THE SEC SPEAKS IN 2016

DIVISION OF CORPORATION FINANCE PANEL

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The SEC Speaks in 2016: Division of Corporation Finance Panel

Senior members of the Division of Corporation Finance ("Corp Fin") of the U.S. Securities and Exchange Commission (SEC) gathered with two former SEC commissioners at the Practising Law Institute's annual "SEC Speaks" conference in Washington, D.C. last month to reflect on some of Corp Fin's work in 2015 and to discuss priorities for 2016.

Shelley Parratt, deputy director of Corp Fin, opened the panel by noting that, in fiscal 2015, Corp Fin reviewed the periodic reports of 4,400 companies and initial public offerings (IPOs) of approximately 600 companies, issued numerous Compliance and Disclosure Interpretations ("C&DIs"), updated Corp Fin's *Financial Reporting Manual,* and proposed numerous recommendations to the SEC for proposed and final rules. We set forth below highlights from the SEC Speaks conference relating to SEC rulemaking, the 2016 proxy season, and recent staff interpretations and reports.

Rulemaking

Dodd-Frank – Executive Compensation and Corporate Governance

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), signed into law on July 21, 2010, the SEC was tasked with issuing certain rulemakings related to executive compensation and corporate governance. Known colloquially as the "Four Horsemen" or "Gang of Four," the rules prescribe disclosure related to the areas of CEO pay ratio, hedging, clawbacks and pay for performance. In 2015, the SEC adopted a final rule implementing the CEO pay ratio disclosure requirements and proposed separate rules related to hedging, clawbacks and pay for performance.

David Frederickson, Chief Counsel of Corp Fin, discussed the three pending rulemakings, noting that Corp Fin has received significant commentary on the proposed rules. He added that the SEC hopes to have final rules in place by 2017, though he did not specify whether the final rules would apply to the 2017 proxy season (or, as is the case with the pay ratio rules, the 2018 proxy season).

The proposed rule on hedging policies would require companies to disclose whether or not they allow employees and directors to purchase financial instruments designed to offset moves in underlying equity securities of the company. Frederickson stated that several commenters were concerned over the potential scope of the proposed rule, questioning, for example, whether an issuer that prohibited hedging generally, but permitted general portfolio diversification strategies (i.e., the purchase of broad-based indices), could nonetheless disclose that it prohibited all hedging transactions. He further noted that commenters have asked whether nonexecutive employees should be covered and, if so, how the policies and or disclosures might be different from those applicable to executive officers and directors.

Frederickson next addressed the proposed rule on pay for performance, which would require companies to disclose clearly the relationship between executive compensation actually paid and the financial performance of the company. Much of the debate has focused on how strict and standardized the disclosure should be. He pointed out that the statute requires "taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions," thereby implying total shareholder return (TSR), which is how the SEC drafted the proposed rule. Frederickson asserted that the Staff is aware of the significant external debate centered on the characterization of TSR and is trying to determine how the rule should work. He also stated that, notwithstanding the freedom given to companies when applying the executive compensation rules on an individualized basis, part of the driving goal behind the rule on pay for performance is to standardize the way companies report the compensation discussion and analysis.

Lastly, Frederickson addressed the proposed rule on clawbacks, which would require the SEC to direct exchanges to establish listing standards requiring issuers to adopt policies that require executive officers to pay back "incentive-based compensation" that is later shown to have been awarded erroneously. As proposed, incentive-based compensation is defined as "any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure." He stated that the challenge has been to determine what financial reporting measures should be included in this definition. While the Staff has proposed including TSR, it acknowledged that estimating TSR and figuring out what amount of compensation was overpaid might be difficult for companies. Frederickson stated that commenters also have questioned whether boards should have discretion with regard to how much compensation to recover, given their fiduciary duties. He pointed out that the statute states that issuers "will recover," which offers wide latitude and a no-fault basis for recovery.

Frederickson concluded his remarks by noting that the Staff is considering all of these issues and preparing recommendations for the commissioners.

FAST Act – Related Securities Provisions

The Fixing America's Surface Transportation Act ("FAST Act"), a $305 billion bill signed into law on December 4, 2015, to provide long-term funding certainty for surface transportation, included a number of securities-law-related provisions that had previously been the subject of individual congressional bills. Elizabeth Murphy, associate director in the Office of Rulemaking, noted that, on January 13, 2016, the SEC issued interim final rules implementing two provisions of the FAST Act.

The first set of rules permits an emerging growth company (EGC) that files an IPO registration statement (or submits a confidential draft registration statement) on Form S-1 or Form F-1 to omit Regulation S-X financial information for historical periods otherwise required as of the time of filing (or confidential submission), provided that (i) the omitted financial information relates to a historical period that the EGC reasonably believes will not be required to be included in the Form S-1 or Form F-1 at the time of the offering, and (ii) prior to the distribution of a preliminary prospectus to investors, the registration statement is amended to include all financial information required by Regulation S-X at the date of such amendment. Murphy noted that the amendments to Form S-1 and Form F-1 will permit EGCs to avoid the costs and burdens of including historical financial statements and related disclosures in their IPO registration statement that will not be part of the registration statement at the time the IPO is marketed and priced (i.e., such financial statements will be superseded by more recent financial statements).

The second set of rules also revised Form S-1 to permit smaller reporting companies (SRCs) to automatically update information in a Form S-1 prospectus by forward incorporation of reports filed with the SEC after the registration statement is declared effective. Eligibility for this forward incorporation by reference depends on eligibility for historical incorporation by reference.

Murphy stated that registrants can immediately rely on the interim final rules, which became effective on January 19, 2016. Murphy noted that the request for comments on the interim rules closed on February 18, 2016, and that many commenters, not surprisingly, had asked the SEC to extend the rule accommodations to all companies, not just EGCs and SRCs. She said the Staff was working to convert the interim final rules to final rules and noted that any additional rulemakings stemming from comments would be published for notice and comment. Finally, Murphy stated that other FAST Act rulemakings, which are mandated by June 1, 2016, are forthcoming, including rules allowing a company to include a summary page in its Form 10-K, provided that each item includes a hyperlinked cross-reference to the more detailed item later in the filing.

Rules 147 and 504

Rule 147 of the Securities Act of 1933 (the "Securities Act"), adopted in 1974, is a safe harbor based on Securities Act Section 3(a)(11), the "intrastate exemption," which exempts from registration offers and sales of securities to residents of the same state or territory in which the issuer resides or does business. Rule 147 has become

more prominent in the last few years as more states have developed intrastate crowdfunding provisions. Another exemption, Rule 504 of the Securities Act, adopted in 1982 as part of Regulation D and often referred to as the "seed capital exemption," exempts from registration offers and sales of up to $1 million of securities over a 12-month period.

In October 2015, the SEC proposed amendments to both Rule 147 and Rule 504 to assist small companies with capital formation. The impetus behind the proposed amendments was not a congressional mandate, but rather a widely perceived need to modernize the exemptions. Sebastian Gomez Abero, chief of the Office of Small Business Policy, stated that the SEC considered the observations and recommendations of a number of disparate market participants, including the North American Securities Administrators Association (NASAA) and the SEC's Advisory Committee on Small and Emerging Companies, as to the general utility of the exemptions and the areas in which they could be updated.

With respect to Rule 147, Gomez Abero noted that the rule has not been substantively revised since 1974 and that some commenters have complained that it has not kept pace with the changing business environment and current technology. He acknowledged that existing limitations under the rule have hindered its usefulness in the electronic age, noting that, because the Internet knows no territorial boundaries, compliance with the in-state residency requirement has become exceedingly difficult. Based on the Staff's recommendations, the SEC proposed amendments to the exemption that would help facilitate capital formation by:

- eliminating the restrictions on offers so that an offer could be made to anyone, not just in-state residents
- continuing to require, however, that all purchasers be residents of the same state as the issuer
- easing issuer eligibility requirements
- limiting the exemption to offerings of up to $5 million of securities over a 12-month period, together with an investment limitation on investors.

With respect to Rule 504, Gomez Abero noted that the $1 million limit on the exemption has not changed since it was raised from $500,000 in 1988. Based on the Staff's recommendations, the SEC proposed amendments to raise the limit on offerings to $5 million of securities and to add bad-actor disqualifications similar to those found in Rules 505 and 506.

In closing, Gomez Abero stated that the proposed amendments would facilitate smaller companies' ability to raise capital and give state regulators greater flexibility to implement coordinated review programs to promote regional offerings. He added that the comment period on the rule amendments closed on January 12, 2016, and that the Staff had received 26 comments, which were generally supportive of both proposed rules.

Crowdfunding

Crowdfunding, a relatively new and evolving form of alternative finance, is the practice of funding a project or venture by raising monetary contributions from a large number of investors. Often conducted via the Internet, an entity or individual raising funds through crowdfunding typically solicits small contributions from individuals interested in the crowdfunding campaign (i.e., members of the "crowd"). Such members may share information about the project, cause, idea or business with each other and use the information to decide whether to fund the campaign based on the collective "wisdom of the crowd."

On October 30, 2015, the SEC adopted Regulation Crowdfunding, pursuant to the mandate under Title III of the Jumpstart Our Business Startups Act (the "JOBS Act"). Title III added new Securities Act Section 4(a)(6), which provides an exemption from registration for certain crowdfunding transactions. Regulation Crowdfunding prescribes rules governing the offer and sale of securities under new Section 4(a)(6) and also provides a framework for the regulation of registered funding portals and broker-dealers that issuers are required to use as intermediaries in

the offer and sale of securities in reliance on Section 4(a)(6). Per Regulation Crowdfunding, issuers engaged in crowdfunding activities will be required to file on “Form C” detailed information about:

- the issuer and its business, capital structure and material debt
- the use of offering proceeds
- the offering itself, including how the securities were valued and target offering amounts and deadlines
- securities transfer restrictions
- intermediary compensation and ownership interest in the issuer
- a narrative discussion of the issuer’s financial condition
- other information related to the issuer.

As permitted, crowdfunding portals have been registering with the SEC since late January 2016. While the rules for issuers will not go into effect until May 16, 2016, issuers have been able to submit a test filing on Form C since December. Per Gomez Abero, the benefits of test filings are twofold: first, the Staff is able to solicit feedback on the new electronic form, and, second, issuers can become familiar with the mechanics of the filing process in advance of the rules going into effect. In closing, Gomez Abero reminded issuers that the Staff had a press release on the Corp Fin website with instructions for conducting a test filing and that testing of Form C would remain open until the end of February 2016.

Proxy Season

Universal Proxy Balloting

In contested elections for a company’s board of directors, an outside party will nominate and run its own slate of directors to contest those directors proposed by the company. Today, when voting by proxy in such situations, shareholders cast their votes by returning either management’s proxy card or the outside party’s proxy card. By operation of federal and state securities laws, shareowners have a limited ability to vote for a mix of management and dissident nominees, unless they attend the meeting and vote in person. Given this issue, significant discussion has occurred about whether the current proxy rules provide shareholders with a sufficient range of choices in casting votes in a contested election.

As explained by Michele Anderson, associate director in the Office of Disclosure Operations, universal proxy balloting contemplates a single proxy card in contested elections that includes both the company’s slate of directors and an outside party’s slate of directors. In January 2014, the Staff received a rulemaking proposal from the Council

of Institutional Investors requesting that universal proxy balloting be mandatory in all contested elections. Before that, the Investor Advisory Committee recommended that the SEC provide the ability for parties to use universal proxy balloting at their option in certain short-slate director nominations. Last year, the SEC held a roundtable to discuss potential improvements to the proxy voting process, including universal proxy balloting. Per Anderson, a common theme in the discussions was that the proxy rules should allow shareholders to do by proxy what they can do by attending a shareholders meeting in person. Several panelists agreed that the current iteration of rules is not achieving this goal in contested elections.

Based on these discussions, as well as suggestions from outside commenters Chair White asked the Staff to develop rules related to universal proxy balloting for the SEC's consideration. Anderson stated that it is far too early to speculate on what actions the SEC may take on the Staff's proposals. However, she did offer several insights from the Staff's efforts, namely that:

- it was looking at the issue from the vantage point of a shareholder who wants to vote for a mix of directors that would best serve the company
- it does not favor the position of the company or outside party and that, in any event, it is not clear that universal proxy balloting would favor one or the other anyway
- it is cognizant of situations where control of the board of directors may be at stake.

Anderson then noted that the key issues being considered were:

- whether universal proxy balloting should be optional or mandatory, and under what circumstances
- when universal proxy balloting should be permitted or required (e.g., every election or only when minority control of the board is at stake)
- what a universal proxy card would look like (e.g., both sides being identical or each side tailored to the party's suiting).

Shareholder Proposal Season

Rule 14a-8 of the Securities Exchange Act of 1934 (the "Exchange Act") establishes a process for shareholders to submit proposals for inclusion in company proxy materials and provides certain bases under which companies may exclude such proposals. Per Rule 14a-8, a company must include a shareholder proposal in its proxy materials, unless it violates one of the rule's eligibility and procedural requirements or falls within one of the rule's 13 substantive bases for exclusion. During each proxy season, the Staff considers the arguments of companies seeking the exclusion of shareholder proposals and issues "no-action" relief to companies in instances where exclusion is appropriate.

Frederickson, whose office oversees the Rule 14a-8 process, initiated his remarks by noting that the volume of no-action letters seeking exclusion of shareholder proposals was down significantly from recent years. Also, as compared to 2015, which saw significant developments with respect to the exclusions for "conflicting proposals" and "ordinary business decisions" that culminated in the issuance of Staff Legal Bulletin No. 14H in October 2015, Frederickson stated that the 2016 shareholder proposal season has been fairly quiet.

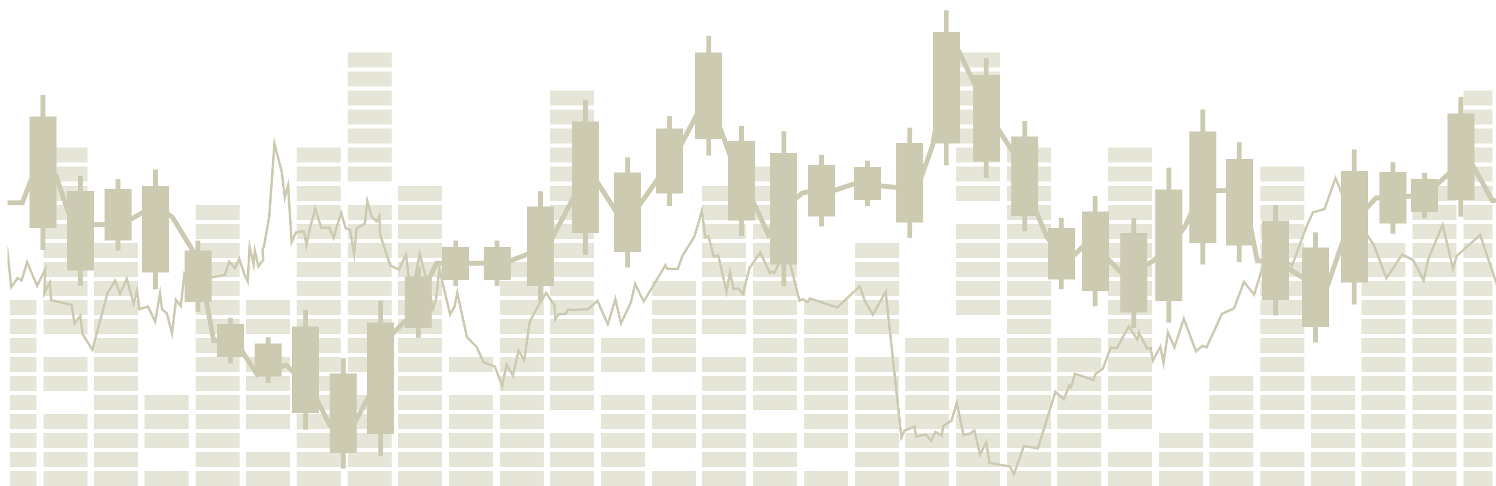
Frederickson did note, however, that the Staff recently granted no-action relief to 15 companies seeking to exclude proxy access shareholder proposals under Rule 14a-8(i)(10) on the basis that the companies already had "substantially implemented" the shareholder proposal. The companies' proxy access bylaws and the shareholder proposal proxy access bylaws each had three-year and three percent ownership standards, but the companies' access bylaws differed, for example, on aggregation limits and the maximum number of proxy access candidates. Frederickson explained that the Staff will grant relief even when the company's proxy access bylaw deviates from the shareholder proposal so long as differences are limited to less material aspects of the access bylaw. In light of the no-action letters and Frederickson's remarks, it seems that the Staff will grant relief when the company's proxy access bylaw deviates from the shareholder proposal in one or both of the following respects:

- limiting the number of shareholders permitted to aggregate (e.g., no more than 20 shareholders), while the shareholder proposal expressly requires "unrestricted aggregation"
- limiting the maximum number of proxy access candidates to 20 percent or 25 percent of the board of directors (rounding down) without also setting a minimum number of access candidates that the company must include, while the shareholder proposal expressly requires that the company include access candidates representing the greater of a percentage of the board or a minimum number (e.g., the greater of 25 percent of the board or two).

Disclosure of Voting Standards and Elections

In recent years, companies have shifted their election of directors from a plurality standard to a plurality-plus standard or a majority voting standard. In a plurality-plus regime, director nominees agree in advance to resign if they receive a majority of "withhold" votes. At that point, the remaining directors have the discretion whether to accept or reject such director's resignation. In a majority voting regime, director nominees are elected only if a majority of the votes cast are in favor of the nominee.

Anderson noted that the Staff has been concerned with the disclosures regarding voting standards in director elections, specifically the lack of clarity or accuracy in some instances. She highlighted that the disclosure requirements for director election voting are found in Rule 14a-4 of the Exchange Act and Item 21 of Schedule 14A.



Per Rule 14a-4, a form of proxy is to provide a means to "withhold authority to vote for each nominee." As a result, proxy cards under a plurality standard offer shareholders the ability to vote "for" a nominee or "withhold" his or her vote; there is no ability to vote "against" a nominee. However, Anderson stated, if applicable state law gives legal effect to votes cast against a nominee, such as under a majority voting standard, then companies should provide a means for a shareholder to vote "against" a nominee in lieu of, or in addition to, an ability to "withhold" a vote. Item 21 of Schedule 14A merely calls for disclosure of the method by which votes will be counted.

According to Anderson, last year, the SEC received two rulemaking petitions related to director election voting disclosures. Both petitioners highlighted what they believed were ambiguities or inaccuracies related to voting standard disclosures in a number of proxy statements. In light of these concerns, and with the help of the Division of Economic and Risk Analysis, the Staff performed an assessment of the quality of voting standard disclosure among a broad, statistically significant sample size of companies. While some inaccuracies were identified, the bulk of the disclosure was not incorrect, but rather ambiguous or less than ideal. The areas of concern include:

- companies that mistakenly use the "against" option when directors are elected by plurality voting
- companies that do not provide an "against" option when directors are elected by majority voting
- companies that disclose that they have adopted majority voting when they actually have "plurality-plus" policies (by which directors offer to resign if they have a majority of withhold votes)
- companies that indicate that withhold votes count in director elections, but do not discuss the impact that withhold votes will have on the outcome of the election.

In closing, Anderson stated that the Staff will continue to monitor this area and consider whether additional action is needed. If action is needed, Anderson noted that it may coincide with the decision on what action, if any, to take with respect to universal proxy balloting. In the interim, she encouraged companies to review their proxy statement disclosures regarding the requisite voting standards and the voting choices on their proxy cards to determine whether changes or enhancements are warranted.

Recent Staff Interpretations and Reports

Disclosure Effectiveness

Under the JOBS Act, signed into law on April 5, 2012, the SEC was required to study the disclosure requirements of Regulation S-K. Based on its December 2013 staff report to Congress, the SEC initiated a "disclosure effectiveness" review of the requirements of both Regulations S-K and S-X to identify ways to reduce the costs and

burdens on companies while still providing material information to investors. Karen Garnett, associate director in the Office of Disclosure Operations, who has taken over the initiative from Keith Higgins, director of Corp Fin, noted that the scope of the initial disclosure effectiveness analysis has focused on the business and financial disclosure requirements in periodic reports. Garnett stated that, while companies, investors and other market participants have submitted interesting comments on proxy statement and registration statement disclosures, those filings are not the Staff's current focus.

In September 2015, Corp Fin opened a request for comment on Regulation S-X, with a focus on the financial disclosures related to acquired businesses, affiliated entities, and guarantors and issuers of guaranteed securities. Garnett said that the Staff had received 50 comment letters so far, which the Staff will evaluate and use to make recommendations to the commissioners. While no similar request for comment has been posted with respect to Regulation S-K, she noted that the Staff was working to develop recommendations on Regulation S-K for the commissioners, possibly in the form of a concept release.

Garnett asserted that the Staff was exploring disclosure more broadly, including the most effective framework for disclosure requirements (e.g., prescriptive requirements versus principles-based requirements), and considering the pluses and minuses of competing approaches (e.g., standardization versus flexibility). Garnett noted that the Staff was also looking at how companies present and deliver information, with a view to encourage companies to use modern technology to provide information more effectively (e.g., hyperlinks and use of structured data). On this point, she added that the Staff would be requesting input on how structured data can enhance the usefulness and quality of disclosure. The Staff is also looking at industry-specific disclosure in the form of industry guides, building on its experience from 2008 in codifying the oil and gas guides into Item 1200 of Regulation S-K.

In closing, Garnett stated that a main goal of the disclosure effectiveness project is to eliminate overlapping disclosure requirements caused by both internal redundancy (e.g., Regulation S-X versus Regulation S-K) and external redundancy (e.g., SEC rules versus Generally Accepted Accounting Principles). Garnett said that she was excited to see that numerous registrants are participating in the discussion of disclosure effectiveness and that such registrants are engaged in efforts to remove duplicative or outdated disclosure in their filings. She reminded companies that they should not only seek opportunities for removing disclosures, but also concurrently seek opportunities for adding and improving the remaining disclosures.

Accredited Investors

As defined in Rule 501 of the Securities Act, under Regulation D, an accredited investor includes certain natural persons and other entities that are considered financially sophisticated and able to sustain the risk of loss of investment, thereby reducing their need for certain protections provided by the federal securities laws. A natural person qualifies as an accredited investor if such person has:

- individual income exceeding $200,000 in each of the two most recent years
- joint income with the person's spouse exceeding $300,000 in each of those years or
- net worth, excluding such person's primary residence, exceeding $1 million.

As noted by Gomez Abero, Dodd-Frank required the SEC to review the definition of "accredited investor" to determine whether the requirements of the definition should be adjusted or modified. In its Report on the Review of the Definition of "Accredited Investor" (the "Report"), dated December 15, 2015, the Staff described the history of the definition, including the bases for the financial thresholds, which were established as part of the passage of Regulation D in 1982 and have not been adjusted for inflation. Gomez Abero noted that, if the financial thresholds were adjusted for inflation, a natural person would need individual income exceeding $500,000, joint income exceeding $600,000 or $2.5 million of net worth to qualify as an accredited investor.

Per Gomez Abero, in preparing the Report, the Staff considered a variety of comments and analyzed various approaches to modifying the accredited investor definition. The Report provided a number of recommendations for updating the accredited investor definition, including:

- leaving the current income and net-worth thresholds in place, but subjecting investors to an investment limitation (e.g., 10 percent of prior year income or net worth)
- creating new inflation-adjusted income and net-worth thresholds that are not subject to investment limitations (e.g., new thresholds of $500,000 of individual income, $750,000 of joint income and $2.5 million of net worth)
- considering other measures of sophistication for individuals to qualify as accredited investors, such as establishing a minimum amount of investments as another qualifying test
- considering individuals with certain professional credentials, such as Series 7, 65 or 82 accreditation
- considering individuals with investment experience
- considering knowledgeable employees of private funds to qualify for investments in their employer's funds
- considering designing an accredited investor examination that would enable sophisticated investors to qualify regardless of wealth, educational background or experience.

In closing, Gomez Abero noted that the Report includes a file for comment, and he encouraged interested parties to submit their views.

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