2017 Trends in Governance

As we approach 2017, SEC rule changes will continue to affect public companies in significant ways. In this article, Keir Gumbs, a partner at Covington & Burling LLP and vice chair of the firm's Securities and Capital Markets practice group, summarizes the major areas of change, the ways in which companies have been adopting the rules over the past two years and how they will affect the 2017 proxy season.

Proxy Access

As was the case in 2015, the most significant corporate governance development in 2016 was the continued proliferation of proxy access bylaws. More than 40% of companies in the S&P 500 have now adopted proxy access and we anticipate a majority of companies in the S&P 500 will have adopted proxy access by the end of the 2017 proxy season. The basic features of most of the proxy access bylaws adopted to date enable a shareholder or a group of 20 shareholders who have held 3% of the company's stock for 3 years to nominate up to 20% of a company's board of directors. This proxy access bylaw structure is the most prevalent model of proxy access, with only 16 companies that adopted proxy access bylaws in 2015 and 2016 that included features that meaningfully deviate from this model.

Many companies that adopted proxy access bylaws did so following their receipt of proxy access shareholder proposals. Shareholders submitted more than 200 proxy access shareholder proposals to companies in 2016, as compared to 115 proxy access shareholder proposals submitted in 2015. Much of the momentum associated with proxy access shareholder proposals is due to the submission of a significant number of proxy access shareholder proposals by New York City Comptroller Scott Stringer on behalf of the New York City Pension Funds. The New York City Funds weren't alone. The 2016 proxy season was marked by a meaningful increase in the number of proxy access shareholder proposals that were submitted by individual shareholders, led by gadflies Jim McRitchie and John Chevedden.

Many of the shareholder proposals submitted in 2016, and many of the proposals that we expect to be submitted in 2017 are so-called "proxy access 2.0" proposals, which seek to eliminate features of proxy access bylaws to which shareholders object. These features include the restrictions on the number of shareholders that can aggregate their shares to satisfy the rule's minimum ownership requirements (seeking to eliminate any limitations on aggregation), the percentage of the board that a shareholder can nominate (seeking 25% as compared to 20%), treatment of loaned shares (seeking confirmation that loaned shares "count" and eliminating recall conditions), provisions that require that shareholders represent that they'll hold their qualifying shares after the relevant annual meeting (seeking to eliminate such provisions), restrictions on the renomination of candidates and similar matters. As a result, even companies that have already adopted proxy access bylaws should expect to receive proxy access proposals in the upcoming proxy season.

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In early 2016, the SEC staff granted no-action relief under Rule 14a-8(i)(10) to more than 30 companies that had adopted proxy access bylaws on the basis that their bylaws substantially implemented proxy access shareholder proposals. Nearly all of these bylaws included provisions that were not addressed by the proposals at issue. Despite these differences, the SEC staff granted no-action relief under Rule 14a-8(i)(10) on the basis the bylaws implemented the essential element of the shareholder proposals—they reflected the adoption of proxy access at companies that previously had not had proxy access bylaws. Many observers expected that these no-action letters would end the debate on proxy access and provide companies with a mechanism of resolving most requests for proxy access. This, however, was not to be the case.

In July 2016, the SEC denied no-action relief to *H&R Block, Inc.* with respect to its plans to rely on Rule 14a-8(i)(10) to exclude a proxy access proposal from its proxy materials on the basis that the proposal was substantially implemented by the company's previously adopted proxy access bylaw. The proposal at issue sought to amend the proxy access bylaw to change the number of shareholder-nominated candidates to up to 25% of the board, explicitly count loaned shares as owned, remove the cap on the number of shareholders that could aggregate their shares to make a nomination and eliminate re-nomination limitations included in the bylaw. *H&R Block* did not amend its proxy access bylaw in response to the proposal and argued that its previous adoption of a proxy access bylaw substantially implemented the proposal seeking to amend the bylaw in various respects. The staff rejected this argument and denied no-action relief.

Notably, the *H&R Block* no-action letter involved a very different outcome from a previous grant of no-action relief by the SEC in relatively similar circumstances. In *NVR, Inc. (granted on recon.*, Mar. 25, 2016), the SEC staff was presented with a proposal that was submitted under circumstances that were similar to *H&R Block* but granted no-action relief under Rule 14a-8(i)(10). In that letter, *NVR* amended its proxy access bylaw to reduce the minimum ownership requirement from 5% to 3% of the outstanding common stock and to amend certain secondary features of the bylaw as requested by the proposal. Notably, *NVR* did not revise certain other aspects of its bylaw as requested by the proposal, such as eliminating the 20-person limit on the number of shareholders who may aggregate their shares to meet the 3% minimum ownership requirement. Nevertheless, the SEC staff agreed that *NVR* had substantially implemented the proposal with its revised proxy access bylaw.

H&R Block and *NVR* illustrate the SEC staff's approach to proxy access shareholder proposals where the proposals are compared against existing bylaws. It appears that the SEC expects companies that argue that they have substantially implemented proxy access proposals to demonstrate that they have already addressed the essential elements of the amendments sought by the proposal. Based on *NVR*, it appears that companies may have to amend their bylaws where those bylaws include significant features that differ materially from the shareholder proposals that they hope to exclude. Companies that are unable to demonstrate that any differences between their bylaws and proxy access shareholder proposals are immaterial may have to consider making further amendments to their bylaws in order to obtain no-action relief.

In preparation for the 2017 proxy season:

Companies that have not yet adopted proxy access, or companies that already have proxy access but may be faced with amending their current proxy access bylaws, should consider taking the following actions:

Educate the Board	The board of directors should be informed of the trends that have developed during the 2016 proxy season, as well as the advantages and disadvantages of pre-emptively adopting, or amending, proxy access bylaws.
Evaluate the Company's Shareholder Base and Engage with Shareholders	There does not appear to be a consensus among the large institutional shareholders on the issue of proxy access. Issuers considering adopting or amending a proxy access bylaw should analyze their shareholder base, review the policies of their shareholders on proxy access and engage with their largest shareholders on the subject.
Consider Which Proxy Access Structure is Appropriate for the Company	To the extent that a company is open to voluntarily adopting, or amending, a proxy access bylaw, it should consider the features it would want to include in its proxy access bylaws.
Amend Current Proxy Access Bylaws	For those companies that have proxy access bylaws that include more restrictive basic features, companies should consider proactively amending the proxy access bylaw to include basic, and potentially also secondary, features that are more consistent with the majority of proxy access bylaws adopted by companies to date.

Say-on-Frequency Vote in 2017

Concurrent with the SEC's adoption of the say-on-pay requirement in 2011, the SEC adopted a rule requiring companies to hold an advisory shareholder vote on whether the say-on-pay vote should occur every one, two or three years. This nonbinding "say-on-frequency" vote must be held at least once during the six calendar years following the prior say-on-frequency vote. Consequently, companies that first held their say-on-frequency vote in 2011, and have not held one since, must hold a say-on-frequency vote in 2017. Due to transition rules for smaller reporting companies, the date of the next say-on-frequency vote for certain smaller reporting companies is pushed out until the 2019 proxy season.

Non-GAAP Financial Measures

In May 2016, the SEC staff updated and clarified its compliance and disclosure interpretations (C&DIs) related to non-GAAP financial measures found here. In light of the new and revised guidance issued by the SEC staff, companies should be mindful of non-GAAP financial measures included in annual reports and proxy statements.
Key takeaways include:

- Confirming that non-GAAP financial measures are presented with comparable GAAP measures and that the GAAP financial measure is presented with equal or greater prominence;

- Free cash flow cannot be characterized as representing the residual cash flow available for discretionary expenditures and cannot be presented on a per share basis;

- If a company presents EBIT or EBITDA as a performance measure, such measures should be reconciled to net income as presented in the statement of operations under GAAP and cannot be presented on a per share basis;

- Omitting non-GAAP per share liquidity measures; and

- Reviewing all non-GAAP adjustments to ensure they will not be viewed as misleading and revise or eliminate adjustments, as necessary.

Nasdaq "Golden Leash" Disclosure

In July 2016, the SEC approved new Nasdaq Rule 5250(b)(3), which requires that Nasdaq-listed companies disclose compensation arrangements by third parties to members of or nominees to a company's board of directors. The rule, known as the "golden leash" disclosure rule, became effective as of July 31, 2016.

Under Rule 5250(b)(3), a listed company must disclose, by the date that it files its definitive proxy statement, "the material terms of all agreements or arrangements between any director or nominee for director on the company's board and any person or entity other than the company relating to compensation or other payment in connection with that person's candidacy or service as a director."

Any such disclosures must be made at least annually until the earlier of the director's resignation or one year following the termination of the disclosed agreement or arrangement. Disclosure is not limited to cash arrangements, but also includes non-cash items such as indemnification and health insurance premiums. The disclosure must be made either on or through the company's website or in the company's definitive proxy or information statement for the next shareholders' meeting at which directors are elected. If the disclosure is made via the company's website, it must be posted no later than the date on which the company files its definitive proxy or information statement.

Nasdaq listed companies may wish to revise their director and officer questionnaires to solicit relevant information required by the "golden leash" disclosure rule.

Pay Ratio

In 2015, as required by the Dodd-Frank Act of 2010, the SEC adopted the "pay ratio" rule, which will require that public companies disclose, annually, the ratio of the median of the annual total compensation of the company's employees to the annual total compensation of the company's principal executive officer (the "PEO"). The pay ratio rule requires annual disclosure of (i) the median annual total compensation of employees other than the PEO, (ii) the annual total compensation of the PEO and (iii) the ratio of the two amounts compensation" would be calculated in accordance with Item 402(c)(2)(x) of Regulation S-K.

When reporting the ratio of these two figures, the amount in clause (i) would be expressed as "1," and the amount in clause (ii) would be expressed as a multiple of the amount in clause (i). Alternatively, the ratio could be expressed narratively as the multiple that the amount in clause (ii) bears to the amount in clause (i). For example, if the median annual total compensation of employees is $40,000 and the annual total compensation of the PEO is $6 million, the ratio would be expressed as "1 to 150" or, alternatively, "the PEO's annual total compensation is 150 times the median annual total compensation of other employees." The compensation ratio needs to be calculated every year, though companies only need to determine the median employee once every three years.

This new disclosure is required to be included in a company's annual report on Form 10-K, registration statements under the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"), and proxy and information statements, to the extent such forms require executive compensation disclosure pursuant to Item 402 of Regulation S-K. The pay ratio disclosure will need to be accompanied by a brief description of the methodology, including any material estimates and assumptions, used by the company to calculate the median annual total compensation of employees.

Companies must comply with the pay ratio rule for the first fiscal year beginning on or after January 1, 2017. As a result, companies with December 31 fiscal years will first be required to provide pay ratio disclosure, for the 2017 fiscal year, in their proxy statements for their 2018 annual meeting of shareholders. Companies that cease to be smaller reporting companies or emerging growth companies are not required to provide pay ratio disclosure until they file a report for the first fiscal year commencing on or after they cease to be a smaller reporting company or emerging growth company.

Other Pending Rule Proposals

The SEC has yet to finalize other executive compensation rules required by the Dodd-Frank Act. Although the SEC has already proposed these rules, it is not expected to act on them until after the presidential election.

Pay For Performance: As mandated by the Dodd- Frank Act, the SEC also has proposed a rule requiring "pay-for-performance" disclosure. This rule would require that public companies disclose the relationship between levels of executive compensation "actually paid" to a company's named executive officers and the company's financial performance. The rule would amend existing executive compensation disclosure rules to require the following narrative and tabular disclosure:

- Total compensation reported in the Summary Compensation Table for the CEO and the average of the reported amounts of total compensation for the remaining named executive officers.

- Compensation actually paid ("Actual Compensation") to the CEO and the average of the Actual Compensation paid to the remaining named executive officers.

- Actual Compensation is defined as the total compensation adjusted to remove change in pension value and to include only the fair value of equity awards that vested during the fiscal year, rather than when the awards were granted.

- Company and peer group total shareholder return.

The SEC must consider comments and meet again to finalize and approve the rule. It is unlikely that the rule would be in place for the 2017 proxy season.

Clawback Policy: Another proposed rule mandated by the Dodd- Frank Act deals with clawbacks. It requires that companies have policies in place to recover incentive based executive compensation for the three fiscal years prior to a financial restatement. The clawbacks would be "no fault," meaning they would happen regardless of whether an executive was involved in any misconduct or was responsible for the restatement.
Many companies have already implemented some form of clawback policies for executive compensation, yet the new rule is substantively different, in that it is based on the requirements of Dodd-Frank rather than Sarbanes-Oxley. Some of these companies may need to modify their policies to make sure they comply with the new rule.

The SEC must consider comments and meet again to finalize and approve the rule. If the proposed rule is adopted, stock exchanges would also need to propose and adopt listing standards requiring that all listed companies have these clawback policies in place. It is highly unlikely that both of these processes would be completed in advance of the 2017 proxy season.

Hedging Policy Disclosure: As required by the Dodd-Frank Act, the SEC has proposed rules that would require disclosure regarding whether their directors, officers, and other employees are allowed to hedge the company's equity securities.

Many companies have insider-trading policies that either prohibit or discourage this kind of hedging, but the policies often provide that employees and executives can do so if they secure special permission from the general counsel or legal department. The proposed rule would treat those companies as allowing hedging—and it would make them disclose that conclusion in their SEC filings. As a result, companies that are looking at potential insider trading or hedging policy changes may want to keep the disclosure requirement in mind, and possibly modify their policies to prohibit all hedging among employees and executives under any circumstances.

The SEC must consider comments and meet again to finalize and approve the rule. It is unlikely that the rule would be in place for the 2017 proxy season.

Identification of Audit Partner

In May 2016, the SEC approved a PCAOB rule that will require that independent auditors provide disclosures regarding participants in an audit. Pursuant to the rule, registered public accounting firms will have to file with the PCAOB a report that identifies the audit engagement partner involved in an audit and includes information about other firms that were involved in the engagement. Auditors will have the option of also including the disclosures included in the PCAOB report in the audit report that is provided to the company at issue. The disclosure with respect to audit partners is effective for auditor reports issued on or after January 31, 2017.

Cybersecurity

As cybersecurity threats become more prevalent, the SEC staff is clarifying the situations that companies need to disclose. Several years ago, the SEC staff came out with guidance that there is no existing disclosure requirement for cybersecurity. Yet there are a number of places where the SEC and investors are looking for information about cybersecurity. Relevant areas for disclosure include:

- Risk Factors. Given that cybersecurity is among the most significant risks that a company faces, the SEC increasingly expects disclosure about cybersecuity-related risks, including the current frequency of cyber incidents, the severity of prior events, and the potential costs and other consequences associated with such incidents;

- MD&A. Consider whether the costs or other consequences associated with known data breaches or the risk of such events could require MD&A disclosure;

- Description of Business. Disclose any cyber incidents that materially affect the company's products, services, relationships with customers or suppliers or competitive conditions; and

- Legal Proceedings. Disclose any material pending legal proceeding that relates to a cybersecurity incident.

In addition, the SEC has begun identifying companies that have experienced a cybersecurity problem—by following articles in the press—and reviewing the affected companies' disclosures to confirm that they are disclosing these events in their next periodic filing. In addition, those companies that do not disclose minor events are likely to get a comment letter from the SEC staff. Those companies that fail to disclose material events could be subject to an enforcement action given the SEC has pursued several enforcement actions involving companies that have experienced cybersecurity breaches.

Finally, it appears that the SEC is evaluating cybersecurity as it relates to internal controls over financial reporting. For example, under the rules that define internal controls, companies need to take reasonable steps to prevent—or detect—the unauthorized acquisition, use, or disposition of their assets if that could have a material impact on the financial statements. Things like customer data, intellectual property, or other assets stored within a company's IT system could all fall into that category and affect its internal control over financial reporting. This is a new interpretive approach—there is no rule regarding cybersecurity in the context of financial controls—but it has been reported that the SEC is pursuing this theory in some of its enforcement actions.

Universal Proxy

Universal proxy is aimed at giving investors better choices during proxy contests. In most contests, the company prepares its own proxy card and the investor group prepares its own separate proxy card. Under current rules, board candidates can only be listed on a proxy card with their consent. In most cases, a company's nominees will not consent to being named in the proxy materials for the insurgent group and the company will not include the insurgent's nominees on the management's proxy card. In practice, that means that institutional investors can't mix and match candidates unless they ask for a custom proxy or attend the annual meeting itself.

To address this, the SEC is considering a rule that would compel a company and the insurgent group, under certain circumstances, to prepare a universal proxy card that includes all nominees to the board. It is still unclear how this would be triggered, but it's conceivable that the process could start any time a person institutes a proxy contest. In those circumstances, the company would be required not only to send out a proxy with its own nominees, but also a universal proxy that includes both their nominees and those of the insurgent group. The insurgent investor would face the same requirement. There is currently no rule proposed, and it is currently unclear when a rule will be proposed, but the SEC is expected to propose a rule in the future that will allow the use of a universal proxy in contested elections.

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