Lead Director Network
ViewPoints
August 19, 2014

A dialogue with Keith Higgins, Director of the SEC's Division of Corporation Finance

Introduction and executive summary

On July 16, 2014, as part of a joint meeting between the Lead Director Network (LDN)[1] and the Compensation Committee Leadership Network (CCLN), members of both networks met with Keith Higgins, director of the Division of Corporation Finance (Corp Fin) at the Securities and Exchange Commission (SEC).[2] For further information about the LDN, see "About this document," on page 7. For a list of participants, see the appendix on page 8.

Mr. Higgins and the members of the two networks discussed the role of Corp Fin, its priorities, and the implications of those priorities for public companies. This *ViewPoints* provides details on the following topics:[3]

- The SEC's disclosure effectiveness project and methods for enhancing the quality of disclosure documents *(page 1)*
- The status of the SEC's efforts to complete the rulemaking mandated by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act *(page 4)*
- Perspectives on proxy advisory firm conflicts and accountabilities *(page 5)*
- Suggestions to improve corporate governance at public companies *(page 6)*

Improving corporate disclosures

Before Mr. Higgins joined the group, King & Spalding's Dixie Johnson provided members with a briefing on the SEC and Corp Fin. She described Corp Fin's current review of company disclosure requirements and said, *"While simplifying disclosures may sound easy, it is really a hard thing to do, with all the different groups that are interested in what companies have to say on particular issues."*

Mr. Higgins provided members with an overview of the SEC's disclosure effectiveness project. The goal of the project is "to determine if the [disclosure] requirements can be updated to reduce the costs and burdens on companies while continuing to provide material information and eliminate duplicative disclosures."[4] He also called on the directors to push for improvements in their company disclosures

[1] Lead Director Network documents use the term "lead director" to refer interchangeably to the titles lead director, presiding director, and non-executive chair unless otherwise stated.

[2] In another session of the joint meeting, held on July 17, 2014, members discussed proxy advisory firm policies with Martha Carter, global head of research, Institutional Shareholder Services, and Robert McCormick, chief policy officer, Glass Lewis & Co. See Lead Director Network, "Proxy trends and advisory firm policy," *ViewPoints*, August 19, 2014.

[3] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

[4] Keith F. Higgins, "Disclosure Effectiveness: Remarks Before the American Bar Association Business Law Section Spring Meeting" (speech, Los Angeles, CA, April 11, 2014); Securities and Exchange Commission, "Disclosure Effectiveness," accessed June 13, 2014.

independently of any additional guidance from the SEC: *"Better disclosure is possible without any changes to our rules. Dense prose is not a requirement of our rules as they stand now."*

The SEC's disclosure effectiveness project

The Jumpstart Our Business Startups (JOBS) Act mandated that the SEC undertake a review of the disclosure requirements for "emerging growth companies" – new public companies with less than $1 billion in total gross annual revenues – with a goal of scaling the requirements for those companies. The report covered Regulation S-K in its entirety, not only as it affects emerging growth companies.[5] After the report was issued, SEC Chair Mary Jo White asked the SEC staff to make recommendations to improve the effectiveness of all corporate disclosures.

Mr. Higgins explained that Corp Fin's Assistant Director (AD) groups – the staff who regularly review company disclosures and issue comment letters to companies[6] – are now reviewing the SEC's current disclosure rules. Mr. Higgins said that staff will make recommendations to the Commission, which may take the form of a concept release.

The disclosure effectiveness project is being staged in two phases. During the first phase, Corp Fin is reviewing the corporate and business information in Form 10-Ks and 10-Qs. The second phase will include a review of disclosures in company proxy statements. Mr. Higgins explained the rationale for this approach: *"We are staging it based on how recently certain requirements have been updated. Also, we believe there is a greater likelihood for consensus on revisions to the disclosure requirements in Form 10-Ks and the 10-Qs."*

Mr. Higgins told members that *"many investors believe they do not get enough information from companies."* Members acknowledged that it is a struggle to cut items from disclosures because different investors and stakeholders look to disclosures for different things. As one member explained in advance of the meeting, *"When you seek feedback from investors, you find that they each have their own thing they would like to see. There is not a consensus out there in the investor community about how disclosures should look."*

Mr. Higgins pointed out that some retail investors seek disclosures that are shorter and more user-friendly, while institutional investors, such as portfolio managers, want as much information as companies can provide. In addition, he noted that debt holders seek different information than equity investors. One member was troubled by the fact that the groups seeking more information are vocal with their requests, while those that want more user-friendly documents are not: *"Lots of different people asking for information leads to information buildup. There is nothing stopping this ever-growing request for information. There is no one asking 'Do we really need all of this information?'"*

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[5] Securities and Exchange Commission, "Report on Review of Disclosure Requirements in Regulation S-K," (Washington, DC: Securities and Exchange Commission, 2013), 2-4, 93.

[6] Securities and Exchange Commission, "Division of Corporation Finance," accessed on July 31, 2014.

One way to satisfy all constituencies is to take a layered approach to disclosure, whereby companies would provide both a summary disclosure and a more comprehensive version. Mr. Higgins noted this could be particularly effective with electronic disclosures, which would allow hyperlinking and cross-referencing to the lion's share of disclosure information that does not change from year to year. One member suggested that a model for this approach is the summary prospectuses that mutual funds provide to their investors. Other members were receptive to this concept. One said, *"In the beginning, summary prospectuses were great because investors could read them and understand them."* But this member cautioned that over time they have expanded to the point that we sometimes need *"summary summary-prospectuses."*

Mr. Higgins reiterated that some investors have requested additional disclosure, particularly concerning political contributions and short-term borrowing practices, as well as information in audit committee reports. One member suggested that investors are seeking (and that companies frequently oblige by providing) more non-GAAP financial disclosures than before, and asked whether the SEC views non-GAAP disclosure as an area for reducing disclosure volume. Mr. Higgins said that in 2010 the SEC staff issued guidance on the use of non-GAAP measures in public company disclosures, including SEC filings: *"We are most concerned about clear disclosure. Say what you are doing and explain why you are doing it. Non-GAAP can be useful, as long as it is not misleading."*

A call to improve corporate disclosures

Mr. Higgins emphasized that changing SEC requirements is only one step to improving company disclosures. He said, *"We are asking companies to look at their disclosures and evaluate how they can make them better."* He pointed to general improvements in the Compensation Discussion and Analysis (CD&A) section of proxy statements in the wake of say on pay as an illustration of companies' ability to enhance disclosures without regulatory mandates. He suggested that companies view other disclosures, like Form 10-Ks and 10-Qs, as communicative pieces rather than solely as compliance documents.

Mr. Higgins suggested two ways that companies can improve disclosures in their Management Discussion and Analysis (MD&A) without SEC action:

- **Make it less repetitive.** He noted that companies often include a table followed by text that says the same thing. *"Don't say what it says, say what it means."*
- **Improve the quality of critical accounting estimate disclosure.** He said these disclosures should not be a recitation of a company's accounting policies. *"Disclose the uncertainties and estimates that could make the numbers change."*

More broadly, Mr. Higgins encouraged companies to experiment with creative changes to make disclosure more effective: *"If disclosure is compliant and better, even if it is different, that's a good thing."* He explained that to make effective changes, management teams and boards must challenge their lawyers and accountants to improve. In particular, he suggested that companies be more thoughtful in their reactions to SEC comment letters to other companies: *"Don't just follow the path. If the issue raised by the comment to another company doesn't relate to your company, don't put it in."*

Mr. Higgins acknowledged that the SEC staff must do its part to encourage effective disclosure by being judicious in its filing review process. He also reminded companies that the SEC comment process is meant to commence a dialogue: *"If you don't think the information is required or material, discuss it with us before including additional disclosure in the filing."* For their part, however, members resisted the idea of an exchange with Corp Fin over immaterial disclosures. One said, *"If we get an SEC letter, we just respond [by amending our disclosure]. Pushing back is not a priority because you are the authority. It is also costly to fight. So why do it? There are other means to communicate with investors."*

As companies consider ways to improve their disclosures, Mr. Higgins invited directors to engage with the SEC. He added, *"We welcome discussions about how to make your disclosures more meaningful."* He also invited members to comment on the disclosure effectiveness project on the SEC's website or by email to disclosure@sec.gov.

SEC rulemaking priorities

The Dodd-Frank Act includes more than 90 provisions that require SEC rulemaking, and many more that give the SEC discretionary rulemaking authority.[7] And the SEC has additional rulemaking obligations under the JOBS Act. Although it has been nearly four years since the Dodd-Frank Act was enacted and more than two years since the JOBS Act became law, the SEC has yet to complete all the rulemaking required by these statutes. In her pre-meeting briefing, Ms. Johnson noted that the SEC's work on these rules continues, even though the deadline for finishing some of the Dodd-Frank rules has passed.

Mr. Higgins said that the mandated rulemaking requirements are a priority for Corp Fin, and that the Division is hard at work on meeting these obligations. In particular, he discussed four executive compensation rulemakings that are included on the Commission's rulemaking agenda:

- **Pay for performance.** Dodd-Frank calls on the SEC to draft rules requiring companies to show the relationship between "executive compensation actually paid and the financial performance of the issuer."[8] Mr. Higgins said that Corp Fin is interested in input from companies on what "actually paid" means. Members were generally receptive to the concept of including any vested equity, which many saw as preferable to calculating pay as of the exercise date. One member said, *"The value at the time an option is exercised has no connection to the job the compensation committee has done."*
- **Compensation clawbacks.** The SEC must direct national exchanges to delist companies that fail to implement a policy to recover incentive-based compensation from current and former executive officers following an accounting restatement.[9] Mr. Higgins explained that Dodd-Frank presents a simple proposition: *"If compensation is based on a number, and it turns out that number was not*

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[7] Securities and Exchange Commission, "Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act," accessed on June 13, 2014.

[8] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376, § 953a (2010)

[9] Dodd-Frank Wall Street Reform and Consumer Protection Act, § 954.

the right number, you ought to pay back the difference." Members noted that clawback policies have long been viewed as good corporate practice and that many boards have implemented them even without final SEC rules. One member said, *"Many companies have left room for the board to have more discretion to exercise the clawback."* Another was concerned that Dodd-Frank's restriction of clawbacks to cases of financial restatement *"will cause companies to stop there and not go beyond to allow clawbacks for bad conduct."*

- **Hedging of company stock.** Other rules, still to be proposed by the SEC, will require companies to disclose in proxy statements whether employees or directors are permitted to hedge against the value of company stock.[10] Both major proxy advisory firms already recommend that companies adopt strict prohibitions on this practice.
- **CEO Pay Ratio.** The Commission must also finalize its rule for disclosure of the ratio between CEO compensation and that of the company's median employee. Mr. Higgins noted that many commenters on the proposed rule disagreed about how the rule should define "all employees." He also noted the flexibility in the proposed rule was intended to implement Congress's intent and reduce compliance costs for issuers.

Proxy advisory firm disclosures and accountabilities

On June 30, 2014, the SEC released Staff Legal Bulletin 20 (SLB 20).[11] In 13 questions and answers, the Bulletin guides investment advisers on assessing the capacity, competency, and independence of proxy advisory firms. It also provides the proxy advisory firms with guidance on their obligation to give investors information about their "significant" relationships with a company or "material interests" in a vote when providing proxy voting advice if they wish to rely on one of the exemptions from the federal proxy rules. Mr. Higgins acknowledged that SLB 20 does not comprehensively regulate proxy advisers and that such regulation would require broader action by the SEC: *"We don't have a current rulemaking project [on proxy adviser regulation]. We would like to see how the guidance works before deciding what further action might be appropriate."*

Some members were critical of the SEC for not going far enough to eliminate conflicts of interest for proxy advisers. One member criticized the fact that the SEC allows Institutional Shareholder Services (ISS) to continue offering consulting services to public companies when its primary business is advising investors on how to vote on those same companies' proxies: *"The SEC has abrogated its responsibility. It is supposed to exist to make sure that markets work well."*

Others were concerned that the SEC did not require action by the proxy advisory firms in areas other than conflicts of interest. In particular, members complained that the SEC does not regulate the accuracy of proxy advisers' reports. Members noted that correcting errors of fact is not enough. It is also important

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[10] Dodd-Frank Wall Street Reform and Consumer Protection Act, § 955.

[11] Securities and Exchange Commission, "Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms," Staff Legal Bulletin No. 20, June 30, 2014.

for proxy advisers to be consistent in applying their policies from one company to the next. One member said it is *"important for the SEC to provide guidelines for the proxy advisers. When they are wrong on the facts, there should be some consequences."*

Mr. Higgins explained that SLB 20 offers a market solution to addressing errors in the proxy advisers' content by putting the onus on their clients to assess the quality of their work. He went on to say, *"Investment advisers have a duty to make sure the proxy advisers get it right. We have not seen a surfeit of errors of a compelling magnitude [to warrant action by the SEC]."* One member countered that board directors, not the advisers' clients, are better positioned to assess the quality and accuracy of proxy advisers' work: *"Most large investors just use the service as a data point. As long as [proxy advisers'] influence remains relatively low, there is less urgency. The people who care are directors, because it is a pride thing."* Mr. Higgins acknowledged this perspective and invited members to contact the SEC directly if they identify major factual errors in a proxy adviser's report.

Improving corporate governance

Members and Mr. Higgins also discussed current trends in proxy voting and corporate governance. Though Mr. Higgins explained that substantive corporate governance is not directly governed by the SEC, he acknowledged that its rules and policies influence board-level decisions, particularly in the following areas:

- **Shareholder proposals.** Mr. Higgins said that the SEC tries to be consistent and to apply precedent when a company makes a "no-action" request to exclude a shareholder proposal. The group discussed calls to raise the SEC Rule 14a-8 threshold for making a proxy proposal from the current requirement that the proponent hold $2,000 or 1% of the company's stock. Members noted that these calls have met strong resistance. One member also suggested that the SEC pay further attention to the tactic of filing a proposal on a popular or controversial issue solely as leverage to negotiate an entirely unrelated issue.
- **Shareholder-director engagement.** The group discussed the trend of large shareholders engaging directly with investors, particularly on the topic of executive compensation. Mr. Higgins said these conversations are covered by Regulation FD (Fair Disclosure), but he also said that directors should not feel that they cannot talk to shareholders because of the regulation. He commented that *"FD is manageable."* According to Ms. Johnson, the SEC often focuses on Regulation FD in connection with a claim of "tipped" insider trading. She added that cases based on a violation of Regulation FD are rare.

Conclusion

Corp Fin has a full agenda of challenging decisions that are likely to shape corporate requirements and practices for years to come. Lead directors and compensation committee chairs appreciated the chance to share the board perspective with Mr. Higgins as Corp Fin continues to solicit input from a variety of constituency groups on these crucial topics.

About this document

The Lead Director Network (LDN) is sponsored by King & Spalding and convened by Tapestry Networks. Drawn from America's leading corporations, the LDN is a group of lead independent directors, presiding directors, and non-executive chairs who are committed to improving the performance of their companies and to earning the trust of their shareholders through more effective board leadership. The views expressed in this document do not constitute advice for any purpose (legal, financial, business, or otherwise) of network members, their companies, King & Spalding, or Tapestry Networks.

Appendix: Network participants

The following directors participated in all or some of the meeting:

- Frank Blount, Former Lead Director, KBR
- Peter Browning, Lead Director, Acuity Brands
- Loren Carroll, Lead Director, KBR
- Erroll Davis, Compensation Chair, Union Pacific
- Tom Donohue, Former Compensation Chair, Union Pacific
- Bonnie Hill, Former Lead Director, The Home Depot
- Karen Horn, Compensation Chair, Eli Lilly
- Bill Kerr, Compensation Chair, Interpublic Group
- Mary McDowell, Compensation Chair, Autodesk
- Steve Miller, Non-Executive Chair, AIG; Compensation Chair, Symantec
- George Muñoz, Audit Committee Chair, Altria
- Ed Rust, Presiding Director, Caterpillar; Lead Director, McGraw-Hill Companies
- Laurie Siegel, Compensation Chair, CenturyLink
- Samme Thompson, Compensation Chair, American Tower
- Linda Wolf, Compensation Chair, Wal-Mart Stores

The following directors took part in pre-meeting discussions:

- Ed Kangas, Non-Executive Chair, Tenet Healthcare; Lead Director, United Technologies
- Marshall Larsen, Compensation Chair, Lowe's Companies
- Jack O'Brien, Lead Director, TJX; Non-Executive Chair, Cabot Corporation
- Steve Reinemund, Compensation Chair, Marriott International
- Michael Rose, Presiding Director, General Mills
- Wes von Schack, Lead Director, Bank of New York Mellon and Edwards Lifesciences
- Sam Scott, Compensation Chair, Bank of New York Mellon
- Stephanie Shern, Presiding Director, GameStop

The following King & Spalding attorneys participated in one or more of the meeting sessions:

- Bill Baxley, Partner; Co-Chair, Mergers and Acquisitions Practice
- Dixie Johnson, Partner; Special Matters and Government Investigations Practice Group
- Glen Reed, Partner and Chair; Healthcare Industry Group
- Laura Westfall, Senior Associate; Employee Benefits and Executive Compensation Practice
- Chris Wray, Partner and Chair; Special Matters and Government Investigations Practice Group

The following Meridian partners participated in the meeting:

- Annette Leckie, Partner and Lead Consultant
- Jim Wolf, Managing Partner