

# SEC outlook and governance trends for 2020

With a full complement of five Commissioners, restored staffing levels and an increased budget, the SEC is well positioned for a busy proxy season in 2020. David Martin and Matthew Franker of Covington & Burling LLP join Cathy Conlon and MaryEllen Andersen of Broadridge to review the major areas of change, and the trends that are likely to affect public companies this year.

## GREATER RESOURCES

After a flat budget for fiscal years 2016 through 2018, funding was increased in 2019 to \$1.68 billion. Another moderate increase has been requested for fiscal 2020. The hiring freeze imposed in 2017 was lifted in 2019 and approximately 130 positions were restored. The 2020 budget would restore another 34 positions and dedicate funding for improvements in information technology and cyber-security upgrades.

## STRUCTURAL CHANGES

Last fall, the Division of Corporate Finance announced a realignment of its disclosure program. Instead of 11 groups assigned to various issuers, there are now seven: :

- Energy and Transportation
- Finance
- Life Sciences
- Manufacturing
- Real Estate and Construction
- Technology
- Trade and Services

The Division is now organized into four groups, the Disclosure Review Program described above, specialized policy and disclosure, which includes the Offices of International Corporate Finance, Mergers and Acquisitions and Structured Finance, an Office of Risk and Strategy, and a new Office of Assessment and Continuous Improvement.

For most issuers, the important thing is to find out whether you're still with the same industry group or if you've been moved into one of the larger disclosure groups with new leadership. There were no changes in the portions of the Division that are not disclosure operations, including the Office of Chief Counsel, Office of the Chief Accountant, Small Business and Rulemaking.

## RECENT RULEMAKING

Recent regulatory proposals include the several items that could affect issuers in the coming year:

- **Testing the waters expansion**, which took effect in early December, extends provisions that previously applied only to emerging growth companies to all issuers.

- **Acquired business disclosure reform:** This proposal would codify existing guidance in the Division of Corporation Finance Financial Reporting Manual with respect to disclosures that companies must provide when they have a material acquisition or disposition. The proposal would also provide greater flexibility in evaluating the significance of an acquisition or disposition and establish the same threshold for pro forma financial statements to reflect an acquisition or disposition.
- **Accelerated filer definition:** This proposal would exempt companies with less than \$100 million in revenue from the requirement to provide an auditor attestation report regarding the effectiveness of a company's internal control over financial reporting.
- **Business, financial and management disclosures** would provide a less prescriptive, more flexible and principles-based method for disclosing information regarding legal proceedings, risk factors and business disclosures. The proposal would also require, to the extent material, business disclosure regarding compliance with government regulation and human capital resources.

## ON DECK FOR 2020

Issuers can look for the following items on the SEC's near-term rule making agenda:

- Modernization of the **accredited investor definition** would add additional means for individuals to qualify to participate in private capital markets based on established, clear measures of financial sophistication. Subsequent to the presentation the SEC proposed amendments to this effect on December 18, 2019.
- Streamlining and modernizing the **earnings release and quarterly reporting process**. Possible updates may include changing the periodicity of reports, removing the requirement or allowing companies to use their earnings release as part of their securities filing for the quarter.
- There has been talk of listing standards for **clawbacks of compensation** to adopt the SEC's 2015 proposal to implement Section 954 of the Dodd-Frank Act. While no rule has been adopted, many companies have policies that mirror the terms of the 2015 proposal.
- **Harmonization of exempt offerings** seeks to improve the exempt offering framework to expand investment opportunities while maintaining appropriate investor protections and to promote capital formation.
- The SEC remains focused on enhancing **disclosure effectiveness**, consistent with the FAST Act and other statutes requiring the Commission to review its rules and disclosure requirements to streamline them, modernize them, and eliminate redundancies.

## LONGER-TERM AGENDA

The SEC is expected to turn its attention to proposals that have been floating around for nearly a decade. Some are proxy related, and a handful of items are Dodd-Frank carryovers. These are all items that Chair Clayton is committed to addressing.

One item is providing greater disclosure on corporate board diversity in proxy statements. This would be a disclosure-based rule, not a substantive rule, and it would require greater disclosure regarding the diversity of members of the board and new director nominees. Even in the absence of a Commission rulemaking on this topic, issuers can think about providing enhanced disclosure regarding board diversity on a voluntary basis.

Potential pay for performance rules are a remaining Dodd-Frank item that would require companies to describe the relationship of compensation actually paid to the company's financial performance as reflected in its TSR.

Another potential item would require institutional investment managers to provide disclosures regarding how they voted their holdings on executive compensation matters. This would include say-on-pay and golden parachute proposals.

A final potential item is a revamping of the conflict minerals rule, which was largely decelerated by a district court decision in 2017. This would require companies to provide disclosures as to whether any of their products have not been found to be DRC conflict-free.

## SPOTLIGHT ON THE PROXY PROCESS

The SEC's current focus on the proxy process began in July of 2018 when the Chair announced topics for a Division of Corporation Finance roundtable on the proxy process. In that announcement he focused on voting processes, retail voting, shareholder proposals, and advisory firms and technology.

The proxy roundtable took place in November 2018, with discussion groups around proxy voting mechanics and technology, the shareholder proposal rule, and proxy advisory firms.

Comment letters started coming in, and the staff is formulating recommendations. The Chair said throughout that he wants the staff and the Commission to take initiatives that can be accomplished, and that would improve the market for long-term mainstream investors.



### **RECENT DEVELOPMENTS: PROXY ADVISORY FIRMS**

The SEC issued two interpretive releases this past August: One that applies to proxy advisory firms and one that applies to investment advisers that receive advice from proxy advisory firms.

The first applies directly to proxy advisory firms, in which the SEC confirmed its prior interpretation that proxy voting advice does constitute a solicitation and is therefore subject to federal proxy rules, including anti-fraud rules. There are exemptions that proxy advisory firms can rely on to avoid providing the information that's specifically required by the proxy rules or from filing either their recommendations or their proxy statement that are available. That was taken as a shot across the bow by the proxy advisory firms. ISS is currently suing the SEC over this guidance.

The second piece of guidance applies to investment advisers regarding their duty to inform clients about advisers' proxy voting responsibilities. The overarching concept is that the SEC considers the duties of care and loyalty that are imposed on investment advisers to extend to proxy voting decisions.

The interpretive guidance addresses the scope of the authority that's assumed by the investment adviser—clarifying that investment advisers are required to make voting decisions that are in the client's best interests. And in order to do that effectively, it requires investment advisers to have a reasonable understanding of what their client's investment objectives are.

Investment advisers need to evaluate proxy advisory firms before they're retained—addressing the adequacy of staffing, the technology employed by the advisory firm, whether the advisory

firm has an effective process in place for seeking input from issuers and advisory firm clients, and whether it has processes in place that address potential factual errors that could affect their voting decisions.

### **SHAREHOLDER PROPOSALS**

In September, the Division of Corporation Finance announced new policies around shareholder proposals. This one-page notice generated a great deal of interest.

Under the new policy, staff will continue to review companies' no-action letter requests to exclude shareholder proposals from their proxy materials, but the staff may now respond either in writing (which has been the custom) or orally. They may respond with an agree, disagree or take no view on a no-action request. The standards for responding in writing vs. orally will involve a determination by the staff that a written response would "provide value."

All shareholders proposals are now posted to a new webpage. A chart on that page details every submission that has been made, including the name of the shareholder that made the proposal, the date of the company's initial submission, and the basis for the request for a no-action letter. The chart also includes the staff's response to the company request, the date of the staff's response, and whether the response was in a letter or communicated orally. The chart is also linked to all underlying documents, so it answers the question of how proponents will know whether staff gave an oral response to a request to exclude their proposal.

## INVESTOR ADVISORY COMMITTEE RECOMMENDATIONS

In September, the SEC's Investor Advisory Committee reported on its examination of the proxy process and included recommendations with respect to:

- End-to-end vote confirmation
- Early confirmation of vote entitlement
- Study of investor views in terms of anonymity and share lending
- The commission's deal with a universal proxy

Although the Commission is not bound by these recommendations, they do inform its thinking and where it is going. They're talking about proxy plumbing, the proxy process, the technical process, technology, and universal proxy and other items that other groups have been talking about.

## PROPOSED REVISION TO THE SHAREHOLDER PROPOSAL RULE

In early November, the Commission issued two proposals. One relates to shareholder proposals, and the second concerns proxy advisors.

The shareholder proposal rulemaking, if adopted, is designed to modernize the ownership guidelines and streamline the shareholder proposal process.

The first aspect of the proposal would be to increase the ownership requirement. Currently, a shareholder must have \$2,000 or 1% of the company's voting securities and hold that amount continuously for at least one year to make a proposal. The proposed amendments would adopt a tiered structure where a shareholder would be required to hold at least \$2,000 for three years, \$15,000 for two years, or \$25,000 for one year.

It includes a re-submission threshold increase that would make it easier for companies to exclude proposals that deal with similar subject matters as prior proposals that received low levels of support. For example, a proposal would have to have received at least 5% of the votes cast if it was presented once within the last three years.

It would require proponents to represent that they are willing to engage with the company regarding the substance of their proposal. And it would also require a proponent be willing to discuss the proposal with the company and require additional documentation for shareholders that are using a representative to submit a proposal.

## PROPOSED REVISIONS TO PROXY RULES FOR PROXY ADVISORS

The proposal for proxy advisors underscores and reiterates what was issued as guidance in August. ISS is suing the SEC regarding the August guidance in part because it's alleging that the SEC violated the Administrative Procedures Act by not adopting a rule. This is the rule that would settle the application of the proxy solicitation rules to proxy advisors.

The proposal would require proxy advisory firms to disclose in a transparent manner, any material conflicts of interest that they have including any information that might be deemed material to evaluating the objectivity of the proxy voting advice that they're providing. That would include any transactions or relationships between the proxy advisory firm and the company or a shareholder proponent.

Proxy advisors would be required to provide companies with a meaningful review and feedback period prior to publicizing voting recommendations, to notify a company of any final voting advice at least two days before delivering the advice to clients, and upon request, to include the hyperlink directing recipients to a written statement setting forth the company's views. Overall, this proposal provides a great deal of what companies have said that they've wanted over the years in terms of their relationships with proxy advisory firms.



## PROXY WORKING GROUPS

Five working groups were established:

- End-To-End Vote Confirmation Working Group
- OBO/NOBO Working Group
- Proxy Distribution Fees Working Group
- Universal Proxy Working Group
- Technology/Long-Term Reform Working Group



The working groups have already begun to meet. The End-To-End Vote Confirmation Working Group has been the most active group to date. They're working diligently on their phase one goal, which is to find out how they can do routine end-to-end confirmations for domestic annual meetings. For phase two, they will look at the international ADRs and contested meeting.

The OBO/NOBO Working Group has met once. Opinions differ with regard to OBO/NOBO, and Broadridge has committed to provide any data they can with regard to the NOBO requests. The broker community at that meeting voiced its concern about privacy issues.

The Proxy Distribution Fees Working Group met for the first time recently and includes a broad representation of asset managers, brokers, mutual funds and ICI. Their goal is to create a chart that lists what work is going on now, what this work does, and the current fees involved.

The last two committees, the Universal Proxy Working Group and the Technology/Long-Term Reform Working Group, have yet to be formed. The SEC is just monitoring these committees; it's up to the industry whether they want to form them.

## 2020 PROXY SEASON ITEMS

Firms should be thinking about three initiatives from a disclosure perspective. The first is implementation of the new hedging policy disclosure requirement that applies to all companies (this has applied to proxy statements since the latter half of 2019.) Specifically, whether they're disclosing categorical prohibitions on all of their employees from engaging and hedging company securities or if it just applies to higher level of executives and to their board. We're seeing a mixed approach to that from companies that have filed so far.

Secondly, audit reports: Investors are increasingly looking to go beyond the scope of what's required by SEC rules. This year, with the requirement for larger companies to disclose critical audit matters and their audit reports takes effect. We're seeing

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disclosures of the consideration of the critical audit matters going into the audit report, which we recommend from a disclosure standpoint.

Lastly, under new disclosure rules that were adopted earlier this year, companies are no longer required, and in fact, encouraged not to include a heading in the proxy statement for delinquent Section 16(a) reports if in fact there are none.

## VIRTUAL SHAREHOLDER MEETINGS BECOME A MAINSTREAM OPTION

Adoption of the Virtual Shareholder Meeting continues to increase. 326 VSMs took place in 2019, a 15% increase over the previous year. S&P 100 and Fortune 500 companies represented 11% each of the total. The majority of VSMs (93%) were virtual only, and 97% of virtual-only meetings were also audio-only.

Further indications of the widespread and growing acceptance of Virtual Shareholder Meetings include:

- The New York's Assembly Bill A434, which changed Corporate Law from prohibiting all virtual meeting formats to allowing the use of "Hybrid Virtual Meetings."
- An article published by ISS detailing trends and acceptance of companies utilizing the VSM platform
- Glass Lewis believes that virtual meeting technology can be a useful complement to a traditional, in-person shareholder meeting by expanding participation of shareholders who are unable to attend a shareholder meeting in person (i.e. a "hybrid meeting").  
Glass Lewis may recommend voting against members of the governance committee if the company does not provide robust disclosure assuring that shareholders will be afforded the same rights and opportunities to participate as they would at an in-person meeting.
- The Best Practices Committee for Shareowner Participation in Virtual Annual Meetings released "Best Practices" documentation in 2018.

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