



2018 Trends in Governance

By Keir Gumbs

At the start of 2018, the changing SEC leadership and resulting rule changes continue to affect public companies. Keir Gumbs, a partner at Covington & Burling LLP and vice chair of the firm's Securities and Capital Markets practice group, discusses the major areas of change, and the trends that will affect the 2018 proxy season.

Overview: SEC driving change

As we approach the 2018 proxy season, the shift in leadership and evolution of policy at the U.S. Securities and Exchange Commission, which is undergoing significant change, is setting the tone for what issuers and investors can expect. The SEC's regulatory agenda and recent staff guidance regarding shareholder proposals are likely to meaningfully influence the 2018 proxy season. In addition, the SEC's proposed reforms regarding disclosure effectiveness and capital formation initiatives are likely to change the disclosure and capital markets landscape. There is also a range of hot-button corporate governance and securities regulation issues, notably proxy access, rules about publishing pay ratios, concerns about cybersecurity, and rising investor interest in sustainability and climate change, among other things.

The SEC's 2018 regulatory agenda

Under the leadership of Chairman Jay Clayton and new leadership that he has brought in, the SEC is undergoing a significant transformation. Clayton has identified eight principles for rulemaking:

- Returning the SEC to its three-part mission: protecting investors, maintaining fair and orderly markets, and facilitating capital formation, now a renewed SEC focus.
- Greater focus on the long-term interests of the Main Street investor.
- A focus on disclosure and materiality.



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- Being attentive to the lasting consequences of regulatory actions and rulemaking.
- Ensuring that the SEC evolves over time, just as markets change.
- Effective rulemaking does not end with rule adoption, but requires monitoring new rules to ensure they work as intended.
- Acknowledging that the cost of rules (to issuers, investors, and markets) includes the cost of demonstrating compliance.
- Coordinating rulemaking with other regulators.

In addition, the SEC has a new approach to its Regulatory Flexibility Act agenda — published semiannually. Historically the rulemaking agenda from the SEC bore little resemblance to its actual rulemaking activities. Now, Clayton intends to use the published agenda to clearly signal to markets what the SEC’s actual agenda will be over near- and long-term time frames.

Guidance on shareholder proposals

Among the most significant undertakings early in this new SEC leadership has been guidance on shareholder proposals — comprising two substantive and two procedural changes — published in November in Staff Legal Bulletin No. 14I (SLB 14I.)

The first substantive change relates to the ordinary business exclusion — Rule 14a-8(i)(7). That exclusion allows a company to exclude shareholder proposals that relate to ordinary business matters. Given the difficulty that the staff has had in determining whether a proposal relates to ordinary business matters, SLB 14I, for the first time, invites boards of directors to play a significant role in the evaluation and potential exclusion of shareholder proposals. Specifically, a company’s Rule 14a-8(i)(7) no-action request now may include a board “analysis of a particular policy issue raised and its significance,” including showing why those conclusions “are well-informed and well-reasoned.” In particular, the new guidance invites boards to address whether any significant social policy issues raised by a proposal have a “nexus” to the company to whom they’ve been submitted.

The second, potentially more significant substantive change relates to the SEC’s revival of the relevance exclusion under Rule 14a-8(i)(5). That provision allows a company to exclude a shareholder proposal if it relates to operations which account for less than 5 percent of the company’s total assets at the end of its most recent fiscal year, and account for less than 5 percent of its net earnings and gross sales for its most recent fiscal year



and are not otherwise significantly related to the company’s business. Over the last few decades, the SEC has only granted a handful of no-action requests under this exception. The SEC’s view has been that if a proposal has *any* meaningful social or ethical relevance to the company, then the proposal cannot be excluded. As is the case under Rule 14a-8(i)(5), SLB 14I invites companies to provide the SEC with the analysis of their board of directors regarding why a shareholder proposal is not otherwise significantly related to the company’s business.

Both of the above changes also apply to historical shareholder proposals that companies may not have been able to exclude in the past, making these changes significant.

SLB 14I also includes guidance regarding procedural issues. Specifically, SLB 14I includes guidance regarding “proposals by proxy” and the use of graphics in shareholder proposals.

Proposals by Proxy - SLB 14I addresses a common occurrence — the situation where a shareholder has another person, typically an agent, submit a proposal on their behalf. This is an area where many companies have complained about perceived abuses by shareholders and their agents where they have provided inadequate information regarding the proposal that is being submitted, or the relationship between the agent and the shareholder that is ostensibly submitting the proposal. Under SLB 14I, a shareholder submitting a proposal by proxy must provide the company to whom it is sending the proposal with enhanced documentation. This documentation must include the shareholder’s name, the person that’s been selected as proxy, the company to whom the proposal has been submitted, the meeting to which the proposal has been submitted, the proposal that’s being submitted, and a dated signature by the shareholder proponent. The procedural change is aimed at addressing perceived abuses of the shareholder proposal rule, but it is unlikely to have a significant change on shareholder proposals.

Images in Proposals - SLB 14I also addresses complaints from companies regarding shareholder proposals that include graphics. SLB 14I makes it clear that shareholders can include graphics or images in a shareholder proposal. It notes, however, that a company can exclude images if those graphics make the proposal materially false or misleading; render the proposal inherently vague or indefinite; directly or indirectly impugn character, integrity, or personal reputation without factual foundation; or are irrelevant to the subject of the proposal.

Disclosure effectiveness reforms

The SEC has been working on disclosure effectiveness for a number of years, and has already taken a number of steps to rationalize and reevaluate such rules. These steps include the publication of a proposal to modernize and simplify the industry guidelines for banking and mining companies, requests for comment on Regulation S-X, which prescribes the rules for financial statements, the publication of a concept release regarding Regulation S-K, and the adoption of new rules requiring companies to include links to exhibits in most SEC filings.

On Oct. 11, 2017, the SEC proposed amendments to Regulation S-K based on the recommendations in the SEC staff's 2016 FAST Act report regarding how to modernize and simplify the requirements of Regulation S-K. The proposed amendments included a number of proposals, but the most significant changes include:

- **Confidential treatment process changes** — Under the proposed amendments, the SEC would allow issuers to omit from material contracts confidential information that is not material and would cause competitive harm if publicly disclosed, without having to request confidential treatment from the SEC. This proposal would change the current practice of requiring a registrant to provide an unredacted copy of each exhibit and request confidential treatment. Companies would be permitted to omit personally identifiable information in all cases without submitting a confidential treatment request.
- **Immaterial schedules and exhibits** — The proposed amendments would allow issuers to omit immaterial schedules and exhibits from any material agreements (and not just agreements relating to business combinations).
- **MD&A changes** — The proposed amendments would permit registrants to forgo discussion of the oldest period (e.g., the third fiscal year) if the information has been previously reported and is no longer material.

- **Legal entity identifiers** — The proposed amendments would modernize the disclosure requirements in Regulation S-K by requiring disclosure of LEIs for those registrants and subsidiaries that choose to obtain this identifier.
- **Filing cover page changes** — The proposed amendments would require that issuers tag in XBRL all the data points on the cover pages of Form 10-K, Form 10-Q, Form 8-K, Form 20-F, and Form 40-F. The SEC also proposes to require the disclosure of a company's trading symbols on the cover page of these forms.
- **File description of securities** — The proposed amendments would require the filing of a description of securities for periodic reports (and not just securities offerings).

Corporate governance and securities regulation issues proxy access

Proxy access remains the No.1 corporate governance and shareholder proposal topic. Four years ago, only a handful of companies had proxy access proposals; now over 60% of S&P 500 companies have provisions allowing nominees to the board of directors from significant shareholders. Now it's a question of whether or not proxy access will continue its march with respect to smaller companies such as the Russell 3000.

Under most proxy access bylaws, a shareholder that owns 3% of a company's stock for three years can nominate up to 20% of the board. To meet minimum ownership requirements, most bylaws allow up to 20 shareholders to group together. However, proxy access bylaws are constantly changing. Proposals in recent years were focused on adopting proxy access but now are pressing for such things as increasing the number of shareholders that can aggregate their shares to meet the 3% rule and changing the number of nominees to guarantee the ability to nominate at least two nominees to the board.



Pay ratio

Two years ago the SEC adopted rules implementing pay ratio disclosure requirements imposed under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Companies will make their first pay ratio disclosures in 2018 proxy statements. Firms have to disclose three things: the total compensation paid to their median employee, the CEO's total compensation, and the ratio of the median employee's compensation to the CEO's compensation. Previously, only the CEO's compensation was disclosed without the context of the other two metrics. Initially, much of the focus of companies was on the proposed disclosure of the CEO pay ratio. As the initial compliance date approaches, the focus of many companies has shifted to the publication of median salary data: Companies will effectively be informing half their employees for the first time that their compensation is below the firm's median. Companies are considering how best to communicate that data and what additional information they may want to provide employees and investors about median compensation.

In guidance that the SEC published in November, the SEC indicated that it will not second-guess companies that use reasonable estimates, assumptions, adjustments, and statistical sampling in identifying the median employee. At the same time, the SEC's Division of Corporation Finance issued [comprehensive guidance](#) regarding the types of records that companies can use, providing examples of acceptable statistical sampling and offering nuts-and-bolts suggestions about the kind of methods companies can use.

Cybersecurity

Cybersecurity remains a top issue at the SEC, notwithstanding the change in leadership at the regulator. The SEC has formed a new cybersecurity enforcement unit to identify hackers that would manipulate markets and illegally access financial information for trading purposes. The SEC has indicated it is also looking at whether it needs to issue new guidance regarding cybersecurity — something that many companies have asked for in light of the continued focus by investors on cybersecurity matters. Regardless of whether the SEC publishes new guidance, there will be a continued focus by the SEC's staff on cybersecurity disclosures by public companies. SEC Chair Jay Clayton has made it clear that he does not want to take enforcement actions against companies that have been hacked. Companies should not take too much comfort in his



position, however. We expect that the SEC will not hesitate to pursue enforcement actions against companies that flagrantly disregard their disclosure obligations in the face of significant cyberattacks. Still, the new leadership at the SEC appears to be signaling its view that victims of cyberattacks should not be further victimized by aggressive enforcement.

Sustainability/Climate change

Companies, boards, management, and investors are spending more time on the topic of sustainability and climate change. Once largely the purview of environmental-, social-, and governance-focused funds, these are now mainstream concerns, as evidenced by the growing number of signatories to the United Nations Principles for Responsible Investment (UNPRI). A growing number of larger public pension funds, private funds, and other institutional investors are taking up the issue of sustainability in the context of shareholder proposals. For example, in 2017, BlackRock, Vanguard, and Fidelity voted for shareholder proposals related to climate change disclosure, which resulted in three such proposals receiving majority shareholder support for the first time, according to ProxyPulse data from Broadridge and PwC. At the same time that a broad group of investors are expressing support for sustainability-related shareholder proposals, companies are increasingly focusing on sustainability. More and more companies are beginning to integrate sustainability into their governance efforts, and producing sustainability reports and similar disclosures.

Climate change is generating a significant number of shareholder proposals, and climate change shareholders are enjoying more success than in the past. Last year, there were seven such proposals that won at least 40% of shareholder votes. Along similar lines, in 2017, 54% of institutional shares supported climate change shareholder proposals, as compared to only 10% of retail shares, according to ProxyPulse.

Political spending and lobbying

Political spending and lobbying remained as a top governance issue in 2017. Political spending and lobbying shareholder proposals were among the most common shareholder proposal topics in 2017, while shareholder interest in the topic, as evidenced by the number of comments in support of the petition seeking disclosure of political spending and lobbying activities, remained high. As is the case with sustainability reporting, larger companies are increasing the nature and extent of information that they publicly disclose regarding political spending and lobbying activities. As part of the change in administration, the rulemaking petition seeking disclosure regarding political spending and lobbying activities has one more advocate at the SEC. Robert Jackson, one of the professors that wrote the original rulemaking petition, was recently sworn in as a commissioner at the SEC. While we don't expect there to be enough support at the SEC for the agency to move forward with the rulemaking, we expect Jackson's appointment may reinvigorate the debate.

Board skills and diversity

Board diversity, board refreshment, and board skills were hot-button issues in 2017 and will continue as such in 2018. One of the most significant developments affecting the 2018 proxy season were the actions of the Office of the New York City Comptroller, which has sent letters to 151 companies as part of the New York City Pension Funds' Boardroom Accountability Project 2.0. Those letters seek information about a variety of topics that are connected to board composition, including, most significantly, information regarding board diversity. Among other requests, the letters ask companies to consider including information about the composition of their boards in a matrix and that the matrix include information regarding a board's skills mix, as well as their ethnicity and gender. It remains to be seen how corporate disclosures will change over time in response to this campaign. It is noteworthy that the New York City funds are not alone in their interest in this issue. Many institutional investors have included board diversity among the topics about which they want to engage with directors. For example, last year State Street Global Advisors voted against the election of directors at 400 companies without a single female board member because they did not feel the companies were making enough progress diversifying their boards, according to ProxyPulse.

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