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2019 Trends in Governance

The U.S.'s SEC now boasts a full complement of five Commissioners and is set for a busy 2019 proxy season. David Martin, Senior Counsel at Covington & Burling LLP and Cathy Conlon, VP Product Strategy at Broadridge review the major areas of change, and the trends that are likely to affect public companies during the year.

OVERVIEW: FULL SEC DRIVING CHANGE

As we approach the 2019 proxy season, the U.S. Securities and Exchange Commission (SEC), which now has a full complement of five Commissioners, is setting the tone for what issuers and investors can expect. Despite a budget and hiring freeze, there is no doubt that the SEC's regulatory agenda for 2019 is broad.

The SEC will continue to ensure effective oversight of changing markets, with two notable priorities being the enforcement and disclosure of cybersecurity and risk management, and the facilitation of capital formation. There are also a range of hot-button corporate governance issues, markedly strong investor interest in social and environmental matters.

REGULATORY ISSUES TO LOOK FOR IN 2019

Issuers can look for some of the following issues to have a place on the SEC's near-term rule making agenda:

- Improving disclosure effectiveness with the continued modernization and simplification of key rules such as S-K and S-X.
- Bringing more companies into the public market with the extension of 'Testing the Waters' provisions beyond emerging growth companies.
- Simplifying and clarifying the rules around the disclosure of financial statements and pro-formas for companies making acquisitions and dispositions.
- Updating and modernizing Industry Guide 3 Bank Holding Company Disclosure, which has been untouched since the 1980s.
- Enhancing corporate disclosure of company hedging policies for directors and employees, as mandated by Dodd-Frank.
- Reducing the need for companies to engage their outside auditor to attest to their internal controls certifications.
- Continuing the strong focus on the interests of the Main Street investor by rationalizing standards of conduct for brokers and investment advisers.

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LONGER-TERM

Over the longer-term, the SEC will turn its attention to the Pay Versus Performance rule, a requirement of the Dodd-Frank Act. The rule not only requires companies to disclose their executive pay for performance information, but also to present that information alongside their peers in a table.

Corporate board diversity could also be on the longer-term agenda. The SEC does not have the jurisdiction or authority to regulate corporate board diversity itself, but it can certainly regulate the disclosure of board diversity. This could lead to rule-making that would urge companies to produce different types of disclosures about board diversity with the end goal of changing behavior around the topic.

DISCLOSURE GUIDANCE FOR CYBERSECURITY

The SEC has been intensifying its cybersecurity message steadily for almost seven years after its first in-depth communication on the subject. In 2011, SEC staff released a statement and interpretive guidance for preparing disclosures about cybersecurity risks and incidents.

The disclosure guidance included advice on risk factors such as breaches and their remediations, their place in management's discussion and analysis (MD&A) in the annual report, possible contingent liabilities, and on testing materiality. In February 2018, the Commission itself voted to approve virtually the same guidance. A ruling from the Commission -- rather than its staff — was a clear message from the SEC that it expects clearer and more robust disclosure by companies about cybersecurity risks and incidents.

The SEC appears to be especially concerned that companies are slow with their disclosures after breaches, because its ruling emphasized the timely disclosure of incidents. There have been several widely-publicized situations where breaches have been announced more than six months after the event.

The SEC also earlier this year encouraged companies to disclose material cybersecurity breaches on a Form 8-K, the report of unscheduled material events or changes at a company. Cybersecurity breaches are unlikely to join the official list of the various situations that require the usage of a Form 8-K anytime soon, but the SEC appears to be urging companies to consider it as a way of getting public information out quickly.

The SEC is advising companies to review previous disclosures to ensure that they don't require updating or rewriting following a cybersecurity breach, and reminds companies that such breaches should be reported as a risk factor, as well as, potentially, in the MD&A section.

In October 2018, the SEC issued a 21(a) report on cyber-related frauds against nine public companies. Section 21(a) allows the SEC to publish a report of an investigation in lieu of bringing an enforcement action against a company. The cases in the recent report related to email scams whereby the companies paid fake vendors or executives for services.

The SEC had a couple of conclusions: it counseled that internal accounting controls might need to be reviewed in light of cybersecurity risk. It also stated that companies were in the best position to determine what controls these would be, and how they would best safeguard assets from such risk.

However, there was a sterner message. The SEC also said that such controls needed to better protect the company's assets by ensuring they were not deployed or distributed without approval from the board or management. The prospect of the SEC imposing monetary penalties on companies that do not adequately guard against future cyber-related frauds cannot not be ruled out.

SEC REGULATORY ACTIVITIES CAPITAL FORMATION AND DISCLOSURE EFFECTIVENESS

The SEC has amended rules to simplify and refine disclosure requirements around capital formation. Some of the measures will cut out duplication. For example, companies no longer need to publish a stock price chart, dividend history or provide disaggregated segment disclosure in their MD&As because such information is already recorded in financial reports.

Scaled disclosure — There was a welcome amendment to increase the number of smaller public companies qualifying for scaled disclosures, which the SEC achieved by broadening the definition of smaller companies to include entities that have raised between $100 million and $250 million of unaffiliated float.

Accelerated filers — Despite the amendment regarding smaller reporting companies, the definition of an accelerated filer — companies that have at least $75 million, but less than $700 million in public float — remains unchanged. If the SEC does put a change to this definition back on the short-term agenda, it may act to raise that minimum public float to $250 million. That would mean that those firms doing scaled disclosure as smaller reporting companies would also be freed of the obligation to get their outside auditors to attest to their internal control certification. This would be a significant development.

Expanded confidential review of draft registration statements — The SEC now accepts voluntary draft registration submissions from all IPO issuers for non-public review. This has expanded the benefit of confidential review from just Emerging Growth Companies (EGCs) to all new companies that are making S-1 filings to list their shares. This means that companies considering an IPO don't need to be EGCs to have their filings processed treated confidentially by SEC staff until they are ready to go to market.

Inline XBRL rule — The SEC adopted amendments in June requiring the use, on a phased-in basis, of Inline XBRL for operating company financial statement information and fund risk versus return summary information. The requirements for complying with iXBRL differ depending on the size of the company:

- Operating companies that are currently required to submit financial statement information in XBRL will be required, on a phased-in basis, to transition to Inline XBRL.
- Large accelerated filers that use U.S. GAAP will be required to comply beginning with fiscal periods ending on or after June 15, 2019.
- Accelerated filers that use U.S. GAAP will be required to comply beginning with fiscal periods ending on or after June 15, 2020.
- All other filers will be required to comply beginning with fiscal periods ending on or after June 15, 2021.
- Filers will be required to comply beginning with their first Form 10-Q filed for a fiscal period ending on or after the applicable compliance date.
- Issuers should ensure that the software they are using, or their service provider is ready to accommodate the format.

2018 PROXY SEASON TRENDS

The following proxy season data covers the results of 4,090 public company annual meetings held between January 1 and June 30, 2018.

Only minor changes in retail vs institutional ownership.

- Institutional ownership of public company shares declined slightly to 70% (from 71% in 2017)
- Retail ownership increased slightly to 30% (from 29% in 2017)
- Retail shareholders voted at a slightly lower rate, declining to 28% (from 29% in 2017)

Digital adoption continues to increase.

- Electronic delivery increased - 76% of all positions were supressed, up from 75% last proxy season
- 95% of shares voted electronically
- About 7 percent of individuals voted their shares in publicly traded companies via phones in fiscal year 2018, up from just 0.7 percent in fiscal year 2016,
- 1.89 million retail positions were voted via a mobile device, up from 1.7 million last proxy season
- 2 million+ positions were cast directly through brokerage firm websites, up from 1.8 million last proxy season

CORPORATE GOVERNANCE TRENDS

Proxy access — Proxy access remains a key corporate governance and shareholder proposal topic, but the number of proxy access proposals continues to decline. Five years ago, only a handful of companies had proxy access proposals; that is because a significant majority (65%) of S&P 500 companies have provisions allowing nominees to the board of directors from significant shareholders. That trend is expected to continue.

Social and environmental proposals — Shareholders submitted 788 proposals during the 2018 proxy season, down 5% from 827 in 2017 and down 14% from 916 in 2016. A large share (43%) of shareholder proposals had a social and environmental focus, according to ProxyPulse. Institutional shareholder support for those proposals has also gradually increased over the past five years from 19% in 2014 to 29% in 2018.

There are several issues on the social agenda: from discrimination and other diversity-related issues to the gender and ethnicity pay gap, human rights, and so-called 'fake news' and gun safety. But diversity is the biggest issue on the agenda, representing 34% of social proposals. Shareholders tabled 30 proposals in 2018 requesting the adoption of a board diversity policy, or a report on board diversity.

Companies are committing to include women and ethnically diverse candidates in the pool of nominees for senior positions. Several companies are adopting a variant of the Rooney Rule — a National Football League policy requiring teams to interview ethnic minority candidates for head coach roles and other senior position – for director recruitment.

A significant push in this area came from New York City Comptroller Scott Stringer and the city's pension funds, whose Boardroom Accountability Project 2.0 aims for diverse, independent boards. The group called on the boards of 151 US companies to disclose the race and gender of their directors, as well as set out their skills. Around one-third of the 151 boards have appointed 59 new directors who are either female or people of color.

The California Public Employees' Retirement System (CalPERS) also reported that it engaged with over 500 large companies on their lack of board diversity, and that they withheld votes from 271 directors at 85 companies as a result.

Social proposals also touched on other issues, most notably gun violence. The February 14 shooting at a school in Parkland, Florida resulted in greater scrutiny of the role of investors in companies that manufacture and distribute civilian firearms. Shortly afterwards, BlackRock published a statement setting out how its Investment Stewardship team would engage on the topic.

Climate change continued to be the largest subcategory of environmental proposals submitted during the year. Environmental proposals revolve around climate change reporting, greenhouse gas emissions (GHG) goals, and climate change risks. However, there is also a focus on recycling, renewable energy, hydraulic fracturing, and sustainability reporting.

Two examples of proposals receiving majority support are: a report on the impact of climate change policies, including commitments to limit global temperature change to two degrees Celsius, at Anadarko Petroleum and Kinder Morgan; and the adoption of company-wide goals for reducing GHG emissions at Genesee & Wyoming.

These results reflect the increased clout of large asset managers, which are in turn being pressured by their clients. These results also reflect increased support from Institutional Shareholder Services, with the proxy advisory giant supporting 90% of climate change proposals in 2018.

Issuers should expect continued shareholder focus on social and environmental issues, mainly because of increasing public awareness of such topics, the emergence of affirmative action, and the considerable influence of large asset managers and ISS.

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