
Morgan Lewis
GLOBAL PUBLIC COMPANY ACADEMY
UPDATE ON RECENT SEC COMPLIANCE AND DISCLOSURE INTERPRETATIONS (CD&I)
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March 7, 2018
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Agenda

- What are CD&Is and Why Should You Care?
- Pay Ratio
- Non-GAAP Forecasts in M&A Transactions
- Integration of 506(b) and 506(c) Offerings
- Deferred Tax Assets Disclosure
- QIB Status
- Emerging Growth Company Filings
- Form S-8
- Registration Fees
- Shareholder Proposals
- Foreign Private Issuer Definition

What are CDI&Is and Why Should You Care?

- Reflect views of the Staff of the Division of Corporation Finance
- Not rules, regulations or statements of the Commission
- The Commission doesn't approve or disapprove
- "Not binding due to highly informal nature"
- Intended as general guidance and not as definitive
- May change without notice
- But very useful indicators of Staff thinking on various issues
- Lots of detail and real-life situations
- Very often based on real questions submitted to the Staff in writing, at conferences, etc.
- Often there's a "needle in a haystack"
- Wide-ranging topics, organized by category

Pay Ratio

- Regulation S-K CDI 128C.01: If a registrant does not use annual total compensation calculated using Item 402(c)(2)(x) of Regulation S-K ("annual total compensation") to identify the median employee, how should a registrant select another consistently applied compensation measure ("CACM") to identify the median employee?
- Answer: Item 402(u) requires registrants to identify the median employee using annual total compensation or another CACM, such as information derived from the registrant's tax and/or payroll records. Because of concerns about the expected compliance costs if registrants had been required to calculate annual total compensation for all employees, the Commission permitted registrants to use a CACM other than annual total compensation as a reasonable alternative to identifying the median employee. Any measure that reasonably reflects the annual compensation of employees could serve as a CACM. The appropriateness of any measure will depend on the registrant's particular facts and circumstances. As the Commission stated in the interpretive release, "a registrant may use internal records that reasonably reflect annual compensation to identify the median employee, even if those records do not include every element of compensation, such as equity awards widely distributed to employees." [October 18, 2016; updated September 21, 2017]

Pay Ratio (cont'd)

- CDI 128C.02: May a registrant exclusively use hourly or annual ***rates*** of pay as its CACM?
- **Answer:** No. Although an hourly or annual pay rate may be a component used to determine an employee's overall compensation, the use of the pay rate alone generally is not an appropriate CACM to identify the median employee. Using an hourly rate without taking into account the number of hours actually worked would be similar to making a full-time equivalent adjustment for part-time employees, which is not permitted. Similarly, using an annual ***rate*** only, without regard to whether the employees worked the entire year and were actually paid that amount during the year, would be similar to annualizing pay, which the rule only permits in limited circumstances. [October 18, 2016]

Pay Ratio (cont'd)

- CDI 128C.03: When a registrant uses a CACM to identify the median employee, what time period may it use? Must the period include the date on which the employee population is determined? Must it always be for an annual period? May it use the prior fiscal year?

- **Answer:** To calculate the required pay ratio, a registrant must first select a date, which must be within three months of the end of its fiscal year, to determine the population of its employees from which to identify the median. Once the employee population is determined, the registrant must then identify the median employee from that population using either annual total compensation or another CACM. In applying the CACM to identify the median employee, a registrant is not required to use a period that includes the date on which the employee population is determined nor is it required to use a full annual period. A CACM may also consist of annual total compensation from the registrant's prior fiscal year so long as there has not been a change in the registrant's employee population or employee compensation arrangements that would result in a significant change of its pay distribution to its workforce. [October 18, 2016]

Pay Ratio (cont'd)

- CDI 128C.04: When someone is furloughed on the date that the registrant uses to determine the population of its employees from which it is required to identify the median, must the registrant include the furloughed person in the employee population used to identify the median employee, and, if included in the population, how should the furloughed employee's compensation be calculated?

- **Answer:** Item 402(u) does not define or even address furloughed employees. Because a furlough could have different meanings for different employers, registrants will need to determine whether furloughed workers should be included as employees based on the facts and circumstances. If the furloughed worker is determined to be an employee of the registrant on the date the employee population is determined, his or her compensation should be determined by the same method as for a non-furloughed employee. Item 402(u)(3) of Regulation S-K identifies four classes of employees: full-time, part-time, temporary and seasonal. The registrant must determine in which class the employee belongs on that date and determine that individual's compensation using annual total compensation or another CACM in accordance with Instruction 5 of Item 402(u). That instruction states that a registrant may annualize the total compensation for all permanent employees (full-time or part-time) that were employed by the registrant for less than the full fiscal year or who were on an unpaid leave of absence during the period. In contrast, a registrant may not annualize the total compensation for employees in temporary or seasonal positions. A registrant may not make a full-time equivalent adjustment for any employee. [October 18, 2016]

Pay Ratio (cont'd)

- CDI128C.06: Given the significant flexibility provided to registrants in Item 402(u) to identify the median employee, would the staff object if a registrant describes the pay ratio as an estimate?
- **Answer:** No. As the Commission stated in the interpretive release, due to the use of estimates, assumptions, adjustments, and statistical sampling permitted by the rule, pay ratio disclosures may involve a degree of imprecision. Therefore, the staff would not object if a registrant states in any required disclosure that the pay ratio is a reasonable estimate calculated in a manner consistent with Item 402(u). [September 21, 2017]
- Will involve a degree of imprecision
- Early models appearing daily and they vary significantly based on company's facts

Non-GAAP Forecasts in M&A Transactions

- CDI 101.01: Are financial measures included in forecasts provided to a financial advisor and used in connection with a business combination transaction non-GAAP financial measures?
- Answer: No, if the conditions described below are met.
- Item 10(e)(5) of Regulation S-K and Rule 101(a)(3) of Regulation G provide that a non-GAAP financial measure does not include financial measures required to be disclosed by GAAP, Commission rules, or a system of regulation of a government or governmental authority or self-regulatory organization that is applicable to the registrant. Accordingly, financial measures provided to a financial advisor would be excluded from the definition of non-GAAP financial measures, and therefore not subject to Item 10(e) of Regulation S-K and Regulation G, if and to the extent:
  - the financial measures are included in forecasts provided to the financial advisor for the purpose of rendering an opinion that is materially related to the business combination transaction; and
  - the forecasts are being disclosed in order to comply with Item 1015 of Regulation M-A or requirements under state or foreign law, including case law, regarding disclosure of the financial advisor's analyses or substantive work. [Oct. 17, 2017]

Non-GAAP Forecasts in M&A Transactions (cont'd)

- Question 101.02
- Question: Does the exemption from Regulation G and Item 10(e) of Regulation S-K for non-GAAP financial measures disclosed in communications relating to a business combination transaction extend to the same non-GAAP financial measures disclosed in registration statements, proxy statements and tender offer statements?
- Answer: No. There is an exemption from Regulation G and Item 10(e) of Regulation S-K for non-GAAP financial measures disclosed in communications subject to Securities Act Rule 425 and Exchange Act Rules 14a-12 and 14d-2(b)(2); it is also intended to apply to communications subject to Exchange Act Rule 14d-9(a)(2). This exemption does not extend beyond such communications. Consequently, if the same non-GAAP financial measure that was included in a communication filed under one of those rules is also disclosed in a Securities Act registration statement, proxy statement, or tender offer statement, this exemption from Regulation G and Item 10(e) of Regulation S-K would not be available for that non-GAAP financial measure. [Oct. 17, 2017]

Integration of 506(b) and 506(c) Offerings

Question 256.34: Is the five-factor integration analysis in the Note to Rule 502(a) the sole means by which the issuer determines whether all of the offers and sales constitute a single offering when commencing a 506(c) offering with general solicitations within 6 months of a Rule 506(b) offering?

- Answer: No. Under Securities Act Rule 152, a securities transaction that at the time involves a private offering will not lose that status even if the issuer subsequently decides to make a public offering. Therefore, we believe under these circumstances that offers and sales of securities made in reliance on Rule 506(b) prior to the general solicitation would not be integrated with subsequent offers and sales of securities pursuant to Rule 506(c).
- So long as all of the applicable requirements of Rule 506(b) were met for offers and sales that occurred prior to the general solicitation, they would be exempt from registration and the issuer would be able to make offers and sales pursuant to Rule 506(c).
- The opposite will not work. Question: If an issuer commenced an offering intending to rely on Rule 506(c) but did not engage in any form of general solicitation in connection with the offering, may the issuer subsequently determine to rely on Rule 506(b) for the offering?
- Answer: Yes, as long as the conditions of Rule 506(b) have been satisfied with respect to all sales of securities that have occurred in the offering. To the extent the issuer already filed a Form D indicating its reliance on Rule 506(c), it must amend the Form D to indicate its reliance on Rule 506(b) instead, as that decision represents a change in the information provided in the previously-filed Form D. [Nov. 13, 2013]

Deferred Tax Assets Disclosure

- Great concern about the impact of the Tax Cuts and Jobs Act (Tax Act) prior to the December guidance (CD&I and SAB 118)
- Example – the Tax Act imposes a tax on foreign earnings and profits that the company previously did not recognize (i.e. a new deferred tax liability)
- Form 8-K CDI 110.02**:** Does the re-measurement of a deferred tax asset ("DTA") to incorporate the effects of newly enacted tax rates or other provisions of the Tax Cuts and Jobs Act ("Act") trigger an obligation to file under Item 2.06 of Form 8-K?
- **Answer:** No, the re-measurement of a DTA to reflect the impact of a change in tax rate or tax laws is not an impairment under ASC Topic 740. However, the enactment of new tax rates or tax laws could have implications for a registrant's financial statements, including whether it is more likely than not that the DTA will be realized. As discussed in Staff Accounting Bulletin No. 118 (Dec. 22, 2017), a registrant that has not yet completed its accounting for certain income tax effects of the Act by the time the registrant issues its financial statements for the period that includes December 22, 2017 (the date of the Act's enactment) may apply a "measurement period" approach to complying with ASC Topic 740. Registrants employing the "measurement period" approach as contemplated by SAB 118 that conclude that an impairment has occurred due to changes resulting from the enactment of the Act may rely on the Instruction to Item 2.06 and disclose the impairment, or a provisional amount with respect to that possible impairment, in its next periodic report. [December 22, 2017]
- Impact on 10K: The new rates and laws implicated many 2017 year-end financial statements, including whether it is more likely than not that the DTA will be realized

Deferred Tax Assets Disclosure (cont'd)

- SAB 118:
  - Report what is complete in 10K at the time of filing
  - But if the accounting for tax effects under the Tax Act is not done when the 10K due, companies may include a reasonable estimate in the 10K
  - If cannot include a reasonable estimate, may apply a "measurement period" approach and disclose the impact in next periodic report as soon as reasonable estimate can be provided
  - During the measurement period, estimates can be adjusted
  - "Measurement period" should not exceed one year
  - Disclose qualitative and quantitative information, including estimates, why not complete, what else must be done, etc.

Determination of QIB Status

- CDIs 138.05-138.10
- In calculating whether an eligible entity owns or manages $100 million in investment securities, you may include:
  - Securities purchased on margin
  - Securities that have been loaned
- You may not include:
  - Borrowed securities
  - Short positions (presumably can include boxed long position)
  - Securities held by private funds held managed by the same adviser, unlike registered funds
- LPs, not GP, are the equity owners of a limited partnership for determining whether all equity owners are QIBs.

Emerging Growth Company Filings

- Helpful relief under the FAST Act for EGCs; also in CDIs 101.04 – 101.05 of Securities Act Forms
- EGC may omit from draft and publicly filed registration statements information for historical periods that EGC reasonably believes will not be required to be included at the time of the offering
- Calendar y/e EGC submits draft registration statement in November 2017 for offering it reasonably believes will start in April 2018. May omit:
  - 2015 annual financial information
  - Interim financial information for 2016 and 2017
- But if this EGC publicly files in January 2018:
  - May omit 2015 annual financial information
  - But must include 2016 and 2017 interim information because it relates to historical periods that will be included at the time of filing

Emerging Growth Company Filings (cont'd)

- FAST Act relief not available to non-EGCs
- However, Staff policy as captured in CD&Is allows non-EGC to omit from draft registration statements interim and annual financial information that it reasonably believes will not be required when it files publicly
- May not omit any required financial information from publicly filed registration statements
- Does not apply to non-EGCs
- SEC Chair Clayton is focused on invigorating sluggish IPO market; is testing the waters for everyone to come?

Form S-8

- CDI 240.15 – Securities Act Rules
- Flexibility in how shares are calculated and registered on S-8 mirrors common practice of rolling in "recycled" shares from an old plan into a new plan
- Companies may register newly authorized shares under a new plan, plus an estimated number of shares that may be rolled into the new plan upon recycling (termination or cancellation of awards under a prior plan)
- In the alternative, companies may file a post-effective amendment to the S-8 for the original plan to indicate that the registration statement will cover
- But any new shares under the new plan would be registered on a brand new registration statement

Registration Fees

- Question 240.16
- Question: When filing fees paid in connection with a prior registration statement are used to offset fees due on a subsequent registration statement pursuant to Rule 457(p), what information pertaining to the offset should the issuer include in a note to the Calculation of Registration Fee table?
- Answer: Rule 457(p) requires a note to the table to state the name of the registrant, the file number and initial filing date of the earlier registration statement from which the offset is claimed and the dollar amount of the offset. In addition, to assist the staff in assessing the registrant's eligibility for offset, the registrant should quantify the amount of unsold securities from the prior registration statement associated with the claimed offset and disclose either that the prior registration statement has been withdrawn or that any offering that included the unsold securities has been terminated or completed. An offering registered on Form S-8 is only completed or terminated when no additional securities will be issued pursuant to the plan covered by the Form S-8, including through the exercise of any outstanding awards. [Nov. 9, 2016]

Shareholder Proposals—Rule 14a-8(i)(7)

- Staff Legal Bulletin No. 14I (November 1, 2017)
- Rule 14a-8(i)(7), permits a company to exclude a proposal that "deals with a matter relating to the company's ordinary business operations." The purpose of the exception is "to confine the resolution of ordinary business problems to management and the board of directors, since it is impracticable for shareholders to decide how to solve such problems at an annual shareholders meeting."
- The policy underlying the "ordinary business" exception rests on the recognition that some proposals raise matters that are "so fundamental to management's ability to run a company on a day-to-day basis that they could not, as a practical matter, be subject to direct shareholder oversight" may be excluded, unless such a proposal focuses on policy issues that are sufficiently significant because they transcend ordinary business and would be appropriate for a shareholder vote. Whether the significant policy exception applies depends, in part, on the connection between the significant policy issue and the company's business operations.
  - These determinations often raise difficult judgment calls that the Division believes are in the first instance matters that the board of directors is generally in a better position to determine. A board acting in its fiduciary capacity and with the knowledge of the company's business and the implications for a particular proposal on that company's business is well situated to analyze, determine and explain whether a particular issue is sufficiently significant because the matter transcends ordinary business and would be appropriate for a shareholder vote.
- Accordingly, going forward, the SEC staff expects a company's no-action request to include a discussion that reflects the board's analysis of the particular policy issue raised and its significance. It should detail the specific processes employed by the board to ensure that its conclusions are well-informed and well-reasoned.

Shareholder Proposals—Rule 14-8(i)(5)

- Rule 14a-8(i)(5) permits a company to exclude a proposal that "relates to operations which account for less than 5 percent of the company's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company's business."
- Over the years, the Division simply considered whether a company conducted any amount of business related to the issue in the proposal and whether that issue was of broad social or ethical concern. The Division now believes that its application of Rule 14a-8(i)(5) has unduly limited the exclusion's availability because it has not fully considered the second prong of the rule as amended in 1982 – the question of whether the proposal "deals with a matter that is not significantly related to the issuer's business" and is therefore excludable. Accordingly, going forward, the Division's analysis will focus on a proposal's significance to the company's business when it otherwise relates to operations that account for less than 5% of total assets, net earnings and gross sales. Under this framework, proposals that raise issues of social or ethical significance may be included or excluded, notwithstanding their importance in the abstract, based on the application and analysis of each of the factors of Rule 14a-8(i)(5) in determining the proposal's relevance to the company's business.
- Where a proposal's significance to a company's business is not apparent on its face, a proposal may be excludable unless the proponent demonstrates that it is "otherwise significantly related to the company's business." The mere possibility of reputational or economic harm will not preclude no-action relief.
- As with the "ordinary business" exception in Rule 14a-8(i)(7), determining whether a proposal is "otherwise significantly related to the company's business" can raise difficult judgment calls. The SEC staff believes that the board of directors is generally in a better position to determine these matters in the first instance and would expect a company's Rule 14a-8(i)(5) no-action request to include a discussion that reflects the board's analysis of the proposal's significance to the company.

Shareholder Proposals– Other Issues

1. Proposals submitted on behalf of shareholders -A shareholder may submit a Rule 14a-8 proposal by proxy through a representative. To address concerns that the eligibility requirements of Rule 14a-8(b) have not been satisfied or that shareholders may not know that proposals are being submitted on their behalf, the staff will look to whether the shareholders who submit a proposal by proxy provide documentation describing the shareholder's delegation of authority to the proxy. In general, the documentation must:
   - identify the shareholder-proponent and the person or entity selected as proxy;
   - identify the company to which the proposal is directed;
   - identify the annual or special meeting for which the proposal is submitted;
   - identify the specific proposal to be submitted (e.g., proposal to lower the threshold for calling a special meeting from 25% to 10%); and
   - be signed and dated by the shareholder.

2. The use of images in shareholder proposals -- Rule 14a-8(d) provides that a "proposal, including any accompanying supporting statement, may not exceed 500 words". The use of "500 words" and absence of express reference to graphics or images in Rule 14a-8(d) do not prevent the inclusion of graphs and/or images in proposals.
   - Potential abuses can be addressed by the exclusion of graphs and/or images would be appropriate under Rule 14a-8(i)(3) where they:
     - make the proposal materially false or misleading;
     - render the proposal so inherently vague or indefinite that neither the stockholders voting on the proposal, nor the company in implementing it, would be able to determine with any reasonable certainty exactly what actions or measures the proposal requires;
     - directly or indirectly impugn character, integrity or personal reputation, or directly or indirectly make charges concerning improper, illegal, or immoral conduct or association, without factual foundation; or
     - are irrelevant to a consideration of the subject matter of the proposal, such that there is a strong likelihood that a reasonable shareholder would be uncertain as to the matter on which he or she is being asked to vote.

Foreign Private Issuer Definition

- CDIs 203.17 – 203.23 of Securities Act Rules
- Definition of Foreign Private Issuer has critical implications for foreign registrants
  - Disclosure implications (10K, 10Q, 8K vs. 20F, 40F, 6K)
  - Application of certain rules/regulations (i.e. Section 16)
- Definition can be complex and difficult to apply
- Issuers with multiple classes of stock with different voting rights can determine whether more than 50% of outstanding voting securities are directly or indirectly owned by U.S. residents by:
  - Calculating the 50% of the voting power of both classes on a combined basis, or
  - Calculating based on the number of voting securities
  - Must apply on a consistent basis
- Factors to determine the status of an individual as a U.S. resident include:
  - Permanent resident status (Green Card holder presumed to be U.S. resident)
  - Others without permanent resident status also may be, based on criteria the issuer consistently applies to determine residence, including tax residency, nationality, mailing address, physical presence, location of financial and legal relationships, immigration status

Foreign Private Issuer Definition (cont'd)

- To determine whether a majority of executive officers or directors are U.S. citizens or residents there are 4 determinations:
  - Citizenship status of executive officers
  - Residency of executive officers
  - Citizenship of directors
  - Residency of directors
  - must treat executive officers and directors as separate groups (not as a single group) and determine for each group
- Issuers with 2 boards of directors:
  - must determine which board performs the functions most closely undertaken by U.S.-style boards
  - if those functions are divided between both boards, issuer may aggregate members of both for calculation of majority
- To determine whether more than 50% of assets are located outside the U.S.:
  - May use geographic segment information used in financial statements, or any other reasonably consistently applied methodology

Foreign Private Issuer Definition (cont'd)

- There is no single factor to determine whether the issuer's business is principally administered in the U.S.
  - Assess location from which officers, partners, managers primarily direct, control and coordinate the business
  - Holding annual or special meetings of stockholders in the U.S., absent other factors is not sufficient
  - Nor is holding occasional board meetings in the U.S. sufficient

Biography

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Laurie A. Cerveny is an accomplished corporate, M&A, and securities lawyer. She has extensive experience counseling US and foreign issuers and their boards on mergers and acquisitions and the ongoing disclosure and reporting requirements of public companies, corporate governance matters, annual meeting and proxy-related issues, securities laws, SEC rules, stock exchange listing requirements, executive compensation, and various other matters affecting public companies and their officers and directors. Laurie is a deputy practice leader of the M&A practice area and a member of the firm's Advisory Board.

Biography

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David A. Sirignano focuses on international and domestic corporate finance, mergers and acquisitions (M&A), and US Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA) regulation. David represents foreign and domestic public companies, broker-dealers, underwriting syndicates, investment managers, and private funds with respect to issues arising under US federal securities laws, including SEC and FINRA registration and reporting obligations, disclosure issues, and insider trading and trading practice regulation.

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Almaty
Astana
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
Moscow
New York
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Shanghai*
Silicon Valley
Singapore
Tokyo
Washington, DC
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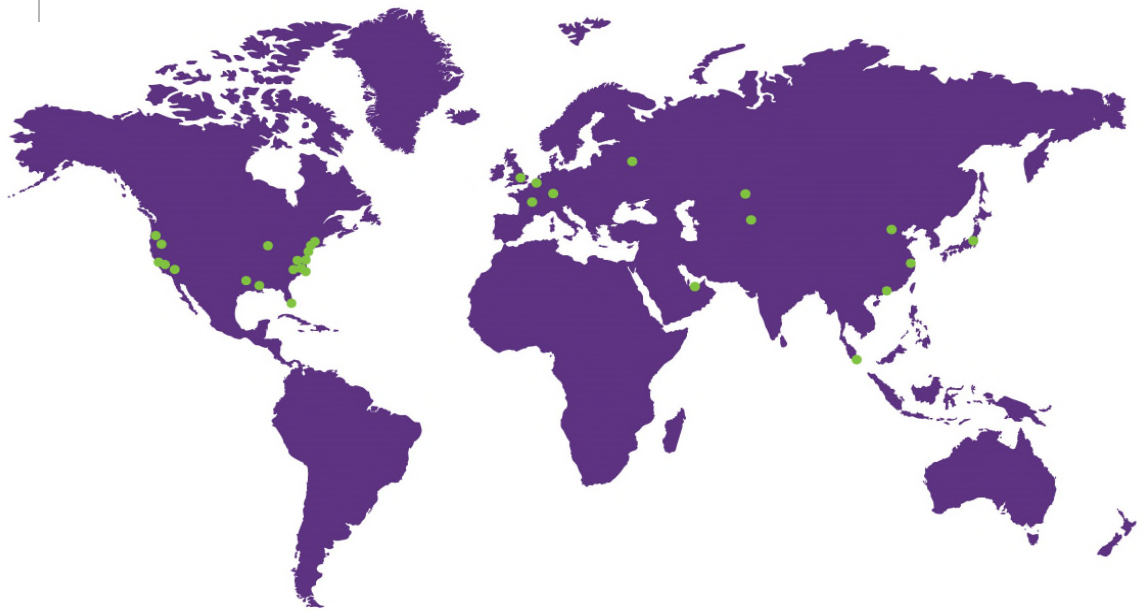

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