of Regulation S-K.

Appendix 3

Directors' and Officers' Liability Insurance: A Visual Guide

<u>Side A Coverage</u>	<u>Side B Coverage</u>	<u>Side C Coverage</u>
Provides coverage directly to directors and officers accused of wrongdoing when company fails to indemnify them	Reimburses company for its indemnification of directors and officers	“Entity coverage” for claims made against the company; typically, public companies are only covered for securities claims

HYPOTHETICAL POLICY PERIOD – JULY 1, 2030, TO JUNE 30, 2031

\$30M	<p style="text-align: center;">Side A (Excess) <i>123 Insurance Co.</i> \$5M Excess Coverage Over \$15M Primary and \$10M Secondary Layers (Coverage from this “difference-in-condition” policy “drops down” in certain situations where carrier below fails to pay) (Side A only)</p>	NO COVERAGE	NO COVERAGE
\$25M	<p>Second Layer (Excess) <i>XYZ Insurance Co.</i> \$10M Excess Coverage Limit Over \$15M Primary Layer (Side A, Side B, Side C)</p>		
\$15M	<p>Primary Layer <i>ABC Insurance Co.</i> \$15M Coverage Limit (Side A, Side B, Side C)</p>		
	\$0 Retention	\$1M Retention – Company’s Obligation	

Appendix 4

NYSE Listing Standards

Continued Listing Standards

This table summarizes the main NYSE continued listing standards applicable to most U.S. companies (investment companies, special purpose acquisition companies, foreign entities, affiliated companies, real estate investment companies and companies that have only listed debt or preferred securities, for example, will have some special standards) using publicly available information on the NYSE's website as of the time this Handbook went to press. When a company falls below any of these criteria, the NYSE usually gives consideration to prompt initiation of suspension and delisting procedures.

Stock Price Criteria	
Average closing price of the listed security over a consecutive 30 trading-day period is less than . . .	\$1.00
Financial Criteria	
Average global market capitalization over a consecutive 30 trading-day period is less than	\$50 million
together with	
Total shareholders' equity is less than	\$50 million
In addition, if a company's average global market capitalization over a consecutive 30 trading-day period is less than \$15 million, the NYSE will promptly initiate suspension and delisting procedures.	

Distribution Criteria	
Number of publicly held shares is less than	600,000
Number of total shareholders (generally including both beneficial and record holders) is less than . .	400
Number of total shareholders (generally including both beneficial and record holders) when average monthly trading volume for most recent 12 months falls below 100,000 shares, is less than . . .	1,200
(Note: Shares held by directors and officers (and their immediate families) and other concentrated holdings of 10% or more are excluded when calculating the number of publicly held shares)	
Qualitative Requirements	
Continued compliance with NYSE requirements and corporate governance standards	See Chapter 9
Absence of certain changes in a company's ongoing corporate status (e.g., sale or intent to cease use for any reason of substantial portion of operating assets; intent to file for bankruptcy or liquidation; SEC registration or periodic filing deficiency) . . .	Discuss with the NYSE as applicable

Appendix 5

The Nasdaq Global Select Market and The Nasdaq Global Market – Continued Listing Standards

This table summarizes the main Nasdaq Global Select Market and Nasdaq Global Market continued listing standards for listed primary equity securities (e.g., common stock) using publicly available information on Nasdaq’s website as of the time this Handbook went to press. Companies generally must meet all of the criteria under at least one of the three standards set forth below. When a company falls below any of these criteria, it should carefully review Nasdaq rules to determine appropriate next steps.

Standards	Equity Standard	Market Value Standard	Total Assets/ Total Revenue Standard
Minimum Bid Price*	\$1.00	\$1.00	\$1.00
Market Makers (registered and active)**	2	4	4
Total Shareholders	400	400	400
Shareholders’ Equity	\$10 million	N/A	N/A
Market Value of Listed Securities*	N/A	\$50 million	N/A
Total Assets AND Total Revenue* (in latest fiscal year OR in 2 of last 3 fiscal years)	N/A	N/A	\$50 million AND \$50 million
Publicly Held Shares (shares outstanding less any shares directly or indirectly held by officers, directors or beneficial owners of 10%)	750,000	1.1 million	1.1 million
Market Value of Publicly Held Securities*	\$5 million	\$15 million	\$15 million
Continued Compliance with Corporate Governance and Disclosure Standards	Yes	Yes	Yes

* Company will be noncompliant if standard is not met for a period of 30 consecutive business days.

** Company will be noncompliant if standard is not met for a period of 10 consecutive business days.

The Nasdaq Capital Market – Continued Listing Standards

This table summarizes the main Nasdaq Capital Market continued listing standards for listed primary equity securities (e.g., common stock) using publicly available information on Nasdaq’s website as of the time this Handbook went to press. Companies generally must meet all of the criteria under at least one of the three standards set forth below. When a company falls below any of these criteria, it should carefully review Nasdaq rules to determine appropriate next steps.

Standards	Equity Standard	Market Value of Listed Securities Standard	Net Income Standard
Minimum Closing Bid Price*	\$1.00	\$1.00	\$1.00
Market Makers (registered and active, one of which may be entering a stabilizing bid)**	2	2	2
Public Holders (shares outstanding less any shares directly or indirectly held by officers, directors or beneficial owners of 10%)	300	300	300
Shareholders’ Equity	\$2.5 million	N/A	N/A
Market Value of Listed Securities*	N/A	\$35 million	N/A
Net Income from Continuing Operations (in latest fiscal year OR in 2 of last 3 fiscal years)	N/A	N/A	\$500,000
Publicly Held Shares (shares outstanding less any shares directly or indirectly held by officers, directors or beneficial owners of 10%)	500,000	500,000	500,000
Market Value of Publicly Held Securities*	\$1 million	\$1 million	\$1 million
Continued Compliance with Corporate Governance and Disclosure Standards	Yes	Yes	Yes

* Company will be noncompliant if standard is not met for a period of 30 consecutive business days.

** Company will be noncompliant if standard is not met for a period of 10 consecutive business days.

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