Lead Director Network

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LDN

VIEWPOINTS

A board guide to the Securities and Exchange Commission's current priorities

The Securities and Exchange Commission (SEC) plays a critical role in the regulation of US public companies, helping to shape the way that firms and their leaders communicate with their investors and the broader public. On November 29, 2018, Lead Director Network members gathered in Washington, DC, to discuss the SEC, its current priorities and activities, and the broader regulatory and enforcement environment. For a portion of the meeting, members were joined by Bill Hinman, Director of the SEC's Division of Corporation Finance (Corp Fin), for an off-the-record conversation about the division's current priorities.

This *ViewPoints* synthesizes conversations with LDN members before and during the meeting about the SEC's current processes and addresses the following major themes:

- **Current SEC and Corp Fin priorities**
- **The securities regulation and enforcement landscape**

Current SEC and Corp Fin priorities

The SEC's threefold mission is "to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The SEC strives to promote a market environment that is worthy of the public's trust."[1] Since taking office in May 2017, the SEC's current Chairman, Jay Clayton, has emphasized the long-term interests of retail investors as a priority for the commission. In remarks early in his tenure, he said that the measure of whether the commission was remaining true to its mission would be found in how well it was promoting "the long-term interests of the Main Street investor. Or, as I say when I walk the halls of the agency, how does what we propose to do affect the long-term interests of Mr. and Ms. 401(k)? Are these investors benefitting from our efforts?"[2]

In the context of this mission and general focus, SEC leaders have emphasized several themes, including fostering attractive public equities markets and reforming the proxy process. LDN members noted that there are the limits to what regulatory reform can achieve, given the power of market actors and economic trends.

Fostering attractive public equities markets

Both Chairman Clayton and Director Hinman have emphasized the need to make public markets more attractive and acknowledged the challenges public companies face. LDN

members also recognize those challenges, including regulatory requirements, navigating pressures from market participants, and managing their relationship with investors.

The growth of private markets

Chairman Clayton and Director Hinman have voiced concerns about the declining number of companies listed on US exchanges, which has been cut approximately in half over the last two decades.[3] This is in part due to consolidation—the average market cap of listed companies is larger than it was in the past, and many venture-backed firms aim to be acquired rather than go public. However, it also indicates that an increasing number of firms find it more attractive to remain private or delay going public, despite the access to capital and liquidity that the public markets provide. By late 2018, there were nearly 150 private companies with valuations of over $1 billion in the United States (including 11 valued at over $10 billion); in 2013 there were fewer than 40 such companies.[4]

Raising large amounts of capital from the private markets has become easier as private assets under management grew from less than $1 trillion to over $5 trillion between 2000 and 2017.[5] In addition, securities deregulation has made it easier for companies to remain private longer. Legislative changes have eased restrictions on private companies selling shares to qualified purchasers and have increased the cap on the number of investors in private companies from 500 to 2,000, while the SEC has adopted regulations encouraging private placements.[6] In this context, some LDN members suggested that private markets would continue to grow: *"I think the private market will increase, in part because the amount of capital allocated to alternative private investment is growing. Their model is changing. Capital is more permanent, not in funds that have to be recycled, so they can hold for a longer period."* Another member noted, *"There is so much private capital out there looking to be put to work,"* and predicted that as valuations of public companies return to more reasonable levels, *"an avalanche of private capital"* could enter the public markets, taking more and larger companies private.

Concerns about the decline of public companies

Both Chairman Clayton and Director Hinman have warned of the dangers that declining numbers of public companies pose. In July 2017, Chairman Clayton said, "Regardless of the cause, the reduction in the number of U.S.-listed public companies is a serious issue for our markets and the country more generally. To the extent companies are eschewing our public markets, the vast majority of Main Street investors will be unable to participate in their growth. The potential lasting effects of such an outcome to the economy and society are, in two words, not good."[7] Director Hinman has likewise emphasized the benefits that accrue to markets when companies go public and do so at an earlier stage in their lives: "Markets as a whole benefit from the increased transparency and the better-informed price discovery that occurs when more companies participate in the public markets. Investors benefit when there are more companies in which to invest … More IPOs occurring at an earlier stage means a wider range of investors are able to more fully participate in the growth of companies."[8]

In addition, Director Hinman has emphasized the ways companies improve as a result of going public: "Accounting policies are sharpened and explained more cogently, risks inherent in the business are examined and disclosed in the crucible of the public reporting system, the business model and the strategy that drives it are better focused and understood. Management is strengthened, sometimes with the aid of new hires. Typically the board becomes more knowledgeable and more independent, and corporate governance is improved. All of these things combine to create a stronger company."[9]

LDN members questioned the claim that companies improve as a result of going public. One member said, *"The underlying hypothesis says that as companies go public, they get better. They do get more orderly, and the controls get better, but the cost of that is quite high. Do they also get better in terms of delivering profit, or are they just better in terms of protecting a different group of investors with a lower risk threshold than private investors?"* Another member suggested that *"in a private model, there is more opportunity to make longer-term decisions because you are not bound by the earnings-and-guidance model."*

The burden of being public

More than one member noted that being a public company imposes a kind of "tax," which, as one member put it, *"has to do with things like activism, proxy access, proxy advisers, and shareholder proposals."* Both Chairman Clayton and Director Hinman have acknowledged the difficulties of being a public company. While recognizing that the regulatory environment is only one factor in a company's decision on whether or not to become a public company, Director Hinman has tasked the Division of Corporation Finance with looking for ways to improve the regulatory environment so as to "strike the right balance with the disclosure and other regulatory burdens placed on companies that join the public sphere."[10] Corp Fin has already implemented or is exploring changes to its processes, disclosure requirements, and interactions with companies with that goal in mind.

The cadence of quarterly reporting, earnings releases and calls, and quarterly guidance has been blamed for promoting a short-term focus at public companies. One member said, *"The core issue that makes the private model more attractive is the consequences from quarterly reporting… the fact you make [business] decisions based on where the [analysts'] consensus is [on earnings], the impact on the stock price if you miss it. It opens you up to activists. You go through that, and the private model starts to look attractive."*

Although members blamed quarterly earnings guidance—which the SEC does not require companies to provide—as much as or more than quarterly reports for creating a short-term mentality, failure to provide guidance brings its own problem. *"There are complexities you have if you don't provide guidance. Analysts provide their own quarterly guidance, and if that gets out of whack, how do you manage it [consistent with Regulation FD]?"* Another member noted, *"Even if you don't provide guidance, quarterly reporting requires a lot of conversation with investors to fill in gaps in the 10-Q."*

As a result, pressure to reconsider the practice of quarterly reporting is mounting. Chairman Clayton affirmed in a November speech that the SEC had put the issue of quarterly reporting on its agenda for 2019, partly in response to a tweet from President Trump. Chairman Clayton acknowledged concerns about the way in which quarterly reporting contributes to short-term thinking: "I very much support the president's question of, are we managing too much for the short term, and what can we do about it," adding, "The president was right to raise this issue. He touched a nerve because I don't think any of us want our very important private-sector enterprises to be run on a short-term, quarter-to-quarter basis."[11] At the same time, Chairman Clayton pointed out that investors need to have timely information and that investors and corporate leaders are divided on whether or not to do away with quarterly reporting. The US Chamber of Commerce backs a reduction in reporting frequency, for example, while the Council of Institutional Investors opposes it.[12]

Reforming the proxy process

Over the last year, Chairman Clayton has said the proxy process must be reviewed to ensure that it is meeting the needs of both retail investors and listed companies. On November 15, 2018, the SEC hosted a roundtable on the proxy process that addressed proxy voting, shareholder proposals, and the role of proxy advisers.

Proxy voting and retail shareholders

Chairman Clayton has suggested that the fact that only 29% of retail investors voted their shares during the 2017 proxy season could be "a signal that our proxy process is too cumbersome for retail investors and needs updating."[13] He has identified retail shareholder participation and shareholder proposals as two areas of special focus for improvement.[14]

Shareholder proposals

Some companies and investors have expressed dissatisfaction with the shareholder proposal process. At the proxy roundtable, representatives of corporate issuers said that the proposal process permits too many nuisance proposals and suggested that the ownership threshold for submitting a proposal should be raised "so that all of those submitting proposals have a meaningful and measured ownership interest in the company."[15] They also suggested that the level of support needed to resubmit a proposal in subsequent years should be raised because the current thresholds "allow a small subset of shareholders or, frankly, a proxy advisory firm, to override indefinitely the express will of a substantial majority of shareholders."[16] LDN members agreed: *"One issue is that shareholders can resubmit the same proposal year after year. Given all the other things we're trying to deal with, it can be seen as a waste of time."* Another noted that *"repeat proposals from those with a small stake"* contribute significantly to the burden faced by public companies. The investor community generally favors the current shareholder proposal process, emphasizing the governance improvements—such as annual director elections, independent directors, and increased attention to environmental and social issues—that have come as a result of shareholder proposals. At the proxy roundtable, one

proponent dismissed the idea that dealing with shareholder proposals represents a major burden, noting that the average US public company receives one shareholder proposal every 7.7 years.[17]

Chairman Clayton has acknowledged that repeated submissions of the same proposal take up board and management time that could otherwise be spent on strategic or operational matters and that resubmission thresholds might be too low. On the other hand, he has insisted that shareholder proposals are an important part of shareholder engagement and can lead to substantial improvements in governance, and he has reaffirmed his commitment to ensuring that retail investors "have a seat at the table."[18]

Corp Fin recently released updated guidance on the exclusion of certain kinds of proposals from proxies. The bulletin reaffirms earlier guidance that a proposal may be excluded on the grounds that it micromanages the company, even if the proposal otherwise addresses appropriate subject matter. It also clarified that proposals that touch on executive and/or director compensation—normally not excludable—may be excluded under the "ordinary business" exclusion if the primary purpose of the proposal relates to an ordinary business matter. In addition, in a change from prior practice, the recent guidance argues that proposals relating entirely to executive and/or director compensation could be excludable on the basis of micromanagement if they "seek intricate detail or seek to impose specific timeframes or methods for implementing complex policies."[19] At the same time Corp Fin encouraged companies that submit no-action requests to include a discussion of the board's analysis of the issues raised by the proposal in their request. (See box on p. 6.)

Proxy advisers

In recent years, various stakeholders have called for additional regulation of proxy advisers such as Glass Lewis and Institutional Shareholder Services (ISS), arguing that they exert excessive influence on proxy voting and lack appropriate oversight. In December 2017, the House of Representatives passed the Corporate Governance Reform and Transparency Act, which would require proxy advisory firms to register with the SEC, disclose the procedures and methodologies they use for establishing their proxy voting recommendations, report on their recommendations and the number of companies that are also consulting-services clients, and develop policies to manage conflicts of interest. They would also be required to have adequate staffing to ensure their recommendations are based on sufficient information, and further, they would be required to develop procedures to allow companies to comment on their recommendations.[20] In November 2018, a bipartisan group of senators introduced a similar bill that would require the SEC to regulate proxy advisory firms under the Investment Advisers Act.[21]

The board's analysis of shareholder proposals

In staff bulletins released in late 2017 and late 2018, Corp Fin encouraged the inclusion of a discussion of the board's analysis of shareholder proposals in no-action requests under the "economic relevance" or "ordinary business" exceptions. Corp Fin noted that the question of whether a specific proposal is significantly related to a company's business or transcends ordinary business often "raises difficult judgment calls that the Division believes are matters that the board of directors generally is well-situated to analyze."[22] While the bulletin noted that the presence or absence of such a discussion would not determine whether or not an exclusion would be granted, it also said that "without having the benefit of the board's views on the matters raised, the staff may find it difficult in some instances to agree that a proposal may be excluded."[23]

The staff bulletin identified some of the items that the board should analyze and include in its discussion:

- the extent to which the proposal relates to the company's core business activities
- quantitative data on the impact the proposal would have on the company
- the extent of shareholder engagement on the issue
- whether and how the company has already addressed the issue in some way
- whether shareholders have previously voted on the matter[24]

Several LDN members indicated interest in hearing more about how the SEC might regulate proxy advisory firms. One member asked, *"Has the SEC looked at role of ISS in speaking for shareholders, and giving certain investors some kind of prophylactic coverage for voting? That's something the SEC and others should think about. How far can they let a proxy advisory firm go without spelling things out?"* Indicative of an evolving position on the role of proxy advisory firms, in September 2018 the SEC withdrew two no-action letters related to proxy advisers. The withdrawn letters, originally issued in 2004 to ISS and Egan-Jones, held that institutional investors could demonstrate that they were voting proxies in the best interest of their clients and avoid conflict-of-interest concerns if they were relying on recommendations from third-parties, such as proxy advisers. Critics have charged that the letters have contributed to overreliance on proxy advisers, and some observers consider the letters' withdrawal to be a welcome correction.[25]

Acknowledging the limits of regulatory reform

While LDN members welcomed the SEC's efforts to streamline disclosure and reporting requirements, improve the proxy process, and review the impact of proxy advisers, they noted that the SEC's ability to change the dynamics in the capital markets and investment landscape is limited. Beyond the fact that the market moves faster than regulation, boards face an array of cross-cutting pressures that affect them more deeply than SEC rulemaking. One member said, *"Someone in [Director Hinman's] position, the best he can do is change things on the margins. Things in the market are moving fast enough that the regulatory side will be left in the dust. It's not a matter of who the person is; it's a matter of how the structure changes. It's baked in concrete. I won't say regulators are irrelevant, but their significance is less and less as things evolve. Whether it's BlackRock, State Street, and Vanguard getting together to decide how things will be or the continued privatization of the economy, whether he changes a filing rule doesn't matter at the end of the day."*

Another member agreed and suggested that the balance of power had shifted to the investor community and away from corporate issuers: *"The SEC is really not the vehicle to affect policy. The reality is that the investment side has become more organized over the last decade, whereas the corporate side has a collective action problem. There needs to be a counterweight, but it will be through private ordering rather than a regulatory push. On the shareholder side, there are four or five major institutions; there has been accelerating concentration on the investor side."*

The securities regulation and enforcement landscape

The activities of other parts of the SEC, particularly in the enforcement division, and of other government agencies are also of concern to board members. In a separate session, LDN members discussed the broader environment of securities regulation and enforcement with King & Spalding partner Dixie Johnson.

Enforcement priorities

Ms. Johnson pointed out several trends in securities enforcement priorities from the SEC and the Department of Justice (DOJ).

- **An increasing number of enforcement actions**. Ms. Johnson noted that many observers expected a degree of regulatory relief and relaxation of enforcement under the current administration. While the first two years of the Trump administration have seen declines in the size of financial penalties,[26] Ms. Johnson also pointed out that the number of SEC enforcement actions increased in FY 2018. In fact, the SEC brought more enforcement actions in 2018 than in any of the previous three years.[27]
- **New kinds of enforcement and settlement mechanisms**. Ms. Johnson noted that the SEC has increasingly deployed creative legal theories as well as various settlement and

enforcement remedies that supplement financial penalties. For example, in the case of Elon Musk and Tesla, not only did both Musk and the company agree to pay a financial penalty, they agreed to undertakings that Musk would not serve as board chair for three years and to bring in two new independent directors.[28] Ms. Johnson also described a recent SEC Report of Investigation involving nine public companies that were victims of cyber frauds. In that report, the SEC stated its view that companies "must calibrate their internal accounting controls to the current risk environment and assess and adjust policies and procedures accordingly."[29]

- **Individual accountability**. Noting that "Institutions act only through their employees, and holding culpable individuals responsible for wrongdoing is essential," the SEC has placed a renewed emphasis on individual liability and accountability. [30] Ms. Johnson noted that more than 70% of the SEC's fiscal 2018 enforcement actions named individuals as well as entities.[31]
- **Renewed attention to fraud**. Ms. Johnson pointed out that government agencies are increasingly working together to prosecute fraud and Foreign Corrupt Practices Act violations. She also noted the formation of a new task force on market integrity and consumer fraud headed by the deputy attorney general and drawing from the SEC, the DOJ, the Consumer Financial Protection Bureau, and the Federal Trade Commission.[32]

A changing whistleblower landscape

The US Supreme Court ruled in February that whistleblowers are only entitled to the retaliation protections of the Dodd-Frank Act if they report their concerns to the SEC. Those who only report internally are not afforded those protections.[33] The ruling gives employees a greater incentive to report to the SEC rather than, or in addition to, reporting internally, and Ms. Johnson noted that in the wake of the decision, the number of calls coming into the SEC's whistleblower line has increased. Ms. Johnson said, *"It is a scary time for companies, for compliance officers, and for boards, especially audit chairs. If a company's culture doesn't encourage people to report internally, you are going to be in an investigation before you know there is a problem."*

This context, members and Ms. Johnson agreed, makes it more crucial than ever to ensure that companies have robust internal reporting processes and policies. Employees need to see that they have avenues for reporting their concerns, and they need to believe that top leadership takes those concerns seriously. Ms. Johnson noted that before the Supreme Court ruling noted above, it had been reported that *"over 70% who came to SEC had reported internally first and nothing had happened, or at least they hadn't seen anything happen."* One LDN member said, *"People go to the SEC because they think nothing will be done if they report internally. To the extent people who report issues see that things change, that people get fired, that's the kind of culture you have to create.*"

Key questions for boards

Ms. Johnson suggested several questions that directors could and should ask themselves in view of the regulatory and enforcement priorities of the current administration.

? What are we doing after a cyber breach to evaluate the successes or failures of our internal controls? What do we learn from what gets escalated or not escalated internally?

? Have we taken a fresh look at our internal whistleblower program since incentives have shifted in the last year? Since Sarbanes-Oxley?

? Based on a varied array of metrics, is our performance an outlier, compared with others in our industry? If so, we need to know why and understand our own data, because the SEC is looking at it.

? Have we taken a fresh look at insider trading policies to take into account new cybersecurity issues?

? Do we point to social media or a website as part of Regulation FD disclosures? If so, how do we oversee that?

? What is happening in our company with respect to trade sanctions? Are we operating in areas newly subject to sanctions?

? Are our disclosures consistent with the volume and quality of the board's dialogue on risks that our board is monitoring?

Appendix A: The structure, mission, and purpose of the SEC

The SEC is an independent federal agency charged with overseeing securities trading on US equities markets. It oversees the activities of approximately 4,300 listed companies and 26,000 other market participants, including investment advisers, mutual funds, and exchange-traded funds.[34] It also oversees the security exchanges themselves, as well as ratings agencies, clearing agencies, and other regulatory bodies such as the Public Company Accounting Oversight Board and the Financial Industry Regulatory Authority. The commission consists of five commissioners, appointed by the president and confirmed by the Senate, one of whom is designated the chair and serves as the SEC's senior executive. At least one commissioner must come from each political party, and there are typically two from each party, as is the case now. Apart from the commissioners, none of the rest of the staff are political appointees. Ms. Johnson emphasized that *"although the Commission is led by presidential appointees, confirmed by senate, everyone else is a member of the staff. The SEC is not an organization full of political appointees. It is not a political body."*

Within the SEC, Corp Fin seeks to ensure that investors are provided with the material, complete, and accurate information necessary to make investment and voting decisions. As part of this task, Corp Fin reviews company filings to monitor compliance with disclosure and accounting requirements. The Sarbanes-Oxley Act (2002) requires the SEC to review the financial statements of reporting companies every three years and more often as necessary. As part of its evaluation of company filings, Corp Fin staff at times issue comment letters designed to elicit more effective disclosure and compliance with relevant requirements. In response to comment letters, companies can revise their filings, provide Corp Fin with supplemental information, and/or provide additional disclosure in subsequent filings. These comment letters and companies' responses to them are made public on the SEC's website. In addition, Corp Fin issues guidance to assist companies in interpreting SEC rules and forms and, in the words of Director Hinman, "stands ready to assist companies in complying with federal securities laws."[35]

Appendix B: meeting participants

Paul Bowers, Incoming Lead Director, Aflac

Sandy Cloud, Lead Trustee, Eversource Energy

Don Felsinger, Lead Director, Archer Daniels Midland and Northup Grumman

Jim Fogarty, Non-Executive Chair, Assertio Therapeutics

Ann Hackett, Lead Director, Capital One

Dixie Johnson, Partner, King & Spalding

Doug Johnson, Lead Director, Aflac

Lou Lavigne, Non-Executive Chair, Accuray; Lead Director, Zynga

Linda Fayne Levinson, Lead Director, Jacobs Engineering Group

Mike McCarthy, Lead Director, Union Pacific

Craig Omtvedt, Non-Executive Chair, Oshkosh Corporation

Cal Smith, Partner, King & Spalding

Steve Specker, Lead Director, Southern Company

Doug Steenland, Non-Executive Chair, AIG and Performance Food Group

Jim Woolery, Partner, King & Spalding

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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.

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Endnotes

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[1] "About the SEC," US Securities and Exchange Commission, May 21, 2018.

[2] Jay Clayton, "Remarks at the Economic Club of New York" (speech, New York, July 12, 2017).

[3] See footnote 7 of Clayton, "Remarks at the Economic Club of New York."

[4] "The Global Unicorn Club," CBInsights, accessed December 10, 2018.

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[6] Ibid.

[7] Clayton, "Remarks at the Economic Club of New York."

[8] William Hinman, "Testimony on 'Oversight of the SEC's Division of Corporation Finance'" (testimony before the US House of Representatives Committee on Financial Services Subcommittee on Capital Markets, Securities, and Investments, Washington, DC, April 26, 2018).

[9] William Hinman, "Keynote Address at the PLI's Seventeenth Annual Institute on Securities Regulation in Europe," (speech, London, February 1, 2018).

[10] Ibid.

[11] "Clayton Backs Plan to Reconsider Quarterly Reporting Rules," bakertilly, November 13, 2018.

[12] Ibid.

[13] Jay Clayton, "Governance and Transparency at the Commission and in our Markets" (speech, PLI 49th Annual Institute on Securities Regulation, New York, NY, November 8, 2017).

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[15] US Securities and Exchange Commission, *Roundtable on the Proxy Process* (Washington, DC: Securities and Exchange Commission, 2018), 127.

[16] Ibid., 128.

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[20] Steve Seelig and Puneet Arora, "The Regulation of Proxy Advisors," *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), August 3, 2018.

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[23] Ibid.

[24] Ibid.

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[29] US Securities and Exchange Commission, "SEC Investigative Report: Public Companies Should Consider Cyber Threats When Implementing Internal Accounting Controls," (press release, October 16, 2018).

[30] US Securities and Exchange Commission, *Annual Report: Division of Enforcement*, 2.

[31] Ibid.

[32] See US Department of Justice, "Department of Justice, Bureau of Consumer Financial Protection, U.S. Securities and Exchange Commission, Federal Trade Commission Announce Task Force on Market Integrity and Consumer Fraud," news release, July 11, 2018.

[33] Andrew Chung, "Supreme Court Declines to Broaden Whistleblower Protections," *Reuters,* February 21, 2018.

[34] US Securities and Exchange Commission, *Strategic Plan: Fiscal Years 2018–2022* (Washington, DC: US Securities and Exchange Commission, 2018), 2.

[35] Hinman, "Testimony on 'Oversight of the SEC's Division of Corporation Finance.'"