QUARTERLY GOVERNANCE REVIEW

MAY 2016

Q1 2016: FOCUS ON THE REGULATORS – IS MORE ENFORCEMENT ON THE WAY?

The big governance news this quarter primarily comes from the SEC, which appears to be forecasting future enforcement actions in several areas critical to corporate governance. In this issue of *Quarterly Governance Review*, we take a concise look at some of these areas, and we offer you action items to consider as you review your business strategies.

Welcome to Spring.

NON-GAAP MEASURES – EXPECTING AN SEC CRACKDOWN

During the past few months, members of the SEC staff have been foreshadowing a renewed focus on enforcement of reporting of financial metrics and the use of "non-GAAP" financial measures by companies in the capital raising process, in quarterly earnings releases and on analyst calls. This renewed focus is leading to new policy statements on the regulatory front, and we expect it to lead to new enforcement actions, which could also impact risk in civil litigation.

The regulatory regime governing the use of non-GAAP financial measures has not changed much since the SEC adopted Regulation G and Item 10(e) of Regulation S-K in 2003. The SEC staff last clarified its interpretation of these rules in 2011. Regulation G applies to all companies that have a class of security registered under Section 12 of the Exchange Act of 1934, as amended and relates to the use of "non-GAAP financial measures" in any public disclosure of material information, whether in writing or orally. Under this regulation, public companies that disclose or release non-GAAP financial measures are required to include, in that disclosure or release, a presentation of the most directly comparable GAAP financial measure and a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP financial measure.

Essentially, in addition to compliance with Regulation G, whenever one or more non-GAAP financial measures are included in a filing with the SEC, Item 10(e) requires the issuer to present with equal or greater prominence, the most directly comparable financial measure or measures calculated and presented in accordance with GAAP and provide a reconciliation of the differences between the non-GAAP financial measure disclosed with the most directly comparable financial measure calculated and presented in accordance with GAAP. In addition, the issuer is required to disclose the reasons why its management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the registrant's financial condition and results of operations.

Over the course of the past six months, the SEC staff has repeatedly voiced its concern that the increased use of non-GAAP measures may be confusing to investors and analysts. For example, in December 2015, SEC Chair Mary Jo White noted that issuers, along with their audit committees, should carefully monitor the use of these measures and consider the following questions:

- Why are you using the non-GAAP measures, and how does it provide investors with useful information?
- Are you giving non-GAAP measure no greater prominence than the GAAP measures, as required under the rules?
- Are your explanations of how you are using the non-GAAP measures – and why they are useful for your investors – accurate and complete, drafted without boilerplate?
- Are there appropriate controls over the calculation of non-GAAP measures?

SEC Chair White and several members of the SEC staff have indicated that the SEC may consider future rulemaking in this area.

On May 17, 2016, the SEC staff revised its C&DIs related to non-GAAP measures, by publishing four new interpretations and revising eight existing interpretations.

Action items

- Consider how your disclosure controls and procedures apply to the disclosure of non-GAAP measures.
- Audit Committees should pay close attention to the non-GAAP measures used by an issuer, including the required related disclosures and the processes the issuer follows to consider both the appropriateness and reliability of the measure and whether the explanation for use should be updated or modified.
- Review the new C&DIs to determine the SEC staff's current thinking on the use of non-GAAP measures.

Find out more by contacting Sanjay Shirodkar, David P. Lewis, Louis Lehot or your regular DLA Piper lawyer.

GENDER PAY GAP – A NEW FRONTIER?

Stockholder proposals regarding gender pay equality have been proposed at several large companies during this year's proxy season, particularly among technology companies.

These proposals generally ask that that the subject company prepare a report that includes the percentage pay gap between male and female employees, discusses policies that address that gap, and provides quantitative reduction targets for the gap. One particular organization has submitted the majority of these proposals.

Except where the company has procedural grounds on which the proposal can be excluded (*e.g.*, untimely notice to the company), the SEC has denied all requests for no action made by companies looking to exclude these proposals from their proxy materials.

Nevertheless, stockholder proposals at five large companies have all been withdrawn after dialogue with the proposing stockholder led the company to adopt new gender pay equality policies. Only a few companies have had stockholders vote on such a proposal. In 2015, a gender pay equality proposal at a large oil and gas company received only 6 percent of the votes cast. In 2016, however, a similar proposal at a large e-commerce company received a majority of the votes cast, although it ultimately failed due to abstentions being counted against it.

Action items

Companies should be aware that these types of proposals are gaining more traction, and interest from the media, and plan accordingly.

- Review current pay practices and compliance with existing labor laws.
- Figure out if any of the investors who have been making these demands is a significant shareholder in your company.
- Consider proactively conducting a pay equity study under legal privilege to preempt or address any requests that your shareholders may make at a later date.

Find out more by contacting Rachel B. Cowen or your regular DLA Piper lawyer.

NEED SOME "SPECIFICITY" IN YOUR PROXY CARD?

The SEC's Division of Corporation Finance has issued a new interpretation related to the form of proxy requirements. The interpretation relates to the specificity with which an issuer must describe a Rule 14a-8 shareholder proposal on its proxy card. Rule 14a-4(a)(3) requires that the form of proxy "identify clearly and impartially each separate matter intended to be acted upon whether or not related to or conditioned on the approval of other matters, and whether proposed by the registrant or by security holders."

The SEC staff noted that **the proxy card should clearly identify and describe the specific action on which shareholders are being asked to vote**, whether it is a management proposal or shareholder proposal.

Per the SEC staff, the following descriptions of shareholder proposals also would *not* satisfy Rule 14a-4(a)(3):

- A shareholder proposal on executive compensation.
- A shareholder proposal on the environment.
- A shareholder proposal, if properly presented.
- Shareholder proposal #3.

The SEC staff also gave the following examples of "bad" and "good" ways to describe a proposal:

"Bad"	**"Good"**
A proposal to amend our articles of incorporation	A management proposal to amend a company's articles of incorporation to increase the number of authorized shares of common stock
A shareholder proposal on special meetings	a shareholder proposal to amend a company's bylaws to allow shareholders holding 10% of the company's common stock to call a special meeting

Find out more about specificity on your proxy card by contacting your regular DLA Piper lawyer or Sanjay Shirodkar.

FASB MODIFIES ACCOUNTING RULES FOR STOCK-BASED COMPENSATION

The Financial Accounting Standards Board (FASB) has issued Accounting Standards Update (ASU) 2016-09, *Improvements to Employee Share-Based Payment Accounting*, which amends ASC Topic 718, *Compensation – Stock Compensation*.

FASB adopted the ASU on March 30, 2016 to improve the accounting for employee share-based payments and simplify how such payments are accounted for as well as presented in financial statements. The ASU includes certain non-public company-only simplifications. However, **the amendments affect all organizations, public or private, that issue share-based payment awards to their employees.**

Specifically, the ASU simplifies several aspects of the accounting for share-based payment award transactions, including:

- Accounting for income taxes of share-based payments.
- Statutory tax withholding requirements with respect to share-based equity grants.
- Accounting for Forfeitures.
- Simplification of rules applicable to private companies.

Accounting for income taxes

Currently, accumulated excess tax benefits (*i.e.*, tax benefits in excess of compensation cost commonly referred to as "windfalls") are available to offset current period and subsequent period tax deficiencies and are factored into determining the annual estimated effective tax rate. The update characterizes excess tax benefits as discrete income tax expenses or benefits in the current income statement (including tax benefits of dividends on share-based payment awards) and thus eliminates the need to track a "windfall pool." In addition, an organization may recognize excess tax benefits whether the benefit reduces taxes payable in the current period or not, and, thus, recognition of such a benefit will be recorded when it arises. Finally, the ASU provides that excess tax benefits should be classified along with other income tax cash flows as an operating activity on the statement of cash flows.

Statutory tax withholding requirements

Under current accounting rules, in order to avoid liability accounting, an employer may only withhold the minimum statutory amount of taxes upon a settlement of an equity award. The ASU provides that an employer may increase the withholding rates used from the minimum statutory tax rates up to the maximum statutory tax rates in the applicable jurisdictions without resulting in liability classification of the award. In addition, cash payments made to applicable taxing authorities when an employer directly withholds shares for tax withholding purposes should be presented as a financing activity on the statement of cash flows.

Accounting for forfeitures

Companies are also permitted to make an entity-wide accounting policy election for the impact of forfeitures on expense reporting. The election allows a company to either estimate the number of awards that are expected to be forfeited or such forfeitures can be accounted for when they occur.

Certain private company rules

The update also provides simplification of accounting for private company share-based compensation by allowing such companies to (1) apply a practical expedient to estimate the expected term for certain share-based awards in lieu of estimating the period of time that a share-based award will be outstanding, which would be adopted prospectively; and (2) make a one-time election to switch from measuring all liability-classified awards at fair value to measuring them at intrinsic value upon adoption of the ASU.

Effective date

For public companies, the amendments are effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. For all other entities, the amendments are effective for annual periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. Companies may want to adopt the update earlier than required to take advantage of certain amendments. Although early adoption is permissible, a company is required to adopt the entire update at one time so it is imperative to review your current accounting practices and equity granting practices to ensure an early adoption is prudent.

Action items

Companies, whether public or private, should review their equity plans and award agreements with counsel to determine whether any necessary amendments should be adopted. There may be certain administrative and other challenges (such as possible changes to processes and controls may be necessary) that require consultation and coordination between the company's finance and legal departments. Companies may also want to consider how to address or otherwise account for the new statutory tax withholding rules in any equity plan that will take effect before the ASU rules become effective.

If you have any questions, or if we can be of any assistance, please contact Rita Patel or James Telfer.

SEC CONTINUES TO FOCUS ON INTERNAL CONTROL FAILURES

The SEC has settled charges against Texas-based oil company Magnum Hunter Resources Corporation (MHR) and several individuals. The list of individuals implicated in this proceeding includes MHR's Chief Financial Officer, Chief Accounting Officer engagement partner responsible for providing its external auditing services, along with a consultant, whose firm was responsible for assisting MHR with certain accounting and reporting processes. The SEC allegations related to deficient evaluation of MHR's internal controls over financial reporting as well as failures to maintain internal control over financial reporting between December 31, 2011 and September 30, 2013.[1] </p>

This proceeding was brought as a result of the efforts of the SEC Enforcement Division's Financial Reporting and Audit Group (the FRAud Group).[2] Most readers will recall that the FRAud Group, officially announced by the SEC in 2013, concentrates on expanding and strengthening the SEC's efforts to identify securities-law violations relating to the preparation of financial statements, issuer reporting and disclosure, and audit failures. The principal goal of the FRAud Group is fraud detection and increased prosecution of violations involving false or misleading financial statements and disclosures. The FRAud Group focuses on identifying and exploring areas susceptible to fraudulent financial reporting, including ongoing review of financial statement restatements and revisions, analysis of performance trends by industry, and use of technology-based tools.

As noted by the Director for the SEC's Fort Worth regional office, this proceeding "emphasizes that all those involved in ICFR assessments – companies, management, external auditors and consultants – must take their responsibilities seriously and rigorously assess controls, including those over financial reporting."

MHR is a Delaware corporation headquartered in Irving, Texas that operates as an independent company engaged in the exploration and production of oil and gas in the United States. It grew from $6 million in revenues in 2009 to $23 million in 2010, largely as the result of an $82 million acquisition in February 2010. Between December 2010 and April 2011, MHR acquired another $70 million in oil and gas properties and leasehold mineral interests. MHR also completed two other acquisitions in April and May 2011 for an aggregate purchase price of $565 million. In 2011, MHR booked over $100 million in revenues – largely as a result of these acquisitions. MHR filed a voluntary petition for bankruptcy in December 2015 and, on April 18, 2016, the bankruptcy court entered an order confirming the chapter 11 plan of reorganization, which became effective in May 2016.

What were the SEC's allegations?

The SEC allegations related to deficient evaluation of MHR's internal controls over financial reporting, and failures to maintain internal control over financial reporting between Dec. 31, 2011 and September 30, 2013. According to the SEC, MHR's rapid growth strained its accounting resources. For example, the SEC staff observed that in connection with the issuance of the external auditor's report on MHR's 2010 year-end audit results, the engagement partner responsible for providing MHR's external auditing services, informed the CFO, CAO and MHR's Audit Committee that MHR's accounting department was experiencing "manpower issues" and lacked sufficient personnel to complete all required tasks on a timely basis.

Beginning in November 2011, MHR failed to complete its standard monthly close process and began formally closing its books on a quarterly basis with only sporadic monthly closes in 2012. The SEC noted that MHR's outside consultant issued a report on MHR's ICFR which identified problems in MHR's accounting department and identified "(a) instances in which reconciliations were not prepared, reviewed or approved on a timely basis; (b) failures to document the completion of required monthly management reviews; and (c) significant delays in preparing financial statements and reports due to 'inadequate and inappropriately aligned staffing.'" In fact, his report noted that "[T]he potential for error in such compressed work environment presents substantial risk." (emphasis in the SEC order) Despite this recognition, the consultant concluded that MHR's staffing problems represented only a significant deficiency, rather than a material weakness. MHR's public accounting firm identified the same ICFR issues as the consultant, but failed to conclude that the deficiencies constituted a material weakness. MHR's annual report on Form 10-K did not include any "material weaknesses" as part of its ICFR.

MHR amended and restated its second quarter 2012 Form 10-Q to correct numerous items and noted that its management had identified several material weaknesses. In its annual report on Form 10-K for 2012, MHR disclosed that its management had concluded that, as of December 31, 2012, its internal control over financial reporting were not effective due to the several material weaknesses.

Without admitting or denying the allegations made by the SEC, MHR agreed to pay a penalty, MHR's CFO and consultant agreed to pay monetary penalties, and MHR's CAO and the engagement partner responsible for providing its external auditing services agreed to be suspended from appearing and practicing before the SEC as an accountant.

Summary: a clear message from the SEC

The message from the SEC staff based on this proceeding and other recent speeches is clear: it is important to evaluate the severity of a control deficiency to determine whether it is a material weakness. As noted by the SEC in its 2007 interpretive guidance, "ICFR cannot provide absolute assurance due to its inherent limitations; it is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. ICFR also can be circumvented by collusion or improper management override."

Action items

The SEC has indicated that as part of the evaluation of ICFR, management should consider whether each deficiency, individually or in combination, is a material weakness at of the end of the fiscal year and that the evaluation of the severity of a control deficiency should include both quantitative and qualitative factors. Some factors that should be considered include:

- Nature of the financial reporting elements involved (issues like related party transactions or suspense accounts may involve greater risk).
- Susceptibility of a related asset of liability to loss or fraud (greater susceptibility increases risk).
- Interaction of the deficiencies (multiple deficiencies may impact a single financial statement amount or disclosure).

Learn more about this development and its implications for your business by contacting Sanjay Shirodkar, David P. Lewis, Louis Lehot, Sarah E. Ritter or your regular DLA Piper lawyer.

THE SILICON VALLEY INITIATIVE – UNICORNS IN SEC'S LINE OF SIGHT: ACTION ITEMS

SEC Chair Mary Jo White and a delegation of officials from the SEC traveled to Silicon Valley early this spring to deliver a shot across the bow to technology and healthcare businesses, entrepreneurs, investors and their advisers.

In a speech delivered at the Stanford Law School's Rock Center on Corporate Governance on March 31, SEC Chair White announced the SEC's "Silicon Valley Initiative" to an audience of regulators, academics, lawyers and entrepreneurs assembled to discuss the issues impacting the startup, venture capital and private equity worlds rooted in Silicon Valley. Noting the prevalence of high-growth innovative companies in Silicon Valley that are not yet public, the SEC chair aimed squarely at private companies: "[b]eing a private company obviously does not mean that you can disregard the interests of investors."

Chair White warned that "unicorns" with sky-high valuations merit special scrutiny and expressed concern that these companies maintain internal controls and investor protections appropriate for the promised projected growth. To be clear, when referring to unicorns, Chair White was not referring to those creatures of fantasy, but to private companies valued at more than $1 billion.

Referring to unicorns, Chair White said "[t]hey do not appear to be an endangered species," and expressed worry that "the tail might wag the horn." "The concern is whether the prestige associated with reaching a sky-high valuation fast drives companies to try to appear more valuable than they actually are."

In reference to the online lending industry, Chair White noted that "[a]s investors are attracted by potentially higher yielding but riskier marketplace loans as an investment strategy, information about the borrower's ability to repay the loan underlying the investment is critical…. Innovation in finance…must be built upon the disclosure of material information."

SEC Enforcement Division Chair Andrew Ceresney was also in attendance, noting that, while based in Washington, he had visited the Silicon Valley region three times in the past year, with more trips planned. Speaking as part of a panel of Silicon Valley executives and investors following Chair White, Mr. Ceresney noted that "[y]ou can't say we don't focus on the West Coast. Not that you want us to, but we are."

Action items

As private companies continue to elect to remain private longer, expect the SEC's regulatory and enforcement efforts to adjust accordingly to ensure appropriate oversight and protection of investors. Founders and advisers of fast-growing private companies should consider governance mechanisms and investor protections, including:

- Whether boards of directors have expanded beyond entrepreneurs and original investors.
- Whether boards have sufficient regulatory expertise.
- Whether leadership includes outsiders with relevant industry experience or experience in public companies.
- Whether board directors understand their fiduciary duties, and that they extend to all stockholders.
- Instituting internal controls over financial reporting to avoid errors or misconceptions in valuation.

To learn more, contact Louis Lehot or your regular DLA Piper lawyer.

ABOUT US

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To learn more, visit www.dlapiper.com.

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