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EXECUTIVE PAY

Clawbacks: Updates from the Field

By Takis Makridis and Josh Schaeffer

The Securities and Exchange Commission's (SEC) Dodd-Frank clawback rule went live last year. That means board-approved clawback policies needed to have been in place by December 1, 2023, and incentive-based compensation received after October 2, 2023 is subject to the policy. Dodd-Frank clawbacks are radically more restrictive given their no-fault and no-discretion nature. As of March 2024, we've worked on two live Dodd-Frank clawback cases and discussed restatements and price impacts with many more companies conducting readiness projects.

While our involvement has been broad, our principal area of focus is determining erroneously awarded compensation related to total shareholder return (TSR) and stock price metrics (market metrics). This will likely be one of the most challenging dimensions of a recovery analysis since it requires building a model that estimates what the stock price would have been had the financials never been misstated (the adjusted or "but-for" stock price).

In this article, we discuss 15 practical issues for dealing with market metrics that every board member, general counsel, CFO, and CHRO should be apprised of in the unfortunate and unlikely event a restatement occurs. The issues are organized into four sections:

1. *Getting Started*: The basics on the rule, standard of care, and process, in other words, getting started on the right foot.
2. *Event Studies (Top-Down Methods)*: An introduction to the methodology cited by the SEC, an event study approach, which is a top-down methodology for linking the restatement to the stock price.
3. *Fundamental Analysis (Bottom-Up Methods)*: A look at a "bottom-up" approach that uses fundamentals-based analysis to forecast the but-for stock price.
4. *Best Practices and Success Factors*: Some tips for an effective analysis, based on our experience so far.

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Getting Started

1. Get key parties aligned on the central issues when conducting a recovery analysis that encapsulates a market metric.

The SEC rule is new, complex (230 pages), and deeply technical. Although it wasn't a surprise that the SEC required market metrics to fall within the scope, these introduce considerably more complexity than basic financial metrics where the clawback amount can be determined using basic math. You'll need time to get the board, executives, and project team members up to speed on what they need to know, so start doing this ahead of a restatement.

The recovery analysis is about isolating how the incorrect financial results may have inflated the stock price. However, if the stock price also suffered for tangential reasons, such as negative governance signaling, these are confounding factors that shouldn't be included. Clarifying what the study is and isn't supposed to measure is an essential starting point.

It'll also take a few conversations to align on the appropriate techniques for measuring the adjusted stock price and why this is required under the SEC's rule. (Later on, we'll walk through the differences between top-down and bottom-up methodologies and their respective merits.) These are foundational details to put on the table early on.

The goal is to determine the compensation that would have been earned had the correct numbers been reported all along, therefore providing a parallel-universe stock price trajectory. This is why the output is called the adjusted or but-for stock price.

To help get everyone on the same page, we've collaborated with clients on a playbook that sketches out the relevant activities, owners, and order of operations. This is not dissimilar to the concept of running tabletop exercises in preparing for a potential cyber breach.

2. Design the recovery analysis with a clear understanding of the standard of care (a "reasonable estimate").

When measuring erroneously awarded compensation (if any) in the context of market metrics, start with the standard of care.

The bar set forth by the SEC is to develop a "reasonable" estimate of the impact of the restatement on the market metric (page 63 of the final SEC rule). There's not a single, unequivocal way to do that. At the same time, the documentation and work product underlying the estimate must be maintained and provided to the listing exchange, which is to say this is very much a formal exercise and not a rough estimate.

The SEC notes in the final rule that issuers may use "any reasonable estimate of the effect of the restatement on stock price and TSR." There are a handful of approaches we believe are reasonable, though it's possible for a generically reasonable technique to be inappropriate in certain fact patterns. We're also aware of techniques that are patently unreasonable, largely because they don't conform to commonly accepted principles in financial economics.

The purpose of the analysis is not to develop the most complex or elaborate calculation methodology. Nor is it to drive toward the lowest number. Bear in mind that many plaintiff litigators will be looking for indications that the recovery analysis was gamed to shield officers. The specialist's job is to consider the fact pattern, assess generally reasonable techniques in light of that fact pattern, and select a methodology that produces a reasonable estimate.

With that said, a reasonable method should focus only on the impact of the restated financials. This impact may be substantially smaller than damages analyses on related shareholder lawsuits that are focused on the broader impact of the restatement (for example, mismanagement, poor controls, etc.). The point of the Dodd-Frank clawback is not to punish officers for having a restatement, but rather to "right the wrong" by adjusting payouts to what they would have been had the accounting error not happened in the first place.

3. Pressure-test the reasonableness of a methodology given the case's unique facts and circumstances.

Be wary of cookie-cutter techniques for measuring erroneously awarded compensation in the context of a market metric. If you've seen one restatement, you've seen one restatement. In all cases, the facts, timing, stock price movements, and information set will differ. Any analysis must put the facts and circumstances of the case under a microscope.

Even a robust technique, such as an event study or fundamentals analysis, will be deeply vulnerable if performed generically and not applied to the fact pattern at hand. A generically, haphazardly deployed approach can overstate or understate recoverable compensation. More often than not, however, it will overstate the monies to be recovered because it won't adjust for confounding factors that aren't punishable under the SEC's clawback framework.

This is ironic because the bigger worry is that the analysis is gamed to minimize the clawback. That's a valid risk, and any analysis must be unassailable in its objectivity. However, we're more concerned that specialists who are broadly trained in running event studies, but not as well versed in the Dodd-Frank clawback rule, may construct an analysis that is overly punitive and goes in excess of what the rule is specifically trying to accomplish.

4. Before diving into the heavy-duty financial and statistical modeling, identify the awards subject to clawback and the breakpoints at which payouts would be degraded.

Start by determining which awards are at risk and which are safe. This will bring clarity and concreteness to the exercise.

First, collect all the awards to the covered employees over the applicable lookback period. Given the October 2, 2023 effective date, initially this won't include many awards or individuals. But the pool will grow over time.

Second, for each award and tranche therein, calculate the maximum stock price reduction that would allow that award to remain unaffected by the recovery analysis. Using the adjusted (but-for) stock price, determine the highest price at which each award tranche would not be affected by the analysis. We call this the breakpoint because it signifies where a payout is first affected by the recovery analysis.

Different award designs will have different sensitivities and breakpoints:

i. **Binary payouts versus payout grids.** Many absolute TSR (aTSR) awards come in the form of a series of tranches that are either earned or not earned based on reaching a stock price watermark. In contrast, relative TSR (rTSR) awards usually come in the form of a single tranche with a payout scale that ranges from 0 percent to 150 percent or 200 percent.

ii. **Step versus interpolation payouts.** Awards with linear interpolation (most common, especially with rTSR designs) will be extremely sensitive to a recovery analysis. In contrast, with step function payouts, the market metric only adjusts the payout at discrete intervals.

iii. **Continuous versus point-in-time measurement.** Some awards measure performance as of a single date, such as the end of the fiscal year, whereas others specify a window of time during which a metric can be achieved. Point-in-time measurement cases obviously will be most sensitive.

This analysis tells you a lot about the problem at hand. For example, if a price hurdle award vested at a watermark of $10 and the stock price continued to run up to $26 during the performance period, the award is likely to be unaffected by the restatement. The breakpoint is $10 because there's a binary payout structure at $10, but the stock price grew well in excess of the breakpoint. Then again, another tranche requiring a stock price of $25 may be in serious jeopardy. The following is a visual depiction of such a breakpoint analysis:

With an rTSR design and linear interpolation, any percentile change is a breakpoint. However, the drop from above threshold (for example, 25th percentile) to below threshold (for example, 24th percentile) could cover a much larger impact on payout. If the rTSR design uses a step function, the breakpoint will be less sensitive.

You might be wondering how this even makes sense for an rTSR award with linear interpolation because virtually any stock price revision will impact the payout. In this context, the analysis gives you a sensitivity factor equating a $1 stock price drop to an X percent payout drop. As we'll discuss below, the recovery analysis won't automatically give rise to an adjusted stock price (that's different from the stock price used to calculate the payouts in the past). The statistics behind the analysis may conclude there's not adequate evidence that the stock price would

Price Hurdle	Applicable Shares	Performance Period End Date	Price Hurdle Met	Allowable Stock Price Decline to Still Surpass Hurdle
$10.00	40,000	12/31/2026	Yes	-61.5%
$25.00	40,000	12/31/2026	Yes	-3.8%
$40.00	40,000	12/31/2026	No	N/A

have behaved differently had the correct numbers been reported all along.

Event Studies (Top-Down Methods)

5. The parallel universe produced by a recovery analysis applies only to the exercise of measuring final performance and payout outcomes.

When a restatement spans many fiscal years, it may encompass not only when performance was measured, but also the grant date. Naturally the question will arise as to what the grants would have looked like if the stock price was lower at the issuance date—in other words, how liberal can the analysis be in the parallel universe constructed? For example, if the adjusted stock price is 20 percent lower, then ostensibly one or more of the following applies:

- More stock could have been granted at a fixed value
- The starting price point would have been lower
- The hurdle prices may have been set lower

While the logic makes sense, and board members often ask about it, we don't believe it's actionable. The intent of the rule is to accept the grant as is and to focus on the outcomes. Consistent with this, the language in the rule doesn't permit an open-ended construction of a parallel universe. Rather, it hones in on the calculations performed at the time compensation was *received*.

For example, Section 10D-1(b)(1)(i) emphasizes the "recovery policy must apply to all incentive-based compensation received by a person…" Received is a defined term and refers to when the performance period is completed and the date in which performance is measured as of.

With many restatements, it's easy to look at the change in financials and say, "These are small numbers that shouldn't matter" or "The restatement didn't touch revenue, which is all our investors care about." There's any number of qualitative assessments—including quite reasonable ones—that can be drawn. While conclusions like these may ultimately be accurate, it's tenuous to make bold statements about the stock price without looking at the stock price. Event studies may not always deliver the most appropriate conclusion, but it's hard to imagine performing a recovery analysis without running some sort of event study.

Even so, as we'll discuss later, an event study may not be the best tool for every situation. For example, in section three of this paper, we discuss an alternative approach—fundamental analysis—which is a bottom-up means of quantifying how changes to earnings or cash flow mechanically should affect the stock price by using market-calibrated multiples.

6. Don't draw sweeping stock price conclusions without studying the stock price (which usually will involve an event study).

If a reasonable estimate is the standard of care, does this imply a particular method is required? No, and the rule says as much. However, we believe that the move in stock price upon the market learning of the restatement (and release of correct financials)[1] must be considered in any analysis of a market metric. Typically, this is done using an event study.

In economics, an event study is a statistical method used to assess the impact of a specific event on the value of a company, typically by analyzing the event's effects on the company's stock price. You develop an event study to compare the stock price movements before and after the event to expected movements, thereby isolating the event's influence from overall market trends.[2]

7. Build the model iteratively to make sure you're measuring what should be measured while filtering out irrelevant and confounding information.

Recovery analyses on market metrics are problems of information overload. This is true for both Big-R and little-r restatements. Let's talk about each type separately.

In a Big-R restatement, the issuer files an Item 4.02 Non-Reliance disclosure, usually via a Form 8-K. Then there's a multi-month lull as the issuer prepares new financials. The market is in a zone of suspense until new financials are released. The SEC cites sources showing that the average Big-R restatement impact on stock price is around 5 percent. However, we've seen announcements where the impact has been 30 percent or more.

Sometimes the stock price recovers partially or fully as the market realizes circumstances aren't so bad. Other times, it stays the same or gets worse. So, while it's important to study the stock price impact at announcement, it's impossible to put the full picture together until the new financials are issued.

In any event, the task at hand is to combine the two discrete revelations of information while vacuuming out unrelated information during the same period. That is, the event study needs to consider the initial effect of the announcement, then it needs to fold in the conclusion when reissued financials are provided. It also needs to crowd out other good or bad news such as forward-looking guidance or product announcements by the company.

Unfortunately, reissued financials are often provided alongside unrelated news and announcements, which obviously have a confounding effect. We've used an iterative approach to tease out the moving parts and form a fuller picture of the restatement-specific effects.

Little-r restatements face the same problem. In a little-r restatement, there might not be an announcement that's separate from the reissuance of financials. Moreover, the reissued financials are provided alongside new financials and forward-looking guidance. For example, if the little-r restatement is crammed into a release of FY 2025 financials, think about all the moving parts:

- FY 2025 financials, which are new and either meet, miss, or exceed analyst estimates (and may also embed a portion of the restatement in relation to previously released quarterly results)
- FY 2026 (and beyond) guidance, which also has an expectations component
- Revisions to FY 2023 and FY 2024 via the little-r restatement
- Other positive or negative surprises contained in the Form 10-K

Fortunately, with little-r restatements, the SEC cites academic research showing how the average stock price effect is about 0.3 percent. While this is hardly a substitute for a case-specific analysis, it provides corroborating evidence for a formal study that also concludes there's minimal or no discernible impact from the restatement.

8. Study all value-relevant information revealed to the market, then parse out information unrelated to the updated results.

To determine the adjusted stock price, we need to account for any day in which investors might have inferred information about the existence and size of the restatement. For example, in addition to the date the 8-K and restated financials are released, dates could be important if:

- There's a news release speculating on accounting irregularities
- The company announces the termination of the CFO and replacement of the auditor
- The company further delays filing of their restated financials

Remember, the goal is to link movements in the stock price to the restatement, so any date where the market gleans something about the restatement is *potentially* relevant to the value. We say potentially because the market may be latching on to something other than the restated results. After all, the market doesn't even have the restated results in hand at the time of the announcement, only the knowledge that they cannot rely on the old numbers and new ones are on their way. For this reason, the measure of price inflation may change as the release date of new financials approaches.

Another potential scenario is a restatement of financials in the seemingly distant past. For example, imagine a restatement announced in 2024 where the company says that acquisition costs were recognized in 2022 but should have been recognized in 2021. It's plausible that an analysis would show the stock price was inflated prior to the release of 2022 financials, but after that, the stock price was unaffected by the misstatement.

You might be wondering how this reasoning applies to little-r restatements. The problem with little-r restatements is that they necessarily get wrapped into one day; there usually aren't discrete markers in the sand to analyze as there are for Big-R restatements. As such, there's a lot of information for the market to digest, but only one piece of that information is relevant to the recovery analysis: the restated financials.

In these cases, we may rely even more on fundamental analysis (discussed shortly) and expand the regression model behind the event study to parse between the confounding pieces of information. We suspect the conclusion will often be that there's nothing to recover because the effect of the little-r restatement is minimal, which is why it's important that the SEC formally acknowledged this reality by citing academic research to corroborate it.

9. See what's moving the stock price and when the market seems to fully incorporate the right information.

With a Big-R restatement, stock price movements should be studied as of the point of announcement all the way through—and often even extending past—the reissuance of financials. That period could last several months as the company sorts out accounting systems issues, hires outside consultants, etc.

We've seen cases where an initial, post-announcement drop in stock price reversed quickly, possibly because investors figured the situation wasn't as bad as it seemed. On the other hand, investors often assume more bad news is on the way and may not change their minds for some time. So, you should expect a strong reaction to the announcement, then be prepared for a variety of movement types during the ensuing weeks or months until the restated numbers are provided and the market can absorb them.

It's reasonable to study stock price movements up to three months after the restatement when assessing the extent to which the price recovered.[3] However, because we're often studying multiple dates, such as the initial announcement and subsequent restatement, we generally include the full period from announcement to reissuance. Then we allow for a moderate tail post-reissuance (say, one to two weeks). A tail that's much longer risks pulling in unrelated events and information.

In contrast, with a little-r restatement, the period after the release of new financials is the only period available to study. While the longer we extend the analysis period the more confounding information can enter the equation, we also gain valuable data points to fold into the model and allow us to parse between restatement-specific effects and other effects. Here the 90-day bounce-back provision could provide an upper limit on how long of an analysis tail to permit.

10. After a clawback, look at the full terms and economics of the award and consider the possibility of the award being "re-earned" prior to the conclusion of the award's performance period.

For price hurdle and certain other awards, it's important to note there's life after a restatement and a clawback. In this case, if the stock price recovers before the end of the performance period, we believe that any awards clawed back would still be eligible for "re-earning."

For example, consider a five-year performance period governing an aTSR metric. The aTSR watermark is achieved after two years and a restatement is announced shortly thereafter. The earned aTSR awards are clawed back. However, in year four, the company's stock price surges past the aTSR hurdle. The restatement is in the rear-view mirror and there's nothing inflated about the stock price.

It's hard to reasonably argue that stock price attainments post-restatement wouldn't have been achieved absent the corrective disclosures. As we pointed out earlier, the SEC rule isn't a punishment device; it's a "make-right" device. Once the financials are made right, there should be nothing stopping awards from vesting that are still outstanding and eligible for vesting.

Fundamental Analysis (Bottom-Up Methods)

11. Test multiple analytical methodologies, then select the most appropriate one.

Event study and similar techniques are top-down methodologies in that they start with the overarching impact of the restatement and whittle away at any confounding and irrelevant information. But it's impossible to know for certain whether all the confounding information has been removed.

The SEC's standard of care is to develop a "reasonable estimate," which suggests there isn't a mandate to run many different analyses. However, doing so can be helpful when the results from a single analysis seem counterintuitive. For example, what if the event study shows a 30 percent stock price drop but the restatement involves reallocating earnings between two segments that are believed to be similarly valued by the market?

This is one of many instances where it may make sense to bring another methodology to the table. The goal is never to methodology shop, but to see how multiple analytical frameworks deal with the economics of the restatement.

One commonly accepted alternative involves fundamental analysis of the restated amounts. We call this a bottom-up analysis because a model is built that links the restated amounts to the stock price using valuation principles.

What if different techniques give different answers? We don't think there's any basis in the SEC rule that requires averaging multiple techniques. We believe the board, in collaboration with a firm like ours, should select the most appropriate one that it believes to be reasonable in light of the fact pattern. The other methodologies considered may or may not be referenced in the final report, but the final conclusion can certainly be based off the one methodology that's deemed most appropriate.

12. Consider fundamentals analysis in addition to an event study.

A company's fundamentals present a good opportunity to apply backward-looking logic to cut through the noise in the stock price movement. Specifically, we can apply pre-restatement stock price multiples to the restated financials to estimate the adjusted stock price. Especially when the restatement and vesting events are years in the past, fundamental analysis may even be a cleaner vehicle for sorting through the noise inherent in stock prices and top-down based methodologies.

As an example, imagine last year's earnings before interest, taxes, depreciation, and amortization (EBITDA) was overstated by 5 percent. If we assume a constant EBITDA multiple, the result is that the stock price was inflated by the same amount. This approach is appealing in its simplicity. Still, if the result doesn't tie to the stock price movement, we need a compelling theory for why.

The first key to a fundamentals analysis is to figure out what matters to investors. For a megacap with decades of operating history, earnings measures are likely going to be the most important. The same isn't the case for a pre-revenue startup, where forecasts are much more important to investors than past financials.

Analyst reports and other investor news discussing stock price movements can be a valuable place to identify and confirm what matters most.

It's important to consider whether this analysis with a constant multiple makes sense. If there's a 1 percent drop in EBITDA, it's probably reasonable to assume the change in stock price would be consistent. On the other hand, if EBITDA falls by 10 percent, this may imply something about the growth trajectory of the firm and result in a non-linear price adjustment by investors (for example, they conclude the company isn't a growth company deserving of a growth-oriented multiple).

Another factor to consider is that larger organizations may have different segments, making it important to drill down to segment levels when segment-level information is being restated. In one case, we developed separate segment-specific multiples for our bottom-up analysis, as earnings were shifted from a high-growth segment to a commodity segment, with no impact to the aggregate.

Best Practices and Success Factors

13. Run analyses under legal privilege to fully evaluate the issues and protect the company against pieces of the analysis being used in inappropriate and unintended ways.

Given the sheer number of moving parts and analytical possibilities, these studies should be performed under legal privilege. The goal of a study is to arrive at a reasonable estimate—plain and simple. However, you'll likely explore alternative paths to arrive at this estimate. There may also be sensitive discussions taking place amid the chaos of sorting out the new financials and trying to filter out confounding information.

For all these reasons, the analysis performed should be privileged. Typically, legal counsel to the board of directors will engage us as part of its broader effort to guide the board in arriving at a complete Dodd-Frank recovery analysis.

14. Take a phased, multi-step approach to any analysis.

With market metrics, information will evolve dynamically as the recovery analysis unfolds. Consider taking an iterative approach that begins as soon as the decision is made to restate financials.[4] This means the analysis must begin before the story has run its full course. However, it allows both us (the specialist) and the board to begin identifying the key issues and variables at play.

In addition to starting the analysis at the point of initial announcement, which may precede the formal reissuance of financials, we also separate probing from pressure-testing (or what we've referred to as level 1 and level 2 analyses). This phased approach allows the board to come on the journey and ask questions along the way, instead of having to take in an exhaustive report all at once.

The difference between the two levels of analysis is that level 2, the deeper analysis, will pressure-test the basic conclusions and assess whether there are alternate explanations. For example, this may be where a fundamental analysis gets layered in (or vice versa). Or, this may be where the event study is refined to consider whether part of the stock price drop is linked to something other than the new numbers, such as negative signaling about future earnings.

15. Tailor your documentation and analysis to each audience

Remember you have at least two direct audiences: the board of directors and the listing exchange (which includes the SEC given they maintain the ability to review information filed with the listing exchange). Management is an indirect audience, not only because they're affected by the results, but also because they're responsible for disclosing details on the clawback enforcement in the proxy and potentially supplying data during the analysis.

Since the board is accountable for the conclusions in the final recovery analysis, they'll want to understand the process as well as the strengths and weaknesses of each analytical framework. It matters how you walk them through the analysis given how dense and technical the topic is. In general, board members appreciate plain language and interaction that allows them to come up to speed. So, avoid delivering the kind of expert report you might see in litigation. Instead, treat board-facing materials like any other compensation-related update they receive: a few pages explaining the issue, the parameters, and the decision points. Follow these with a moderately-sized appendix containing supporting analysis.

In addition to board-facing materials, a report must be filed with the listing exchange documenting the final conclusion, methodology, and key assumptions. This doesn't need to look like an expert report either. But it should be clearly organized and focus on explaining the methodology, why it was selected, and why it delivers a reasonable estimate in light of the fact pattern.

Finally, remember the proxy requires comprehensive disclosure as to the clawback amounts, the assumptions in determining these amounts, and the company's progress toward recovery. The language should be clear and complete to demonstrate the board is responsibly discharging its obligations under the company's clawback policy.

Notes

1. In a Big-R restatement, these two events occur at different periods of time, whereas little-r restatements often will comingle the announcement of restated numbers with the restated numbers and many new forward-looking numbers.
2. For more on how an event study works, you can read our discussion *here. https://www.equitymethods.com/articles/clawbacks-demystifying-the-event-study/*.
3. 90 days is used based on the bounce-back provision contained in the Public Securities Litigation Reform Act of 1995.
4. With a Big-R restatement, there's most definitely a time gap between the announcement and reissuance of financials. With a little-r restatement, there may not be an announcement, and therefore only one event date to analyze.

The Impact on Equity Compensation Tax Withholding of the SEC's New T+1 Settlement Cycle

By David Sakowitz, Joe Adams, Marissa Sims, and Mollie Goldfarb

Last year, the Securities and Exchange Commission (SEC) adopted its final rule to shorten the settlement cycle for most broker-dealer securities transactions to one business day after the trade date (T+1). Previously, the standard settlement cycle was two business days after the trade date (T+2). Beginning on May 28, 2024, the T+1 settlement cycle applies to most broker-dealer securities transactions.[1]

T+1 Impact on Equity Compensation Settlement and Tax Withholding

The T+1 shortened settlement cycle applies to most broker-dealer transactions. This includes certain broker-facilitated transactions relating to equity compensation plans and, in turn, impacts when an employer is required to remit tax withholding deposits to the Internal Revenue Service (IRS).

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IRS's Next-Day Deposit Rule

Under IRS tax withholding rules, many employers are subject to the "next-day deposit rule" under Treasury Regulations Section 31.6302-1(c). That is, notwithstanding an employer's monthly or semi-weekly tax withholding deposit schedule, if an employer has amassed a tax withholding obligation of $100,000 or more as of any day during a deposit period, then it must remit the required tax withholding deposits to the IRS by the close of the following business day.

The IRS commonly audits remittance of tax withholding deposits, and failure to timely and properly remit such deposits can lead to failure-to-deposit (FTD) penalties under Section 6656 of the Internal Revenue Code.[2] As shown below, the penalty amounts increase significantly based on the number of days the deposit is late. Specifically, the penalty jumps from 2 percent to 5 percent of the unpaid deposit if the payment is *six* calendar days late as opposed to *five* calendar days, and because the IRS bases the penalty on calendar days that include weekends and holidays when deposits cannot be made, the one day lost in the move from T+2 to T+1 settlement might mean more employers wind up paying a higher penalty amount. (*See* Table below.)

Number of Days Deposit Is Late	***Amount of the Penalty***
1–5 calendar days	2% of the unpaid deposit
6–15 calendar days	5% of the unpaid deposit
More than 15 calendar days	10% of the unpaid deposit
More than 10 calendar days after the date of first notice or letter (for example, CP220 Notice) **or** the day of a notice or letter for immediate payment (for example, CP504J Notice)	15% of the unpaid deposit

The "next-day deposit rule" clock generally starts for employers once employment taxes are required to be withheld. Under IRS guidance (that has been questioned), this technically occurs for nonqualified stock options (NQSOs) and stock-settled stock appreciation rights (SARs) at the time the executive exercises the award, and occurs for stock-settled restricted stock units (RSUs) at the time the employer initiates payment of the award.[3] Under the next-day deposit rule, to avoid the imposition of an FTD penalty, tax withholding deposits would need to be funded within one business day of the exercise of NQSOs and SARs and within one business day of the date an employer initiates payment of an RSU.

Limited FTD Penalty Waiver for Certain Incentive Equity Transactions

Certain broker-facilitated transactions involving incentive equity awards can make it challenging for an employer to meet the next-day deposit rule, particularly when cash generated from the transaction will be used by an employer to fund its deposit liability. For example, many employers permit employees to exercise NQSOs and SARs through a same-day sale or broker-assisted cashless exercise to fund the payment of tax withholding obligations. Similarly, employers granting RSUs may utilize a sell-to-cover transaction, whereby enough shares to cover the tax withholding obligation generated by the vesting and payment of the shares underlying the RSU are sold into the market by a third-party broker, who in turn remits the cash proceeds to the employer and the net shares to the participant.

Under the technical IRS next-day deposit guidance discussed in the prior paragraph, it would have been impossible for an employer to fund the tax withholding deposit liability using the proceeds from the broker-assisted sales, since the employer had one business day from the exercise of an NQSO/SAR or payment of an RSU to make tax withholding deposits to the IRS, while under the prior T+2 settlement cycle the broker had two business days from the execution date of a trade to remit cash proceeds for tax withholding obligations to the employer.

Although no statutory relief exists, the IRS historically has permitted a limited administrative waiver of the FTD penalty for the next-day deposit rule under Section 20.1.4.26.2(5) of the Internal Revenue Manual (IRM) used by IRS auditors. Essentially, the waiver permits employers to make tax-withholding deposits within one business day of the broker settlement date (that is, when the employer received the funds from the broker), as opposed to one business day from the exercise date or payment date of the award.[4]

However, if the broker settlement date occurred more than three business days after the exercise date or payment date of the award, then the auditor would use the third business day after the award exercise date or payment date as the start date for the "next-business day deposit rule" clock. Notably, the IRS has only permitted this administrative waiver for tax withholding liability incurred in connection with the exercise of NQSOs and stock-settled SARs and the payment of stock-settled RSUs. Cash-settled awards, restricted stock and other equity awards are not eligible for this waiver.

The administrative waivers reflected in Section 20.1.4.26.2(5) of the IRM were updated in March 2024 to reflect the forthcoming change from the T+2 to the T+1 settlement cycle. Now, in order for the administrative waiver to be available, the broker settlement date must occur within *two* business days after the exercise date or payment date of an award, as opposed to *three* business days. Importantly, following the change to the T+1 settlement cycle, even with the available administrative relief, employers now have one fewer day within which to calculate, withhold and remit tax withholding deposits funded through broker-facilitated market sales.

Practical Recommendations for Employers Permitting Same-Day Sales and Sell-to-Cover Transactions

1. **Ensure payroll teams and systems are prepared for, and remain compliant with, shortened remittance schedules.** Prior to any upcoming sell-to-cover events or sale-day sales, make sure internal teams are aware of the change in timing and connect with your stock plan administrator and/or third-party broker to ensure broker settlements occur within the IRS administrative waiver periods to minimize any potential FTD penalties. Employers with special handling arrangements that allow for large sell-to-cover transactions to be handled over several days to ensure a sale is made at the best possible price should consult with their brokers and legal advisors to ensure the arrangement still allows them to remain in compliance with the next-day deposit rule.
2. **To mitigate the loss of one day in the "next-day deposit rule" remittance timing, find other efficiencies.** Consider leveraging technology to efficiently calculate withholding tax obligations and automate payroll deposit processes. Additionally, to conform to the expedited settlement timeline, employers should consider calculating tax withholding using the closing or opening trading price *from the date prior to the trade execution date*. (The IRS rules do not necessarily require the use of the closing price on the execution date for purposes of calculating the required withholding amount; instead, the IRS rules merely require the use of any reasonable valuation method.)

   Employers will want to review their equity compensation plan document to determine how it addresses required withholdings and consult with counsel regarding whether a plan amendment is advisable. Generally, we would not expect such a plan amendment to require stockholder approval under applicable exchange rules.
3. **If meeting the new requirements is not feasible, consider alternatives to funding tax withholding obligations.** If permitted under their equity plans, employers could require some or all employees to self-fund their tax withholding obligations by remitting cash to their employer in lieu of a sell-to-cover transaction.

In many cases, the aforementioned method is not possible or desirable, and can lead to employee relations challenges with executives and rank-and-file employees alike. More palatable for employees, but often less feasible for early-stage companies, employers could move from same-day sales, broker-assisted cashless exercise and sell-to-cover transactions to net-settlement transactions. With net settlement, the employer would hold back a number of shares from an award equal to the award's tax withholding obligations as of the date of the award exercise or payment. The employer would then use existing cash reserves to make the tax withholding deposits to the IRS. One benefit of this practice is that it avoids the downward pressure on an issuer's stock price that can occur when a broker is exercising a large sell-to-cover transaction following a big RSU vesting event.

Employers could also take a mixed approach if they have enough cash on hand. The employer could make *estimated* remittance payments for tax withholding obligations prior to their due date to cut off any potential FTD penalty liability, and then make themselves whole once they receive funds from third-party brokers following the completion of same-day sales, broker-assisted cashless exercise and sell-to-cover transactions.

Notes

1. *https://www.sec.gov/files/rules/final/2023/34-96930.pdf.*
2. *https://www.irs.gov/payments/failure-to-deposit-penalty.*
3. *https://www.irs.gov/pub/lanoa/am-2020-004.pdf.*
4. *https://www.irs.gov/irm/part20/irm_20-001-004r#idm140431078783472.*

DIRECTOR COMPENSATION

Analyzing "At-Appointment" Equity Awards for New Directors

By Stephen Huber

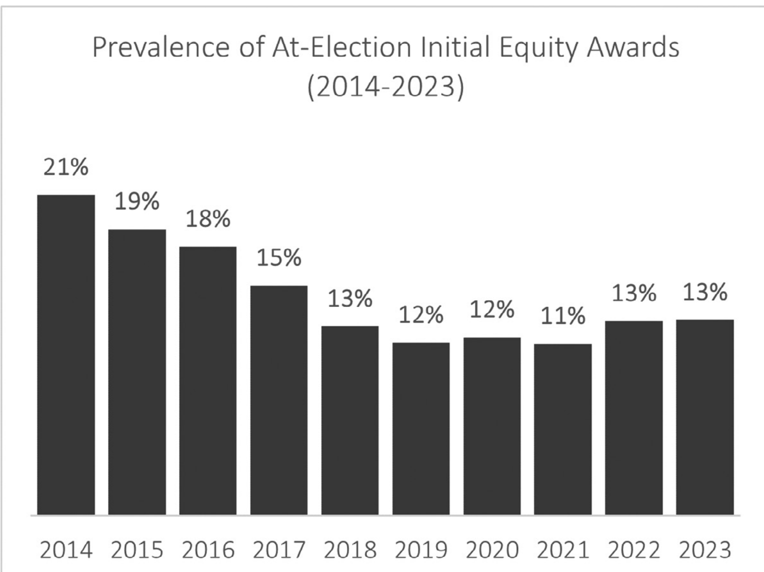
As the competition for skilled and diverse outside directors intensifies, companies are considering innovative strategies to attract top-tier board talent. One such enticement gaining attention is the use of special "at-appointment" equity grants. With the aim of refreshing and diversifying board memberships, these grants offer a way to distinguish a company's pay program in the recruitment process without a more costly increase to annual director pay levels.

The rationale behind at-appointment equity grants lie in their potential to immediately and substantially align directors with the interests of shareholders—beyond the more common practice of issuing a pro-rated portion of the standard annual board equity grants. However, the drawback is significant: These substantial one-time equity grants can draw the ire of shareholders and advisory firms—especially if perceived as excessive.

Prevalence Over Time

Data over the last decade reveals a decline in the use of at-appointment equity grants, dropping

Exhibit 1



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from 21 percent in 2014 to 13 percent in 2023.[1] (*See* Exhibit 1.) While the decrease was sharpest from 2014 to 2018, prevalence has since leveled off. The question arises: Might we witness a rebound or increase as director competition intensifies?

Relationship Between At-Appointment Equity Grants and Company Scale

Smaller companies lead in the utilization of at-appointment equity grants, with prevalence rates of 17 percent and 18 percent at small and micro companies, respectively, compared to less than 10 percent at larger counterparts.[2] This trend suggests that smaller companies may be competing for the same directors as larger firms, where appointments can be perceived as more prestigious or coveted. At smaller, emerging/high-growth companies, a substantial one-time equity grant can be particularly attractive due to its potential for higher upside. (*See* Exhibit 2.)

Prevalence of At-Appointment Equity Grants Across Different Sectors

Certain industries exhibit a higher prevalence of at-appointment equity grants. Notably, the information technology and healthcare sectors award at-appointment grants at rates of 29 percent and 25 percent, respectively, compared to the overall rate of 13 percent. Traditional sectors such as industrials, materials, and utilities rarely offer such grants, potentially highlighting where the competition for outside directors is most intense. (*See* Exhibit 3.)

Conclusion

While at-appointment equity grants can serve as a valuable tool to attract outside directors and immediately align their interests with those of stockholders, it remains a relatively uncommon practice. Prevalence varies based on company size and industry dynamics. Companies considering this approach should be prepared to defend the

Exhibit 2

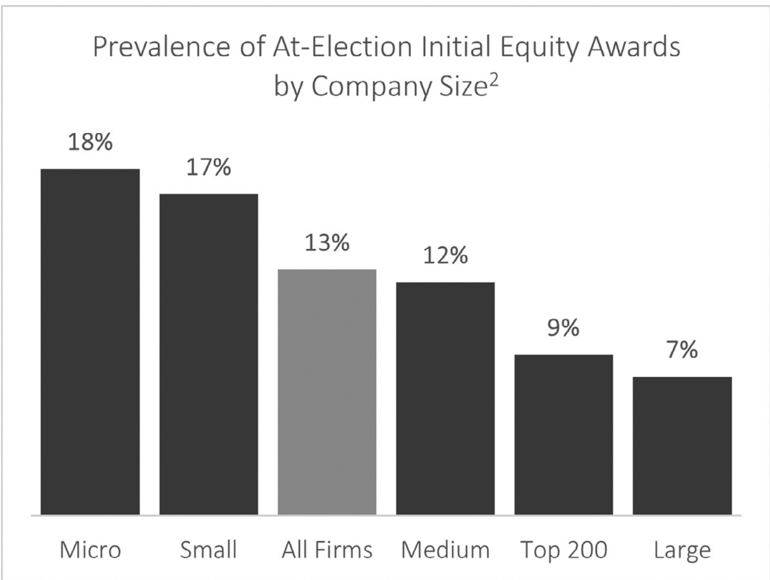
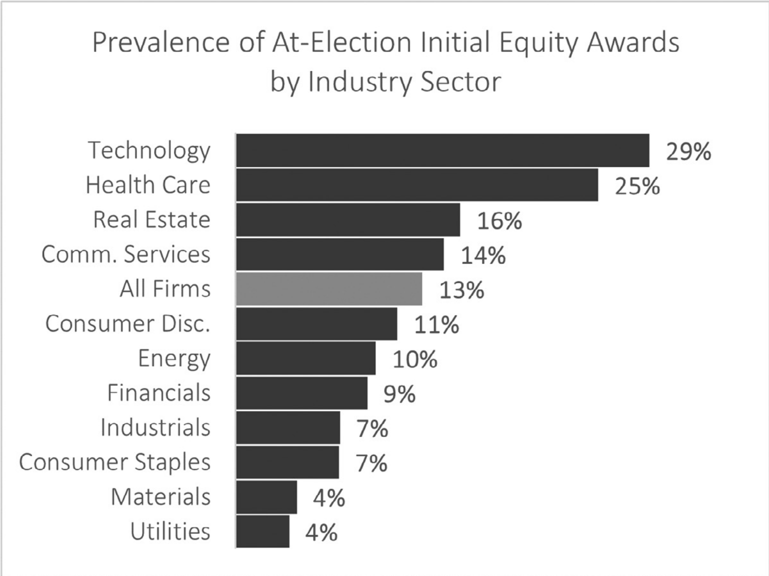


Exhibit 3



rationale for such grants against criticisms of outsized director pay. Additionally, those that elect to adopt such programs moving forward must balance perceptions of fairness among longstanding directors who may feel overlooked compared to new directors. As with so many corporate governance issues, in the evolving landscape of director compensation, balancing innovation with fairness is essential.

Notes

1. Data in this article is sourced from the 2023/2024 Pearl Meyer/NACD Director Compensation Report covering 1400 public companies.
2. Report data is divided into five company size categories based on annual revenue: (1) Micro: \$50M–\$500M; (2) Small: \$500M–\$1B; (3) Medium: \$1B–\$2.5B; (4) Large: \$2.5B–\$10B; and (5) Top 200: largest 200 companies in the S&P 500.

CYBERSECURITY

SEC Staff Makes Clear That Cyber Disclosures Under Item 1.05 of Form 8-K Should Be Limited to Material Incidents

By David M. Lynn, Jonathan H. Hecht, L. Judson Welle, Jacqueline R. Kaufman, James H. Hammons, and Jonathan Burr

On May 21, 2024, Erik Gerding, director of the Division of Corporation Finance of the US Securities and Exchange Commission (SEC), issued a statement with clarifying guidance on cybersecurity incident disclosure under Item 1.05 (Material Cybersecurity Incidents) of Form 8-K.[1] The central message of the statement is that voluntary disclosure of cybersecurity incidents that have not been found to be material or for which a materiality determination has not yet been made should not be disclosed under Item 1.05 of Form 8-K. Such disclosures are better made under Item 8.01 (Other Events) of Form 8-K.

While the guidance is not a formal statement by the SEC or otherwise legally binding, companies making disclosure decisions should carefully consider the guidance.

Background

On July 26, 2023, the SEC adopted new Item 1.05 of Form 8-K, which requires that public companies disclose any cybersecurity incident that is determined to be material and describe the material aspects of the nature, scope, and timing of the incident as well as the material impact or reasonably likely material impact of the incident on the company, including its financial condition and results of operations.[2] Companies must determine the materiality of an incident without unreasonable delay following discovery and, if the incident is determined to be material, file an Item 1.05 Form 8-K within four business days of such determination.

A company is required to file an amendment to its Form 8-K filing if certain required information was not available at the time of the initial filing within four business days of determining such information or after such information becomes available. The new disclosure obligation became effective on December 18, 2023.

In the five months since the effective date, 17 companies have disclosed cybersecurity incidents under Item 1.05 of Form 8-K. In nearly all of those filings, companies have included language to the effect that they do not believe the cybersecurity incident has had or is likely to have a material impact on the company's financial condition or results of operations. Most disclosures also indicate that an investigation of the incident is ongoing; accordingly, the full scope, nature, and impact of the cybersecurity incident are not yet known.

Except for one company that indicated in its Form 8-K an expectation that the cybersecurity incident would have a material impact on its results of operations for the fourth quarter of 2023, no companies stated that the cybersecurity incident was material to the company. While each of these situations is unique, investors could potentially be confused about the materiality of a cybersecurity incident when a company discloses the incident under Item

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1.05 of Form 8-K but includes a statement that the cybersecurity incident has not had, or is not likely to have, a material impact on the company's financial condition or results of operations.

Statement on Item 1.05 (Material Cybersecurity Incidents) of Form 8-K

As reflected in Mr. Gerding's statement, the SEC Staff encourages disclosure of a cybersecurity incident for which a company has not yet made a materiality determination or a cybersecurity incident that a company determined was not material under a different item of Form 8-K than Item 1.05, such as Item 8.01:

> Although the text of Item 1.05 does not expressly prohibit voluntary filings, Item 1.05 was added to Form 8-K to require the disclosure of a cybersecurity incident "that is determined by the registrant to be material," and, in fact, the item is titled "Material Cybersecurity Incidents." In addition, in adopting Item 1.05, the Commission stated that "Item 1.05 is not a voluntary disclosure, and it is by definition material because it is not triggered until the company determines the materiality of an incident." Therefore, it could be confusing for investors if companies disclose either immaterial cybersecurity incidents or incidents for which a materiality determination has not yet been made under Item 1.05. [footnotes omitted]

Mr. Gerding emphasizes that the statement is not intended to discourage voluntary disclosure of cybersecurity incidents that do not (yet) fall under the disclosure mandate of Item 1.05; "[r]ather, this statement is intended to encourage the filing of such voluntary disclosures in a manner that does not result in investor confusion or dilute the value of Item 1.05 disclosures regarding material cybersecurity incidents." Instead, the Division of Corporation Finance Staff encourages companies to disclose such cybersecurity incidents under a different item of Form 8-K, such as Item 8.01(Other Events). Mr. Gerding further explains:

> Given the prevalence of cybersecurity incidents, [the] distinction between a Form 8-K filed under Item 1.05 for a cybersecurity incident determined by a company to be material and a Form 8-K voluntarily filed under Item 8.01 for other cybersecurity incidents will allow investors to more easily distinguish between the two and make better investment and voting decisions with respect to material cybersecurity incidents. By contrast, if all cybersecurity incidents are disclosed under Item 1.05, then there is a risk that investors will misperceive immaterial cybersecurity incidents as material, and vice versa.

The statement includes a recognition that a company may determine that, after further investigation, a cybersecurity incident that it initially disclosed voluntarily under Item 8.01 is, in fact, material for purposes of Item 1.05. In such situations, the company should file an Item 1.05 Form 8-K within four business days of such subsequent materiality determination. The new filing may refer to the earlier Item 8.01 Form 8-K but must independently satisfy the specific requirements of Item 1.05.

The SEC made clear in the adopting release for Item 1.05 of Form 8-K that "materiality" is to be determined consistent with the standard set out in case law addressing materiality in the securities laws—information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision or if it would have "significantly altered the 'total mix' of information made available."

Mr. Gerding's statement reiterates guidance in the adopting release on considerations for companies assessing the materiality of a cybersecurity incident. Specifically:

- The assessment should not be limited to the impact on financial condition and results of operation.
- Companies should consider qualitative factors alongside quantitative factors, such as whether the incident will harm its reputation, customer or vendor relationships, or competitiveness.
- Companies should consider the possibility of litigation or regulatory investigations or actions, including regulatory actions by state and federal authorities and authorities outside the United States.

The materiality assessment guidance also describes a scenario in which a company experiences a cybersecurity incident that is so significant that it can be deemed material, even though the company has not yet determined its impact (or reasonably likely impact). In such a case, the company should disclose the incident in an Item 1.05 Form 8-K, include a statement noting that the company has not yet determined the impact (or reasonably likely impact) of the incident, and amend the Form 8-K to disclose the impact once that information is available.

The initial Item 1.05 filing must provide investors with the information necessary to understand the material aspects of the nature, scope, and timing of the incident, notwithstanding the company's inability to determine the incident's impact (or reasonably likely impact) at that time.

Conclusion

Mr. Gerding's statement is just the latest indication of the agency's focus on cybersecurity. For example, the SEC adopted new rules on May 16, 2024, that mandate registrants in the financial services industry to adopt written policies and procedures and safeguards related to customer records and information.[3] The SEC's Division of Corporation Finance Staff has continued to emphasize the applicability of its 2018 interpretive guidance on the importance of adopting disclosure controls and procedures that enable companies, among other things, to identify and evaluate cybersecurity risks and incidents, make sure information is reported up to management and appropriate committees, assess and analyze their impact on a company's business, and make timely disclosures.[4]

The SEC's Division of Enforcement has also been active, pursuing actions against companies for allegedly misleading disclosures about the impact of data breaches and other cybersecurity incidents.

Beyond securities law compliance, there are myriad intertwined issues and legal risk and operational considerations that arise from cybersecurity incidents, including investigations, private litigation, state and federal law enforcement actions, and data preservation and management requirements.

Notes

1. *https://www.sec.gov/corpfin/announcement/gerding-cybersecurity-incidents-05212024.*
2. *https://www.sec.gov/files/rules/final/2023/33-11216.pdf.*
3. *https://www.sec.gov/files/rules/final/2024/34-100155.pdf.*
4. *https://www.sec.gov/files/rules/interp/2018/33-10459.pdf.*

The SEC's Controls-Based Approach to Cybersecurity Enforcement Continues, with an Accounting Twist

By Haimavathi V. Marlier, Miriam H. Wugmeister, Nicole K. Serfoss, and Dan Baskerville

On June 18, 2024, R.R. Donnelley & Sons Co. (RRD) settled a $2.125 million Securities and Exchange Commission (SEC) administrative enforcement action based on RRD's alleged failure to design effective disclosure controls and procedures as required by Securities Exchange Act of 1934 (Exchange Act) Rule 13a-15(a). The SEC also alleged that RRD violated Exchange Act Section 13(b)(2)(B), a statute that requires public companies to devise and maintain "a system of internal accounting controls" that prohibit access to a company's "assets" without authorization by management.[1]

According to the SEC, RRD's alleged failure to maintain adequate cybersecurity controls over its information technology systems and networks, which contained sensitive business and client data, violated this statute. SEC Commissioners Hester Peirce and Mark Uyeda dissented to the application of Section 13(b)(2)(B) to non-accounting controls, consistent with their November 2023 dissent in the SEC's settlement with Charter Communications relating to stock buybacks and Rule 10b5-1 trading plans.[2]

Key Takeaways

- ***This settlement marks the SEC's second application of Section 13(b)(2)(B) to cybersecurity controls in the aftermath of cyber incident threat actors accessing a public company's IT systems and networks.*** Historically, the SEC uses Section 13(b)(2)(B) to enforce accounting controls violations which allowed alleged unauthorized access to a company's financial or payment systems, typically resulting in payments made by company employees without proper authorization.

  Along with the SEC's litigation against SolarWinds, discussed below, the RRD settlement is the latest indication from at least three of the SEC Commissioners of their view that public companies' cyber incident and response policies, as well as actions taken by company personnel in accordance with those policies, fall within the purview of Section 13(b)(2)(B).
- ***Questions about the application of Section 13(b)(2)(B) to cybersecurity controls are currently being litigated in federal court.*** The SEC's first cyber enforcement action including Section 13(b)(2)(B) charges is currently under consideration by Judge Paul Engelmayer in the Southern District of New York at the motion to dismiss stage. *See SEC v. SolarWinds Corp. et al.*, No. 1:23-cv-09518-PAE. A victory by SolarWinds on its 13(b)(2)(B) defense could affect how the SEC approaches future Section 13(b)(2)(B) cybersecurity enforcement actions involving exfiltration of computer code and software or access to IT infrastructure.
- ***Public companies should review their incident response and escalation policies in the wake of the RRD settlement and SolarWinds litigation.*** While questions remain about

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whether cybersecurity controls constitute accounting controls, and whether computer code and IT networks are in fact "assets" under Section 13(b)(2)(B), public companies should take steps to ensure that their cybersecurity incident response policies: (1) clearly identify responsible personnel with authority for responding to cybersecurity incidents; (2) establish unambiguous guidelines for reviewing and prioritizing alerts and incidents; and (3) create well-defined processes for escalating and reporting incidents internally, including communication with decision-makers responsible for disclosure. Public companies should also ensure that they are adequately resourced to execute existing policies and procedures and that they implement adequate investigative and remedial actions in accordance with their incident response and escalation policies when necessary.

Overview of the SEC's Allegations

Between November and December 2021, RRD suffered a ransomware network intrusion. RRD's intrusion detection system issued alerts, which were reviewed by RRD's third-party managed security services provider (MSSP). MSSP escalated some, but not all, alerts to RRD's internal security personnel beginning on November 29, 2021. While RRD reviewed these escalated alerts, it did not take infected systems off the network and failed to conduct an investigation until December 23, 2021. During this period, MSSP also reviewed, but did not escalate to RRD's internal security personnel, at least 20 alerts relating to the same malware being installed or executed on multiple other computers across the network.

RRD began responding to the attack on December 23, 2021, after its Chief Information Security Officer was notified of anomalous internet activity by an unidentified company with shared access to RRD's network. Four days later, RRD self-reported the incident to the SEC and then filed a Form 8-K.[3] In total, the threat actor exfiltrated 70 GB of data belonging to RRD's clients, including personal identification and financial information. RRD uncovered no evidence that the threat actor accessed RRD's financial systems or corporate financial or accounting data.

In deciding to bring Section 13(b)(2)(B) charges, the SEC alleged that RRD's cybersecurity alert review and incident response policies did not adequately establish prioritization schemes or provide clear guidance on how to review and respond to cybersecurity incidents to internal and external personnel. The order noted how RRD security personnel "failed to adequately review [] alerts and take adequate investigative and remedial measures," and that RRD staff tasked with reviewing and responding to escalated alerts had "significant other responsibilities, leaving insufficient time to dedicate to the escalated alerts and general threat-hunting."

The SEC's press release credited RRD's "meaningful cooperation that helped expedite the Staff's investigation" and voluntary adoption of "new cybersecurity technology and controls," as factors resulting in the $2.125 million civil penalty.[4]

Internal Agency Concerns Regarding the Expansive Interpretation of Regulatory Scope under Section 13(b)(2)(B)

In a dissenting statement of the RRD order, Commissioners Peirce and Uyeda expressed concerns about the SEC's use of Section 13(b)(2)(B) as a tool to enforce cybersecurity-related internal accounting controls. Commissioner Peirce asserted that "computer systems," while technically assets insofar as they are corporate property, are *not* the types of assets covered by Section 13(b)(2)(B)'s internal accounting controls provisions because "computer systems" are not the subject of corporate transactions.[5] She emphasized that the Commission's role with respect to public companies' activities, including cybersecurity, is limited and cautioned against agency overreach by eroding the distinction between internal accounting controls and administrative controls more broadly.

Notes

1. *https://www.sec.gov/files/litigation/admin/2024/34-100365.pdf*.
2. *https://www.sec.gov/news/statement/peirce-uyeda-statement-rr-donnelley-061824*.
3. *https://www.sec.gov/ix?doc=/Archives/edgar/data/0000029669/000119312521367028/d280996d8k.htm*.
4. *https://www.sec.gov/news/press-release/2024-75*.
5. *https://www.sec.gov/news/statement/peirce-uyeda-statement-rr-donnelley-061824*.

ESG

Practical Suggestions When Reviewing ESG Disclosures

By Jurgita Ashley and Tanya Nesbitt

As companies increasingly provide environmental, social, and governance (ESG) disclosures, risks of greenwashing claims, other types of litigation, and regulatory enforcement actions similarly increase, albeit they may follow a few years after the release of disclosures. Although resources are more often than not limited and teams are overextended, investing on the front end should mitigate these risks, ultimately saving time and dollars. Below are 10 common issues and practical suggestions that might help to shortcut review of ESG disclosures:

1. Scope and Tailored Disclaimers

Begin by understanding the scope of the ESG disclosures and the intended audience. The company should assess if disclosures align with the company's operations, strategy, and material risks, as well as industry reporting best practices. The company should disclose whether the greenhouse house emissions (GHG), water and waste usage, diversity, equity, and inclusion (DEI), and other ESG data covers the entire organization, or if it excludes certain geographic regions, carves out recent mergers and acquisitions activity, and contains temporal or other limitations. Then, tailored disclaimers should be crafted to describe these exclusions, explain any assumptions, and clarify the limitations of the disclosed information, including when targets and undertakings are aspirational.

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2. Regulatory Compliance

Stay updated on evolving regulatory requirements concerning ESG reporting and ensure that disclosures adhere to relevant mandates. For example, while there is some overlap between European Union, International Sustainability Standards Board (ISSB), Securities and Exchange Commission (SEC), and California, the scope and differences are significant and integrated reporting will take time. In the meantime, is the company monitoring law and regulations to which it will likely be subject, and has the C-Suite been updated as to compliance costs?

3. Identifying Gaps and Supporting Policies

Consider the company's ESG prioritization assessments, peer and industry data, any applicable regulatory requirements, ESG reporting frameworks, and any recent customer questionnaires, shareholder feedback and other stakeholder input when developing ESG reports. If reviewing late in the game, look at some peer disclosures and industry survey data, where available, for any significant gaps in ESG disclosures and developing areas.

For example, how is the company addressing human rights and human rights due diligence? What about nature-based risks, such as biodiversity loss or deforestation, sustainable sourcing practices, recycling, and ecosystem conservation efforts? In addition to the ESG report, does the company have policies to back up its ESG pillars and main goals, which policies ISS and other rankers score? Sometimes the company is already addressing these areas (for example, cybersecurity and artificial intelligence) and it is a matter of determining if, how, and where they should be disclosed. Other times, the company may want to build out a particular area and address it the following year.

4. Applicable ESG Frameworks

Along similar lines, assess if the company has adopted recognized ESG frameworks such as the Sustainability Accounting Standards Board (SASB), Global Reporting Initiative (GRI), Task Force on Climate-Related Financial Disclosures (TCFD) (with ISSB Standards—IFRS S1 and IFRS S2—now incorporating TCFD), and United Nations (UN) Sustainable Development Goals (SDGs).

Alignment with these frameworks can enhance transparency and comparability and is usually one of the first steps when developing an ESG program. TCFD is foundational for much of climate-based disclosure regulation as well and can be an effective interim step when preparing for regulatory reporting.

5. Data Accuracy and Verification

Consider disclosure controls and the accuracy and reliability of the data presented in ESG disclosures. Look for outliers in disclosure and ask questions. Is the company using third-party verification? If internal, are there ESG data audits and validation processes to mitigate the risk of erroneous information? Are the disclosure committee and the board committees involved in overseeing these processes? Who needs to review and approve the ESG report? The ESG report should explain how this data is validated and the extent of internal validation procedures if no third-party verification is obtained.

6. Consistency Across ESG Report, Proxy and Other SEC Filings, and Public Disclosures

Ensure general consistency between ESG report and other corporate communications, such as annual reports, proxy statements, press releases, marketing materials, and website disclosures. Has the company considered materiality under securities laws? Is the company familiar with ESG-related comment letters that its peers may have received? Is the company responsive to any undertakings to the SEC, investors and other stakeholders that the company may have made?

7. FTC Green Guides for Climate-Related Disclosures

In addition to reviewing for accuracy, consistency and under the guidelines of securities laws, consider ESG disclosures through the lens of the Federal Trade Commission (FTC) Green Guides. For example, ensure that any marketing and environmental benefit claims are substantiated and comply with regulatory standards. Avoid unqualified environmental benefit claims and be sure to review the latest judicial interpretations of your claims, if applicable. Revised Green Guides should be available by late 2024 or early 2025.

8. DEI Disclosures

Given recent litigation in the DEI space and the rapidly evolving landscape, understand related risks and the company's risk tolerance. Many, but not all, companies are choosing to modify these disclosures and/or related programs—as with many other ESG areas, cross-functional coordination and alignment within the organization is necessary. Has the company recently engaged with investors and employees on these topics? Has the company made any commitments in response to shareholder proposals?

9. Message Conveyance through Images, Graphs, and Callouts

Carefully review the visual elements used in ESG disclosures, such as images, graphs, and callouts. Evaluate if these visual aids appropriately convey the company's message. Is the messaging representative of the company and its constituencies? Do details create inconsistencies? Are the callouts the most important points? What if someone only looks at visual aids? What message will they walk away with?

10. Responsiveness to Stakeholders and Political Environment

Assess the responsiveness of ESG disclosures to the interests and expectations of key stakeholders, including investors, customers, employees, and communities. What is the company's strategy for addressing anti-ESG backlash that may conflict with its intended ESG goals? ESG disclosures ideally address stakeholder concerns, are sensitive to increased politization of "ESG," are intentional with related wording, and demonstrate the company's commitment to long-term sustainability and value creation.

Sometimes minimal changes can be impactful in enhancing the quality, credibility, and impact of ESG disclosures.

Sustainability Assurance: The New Expectations Gap

By Dan Goelzer

Companies frequently obtain third-party assurance over portions of their sustainability reporting, and sustainability reporting rules typically require assurance. However, assurance reports on sustainability disclosures often provide only limited, rather than reasonable, assurance.[1] Similarly, the Securities and Exchange Commission's (SEC) climate rules initially require only limited assurance over greenhouse gas (GHG) disclosures, and, for many smaller companies, reasonable assurance will never be required.[2] In contrast, under Public Company Accounting Oversight Board (PCAOB) standards, an auditor's opinion on financial statements must provide "reasonable assurance" that the statements are fairly presented in conformity with generally accepted accounting principles (GAAP).

In "Managing Expectations: How Assurance Level and Sustainability Reporting Approach Affect Investor and Auditor Confidence," Lori Shefchik Bhaskar (Indiana University), Jeffrey Hales (University of Texas at Austin and a member of the International Sustainability Standards Board), Tamara A. Lambert (Lehigh University), and Roshan K. Sinha (Indiana University) explore how the choice between reasonable and limited assurance) affects nonprofessional investor confidence in sustainability information.[3] They find "significant expectation gaps" and that "investors fail to sufficiently adjust for the lower level of assurance that a limited-assurance engagement provides."

In simplified terms, the approach of the Managing Expectations study was to ask two sets of participants to review an ESG disclosure regarding water management and an independent auditor's report on that disclosure. One group of participants—the proxies for investors—consisted of 117 MBA students. The second group consisted of 110 large firm auditors with ESG experience.

The researchers varied the disclosures participants reviewed in two respects. First, they described the

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company's approach to disclosure as either investor-oriented or broad-stakeholder oriented (that is, the company's disclosure objective was either to provide information specifically relevant to investors or to provide information relevant to a broader range of stakeholders). Second, the auditor's report on the disclosure provided either reasonable assurance or limited assurance.

The researchers measured the level of confidence participants reported in the various disclosures. They also calculated the difference between the confidence levels reported by experienced auditors—who are presumably familiar with the difference between reasonable assurance and limited assurance engagements—and those reported by the more generalist MBA students.

The core finding of the study is that, while investors understand that there is a difference between reasonable and limited assurance, they overestimate the value of limited assurance:

> Consistent with our predictions, results reveal investor confidence depends on assurance type, such that investors differentiate limited from reasonable assurance. However, results also reveal significant expectation gaps between investors and auditors, with investor confidence being significantly higher than auditor confidence for sustainability disclosures with limited assurance. Interestingly, the expectation gap is avoided entirely for sustainability disclosures with reasonable assurance.
>
> Thus, our results highlight an area of concern related to companies obtaining limited assurance on sustainability disclosures and suggest reasonable assurance as one potential solution. Alternatively, while limited assurance remains a popular choice, and is already mandated for some sustainability disclosures, our study highlights the need to better inform investors about the meaning and limitations of limited assurance.

Ceres and others have argued that the use of limited assurance reports on sustainability disclosures should be curtailed in favor of reasonable assurance.[4] The "Managing Expectations" study lends support to those arguments:

> [O]ur finding that the expectation gap can be fully alleviated with reasonable assurance gives credence to investors' and audit firms' calls for reasonable assurance on sustainability disclosures . . .. In the absence of reasonable assurance, our findings highlight the need to better inform investors on how to interpret limited assurance.

Audit committees may want to consider the findings of this study when discussing with sustainability assurance providers the level of assurance they will provide.

Notes

1. *See* Large Companies Worldwide Continue to Expand Their ESG Disclosure and Assurance, February 2024 Update (95 percent of sustainability assurance reports worldwide provided limited assurance) at *https://www.auditupdate.com/post/large-companies-worldwide-continue-to-expand-their-esg-disclosure-and-assurance*.
2. *See* SEC Adopts Landmark Climate Change Disclosure Rules, March 2024 Update at *https://www.auditupdate.com/post/sec-adopts-landmark-climate-change-disclosure-rules*.
3. *See* "Managing Expectations: How Assurance Level and Sustainability Reporting Approach Affect Investor and Auditor Confidence" at *https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4784726*.
4. *See* Ceres Advocates Climate Disclosure Reasonable Assurance, March 2024 Update at *https://www.auditupdate.com/post/ceres-advocates-climate-disclosure-reasonable-assurance*.

SEC ENFORCEMENT

Two New SCOTUS Opinions Securities Practitioners Should Read

By Russ Ryan

Although the end-of-term flurry of Supreme Court opinions this month has not yet, as of this writing, included the one most anticipated by securities practitioners (that is, *SEC v. Jarkesy*), decisions involving two other agencies could have significant ramifications for the Securities and Exchange Commission (SEC).

One of them could further insulate legacy SEC disclosure rules from First Amendment challenges, while the other threatens an eventual end to the agency's historical practice of routinely demanding (and usually getting) statutory injunctions in every enforcement case it prosecutes in federal court.

First, the Court held in *Vidal v. Elster* that the "names clause" of the Lanham Act—which prohibits registration of a trademark that "[c]onsists of or comprises a name . . . identifying a particular living individual except by his written consent"—does not violate the First Amendment even though it is a content-based restriction on free speech.[1]

Although content-based speech restrictions are presumptively invalid, the names-clause restriction is not also *viewpoint*-based, because it bars the unauthorized use of *all* names rather than favoring certain types or categories of names over others or, say, prohibiting only the unflattering use of names. Most relevant to the SEC, however, was the Court's reliance on the long history of content-based restrictions in trademark registration and "the fact that trademark protection necessarily requires content-based distinctions."

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In the face of future First Amendment challenges to its disclosure regulations, the SEC would likely urge courts to apply similar reasoning—at least for regulations that are genuinely viewpoint-neutral and directly relevant to a company's financial health and performance. (Novel rules forcing speech about impertinent and politically charged subjects, such as the SEC's ill-fated conflict-minerals rule and its recent climate-disclosure rule, would likely fail this test of viewpoint neutrality.) [2]

The agency also would likely argue that the securities laws have a long history of speech restrictions and forced disclosures that are content-based but viewpoint-neutral, and that investor protection, like trademark protection, "necessarily requires" them. (Again, novel rules forcing politically tinged speech, particularly speech that doesn't directly relate to a company's financial health and performance, should enjoy no such history of acceptance or necessity.) Add in that some SEC speech restrictions and forced disclosures arguably impact only the somewhat lesser-protected category of speech called "commercial speech," and the agency's core and historically uncontroversial disclosure requirements may be safe for now.

Not so much with injunctions. I have previously criticized the SEC's indefensible habit of demanding injunctions in virtually every case it files in federal court.[3] In *Starbucks Corp. v. McKinney*, the Court held that to obtain a statutory preliminary injunction from a federal district court, the National Labor Relations Board must establish all of the elements of proof that any other litigant would have to establish before being awarded similar equitable relief.[4] The court below had dispensed with some of those elements—such as likelihood of success on the merits and irreparable harm—thus giving the National Labor Relations Board (NLRB) a much easier path to injunctive relief, but eight of the nine justices would have none of it. (Justice Jackson dissented in part while concurring in the judgment.)

The *Starbucks* opinion is an ominous one for the SEC, because courts also routinely dispense with traditional equitable principles when granting SEC injunctions—most notably, by excusing the agency from having to prove irreparable harm if the injunction is denied. When it comes to granting injunctions in final judgments (as opposed to preliminary injunctions), courts also routinely excuse the SEC from having to prove that it lacks an adequate remedy at law. That's a huge dispensation because the SEC nearly always has a powerful remedy at law available in the form of monetary penalties.

I see no obvious legal distinction between the kinds of evidentiary dispensations the Court rejected for NLRB statutory injunctions in *Starbucks* and the ones routinely granted to the SEC in dozens of cases each year. Considering that just four years ago, in *Liu v. SEC*, the Court applied a similar analysis in curtailing the SEC's ability to obtain disgorgement as a putatively equitable remedy, it's difficult to see how courts can continue to routinely grant SEC putatively equitable injunctions absent proof of both irreparable harm and inadequate remedies at law.[5]

Maybe it's wishful thinking, but I predict the *Starbucks* precedent may ultimately prove more consequential for SEC enforcement practice than even a worst-case-scenario outcome (from the agency's perspective) in *Jarkesy*.

Notes

1. *https://www.supremecourt.gov/opinions/23pdf/22-704_4246.pdf.*
2. *https://casetext.com/case/natl-assn-of-mfrs-v-sec-amp-exch-commn.*
3. *https://www.linkedin.com/pulse/could-injunctions-become-secs-next-headache-russ-ryan/.*
4. *https://www.supremecourt.gov/opinions/23pdf/23-367_f3b7.pdf.*
5. *https://www.supremecourt.gov/opinions/19pdf/18-1501_8n5a.pdf.*

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