2016 Trends in Governance

New rules that could affect the upcoming proxy season

With the 2016 proxy season underway, companies face an ever-evolving set of SEC rules—some still in the works, others proposed, and still others already adopted. To make sense of the new environment, Broadridge recently hosted a webcast with Keir Gumbs, a partner at Covington & Burling LLP and vice chair of the firm's Securities and Capital Markets practice group, click here to view it.

This article summarizes that discussion and provides a brief rundown of the SEC rule changes that could have the largest potential impact on proxy campaigns this year.

Proxy access

The biggest development in corporate governance in 2015 was proxy access. More than 100 access proposals were submitted to companies, with the biggest proponent of those proposals being the New York City pension funds, which launched a boardroom accountability project in 2015. Proposals were largely modeled after the SEC's old proxy access rule, which stipulates that a company's proxy materials must include the board nominees of any shareholder who has owned at least 3 percent of the company's stock for at least three years. In general, the proposals allow a shareholder to nominate up to 25 percent of the board.

This trend is likely to continue in 2016. Many companies are taking proactive steps and adopting their own proxy access bylaws along these lines, even before receiving a proposal from a shareholder. Unlike the proposals submitted by the Boardroom Accountability Project, most of these bylaws include some restrictions on aggregation among shareholders. For example, many bylaws say that such groups can contain no more than 20 shareholders can aggregate their shares for the purposes of making a nomination under the proxy access bylaws.

For the companies that haven't taken action yet but are considering doing so, the first imperative is to survey the landscape and see what other companies have done to this point. Proxy access bylaws are evolving, and earlier iterations of proxy access bylaws had provisions that are very different than the latest proposals. Second—and more importantly—management teams should actively engage with shareholders before making any changes. Once the board has reached a consensus regarding proxy access, management should discuss the company's proposed proxy access bylaw with their most important and largest shareholders, to gauge investor support for the proposed bylaw.

THE TOP SHAREHOLDER CONCERNS IN PROXY ACCESS BYLAW PROVISIONS:

1. the minimum percentage of shares owned to propose board nominees,
2. the minimum ownership period,
3. the number of board members who can be nominated,
4. whether shareholders can aggregate their holdings.

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There are many types of provisions in proxy access bylaws—some more controversial than others—but in general shareholders care most about four things:

1. the minimum percentage of shares owned to propose board nominees,
2. the minimum ownership period,
3. the number of board members who can be nominated,
4. and whether shareholders can aggregate their holdings.

Executive compensation

There are also new rules regarding executive pay disclosure that have been adopted or are under consideration at the SEC.

Pay ratio

The first, which the SEC has already adopted, deals with pay ratios. It requires that companies disclose not only the CEO's compensation, which is already required, but also the total compensation for a median employee at the company, and the ratio of those two.

That requires a relatively complicated calculation in coming up with the compensation for the median employee. Companies can rely on statistical sampling to identify the median employee, but they have to disclose their methods and assumptions. The compensation ratio needs to be calculated every year, though companies only need to determine the median employee once every three years.

Pay for performance

The SEC also proposed a rule—not yet adopted—regarding pay-for-performance disclosure. In addition to previous requirements that companies disclose the compensation paid to the CEO and also to other named executive officers as a group, the new rule stipulates that companies would also need to disclose their financial performance using total shareholder return (TSR) as a metric, along with the TSR of their peer group. During the comment period on this proposed rule many companies questioned the emphasis on TSR.

Clawback policy

Another proposed rule deals with clawbacks. It requires that companies have policies in place to recover incentive-based executive compensation for the three fiscal years prior to a financial restatement. The clawbacks would be "no fault," meaning they would happen regardless of whether an executive was involved in any misconduct or was responsible for the restatement. If the proposed rule is adopted, stock exchanges would also need to include a new standard requiring that all listed companies have these clawback policies in place.

Many companies have already implemented some form of clawback policies for executive compensation, yet the new rule is substantively different, in that it is based on the requirements of Dodd-Frank rather than Sarbanes-Oxley. Some of these companies may need to modify their policies to make sure they comply with the new rule.

Hedging policy disclosure

The SEC has proposed rules that would require disclosure regarding whether their directors, officers, and other employees are allowed to hedge the company's equity securities. Many companies have insider-trading policies that either prohibit or discourage this kind of hedging, but they often provide saying that employees and executives can do so if they secure special permission from the general counsel or legal department. A proposed SEC rule on disclosure would treat those companies as allowing hedging—and it would make them disclose that in their financial filings.

As a result, companies that are looking at potential policy changes may want to keep the disclosure requirement in mind, and possibly modify their policies to prohibit all hedging among employees and executives under any circumstances.

Universal proxy

Universal proxy is aimed at giving investors better choices during proxy contests. In most contests, the company prepares its own proxy card and the investor group prepares its own separate proxy card. Under current rules, board candidates can only be listed on a proxy card with their consent. In most cases, a company's nominees will not consent to being named in the proxy materials for the insurgent group and the company will not include the insurgent's nominees on the management's proxy card. In practice, that means that institutional investors can't mix and match candidates unless they ask for a custom proxy or attend the annual meeting itself.

To address this, the SEC is considering a rule that would compel a company and the insurgent group, under certain circumstances to prepare a universal proxy card that includes all nominees to the board. It is still unclear how this would be triggered, but it's conceivable that the process could start any time a person institutes a proxy contest. In those circumstances, the company would be required not only to send out a proxy with its own nominees, but also a universal proxy that includes both their nominees and those of the insurgent group. The insurgent investor would face the same requirement. There is currently no rule proposed, but the SEC is actively looking at this topic.

Cybersecurity

Last, as cybersecurity threats become more prevalent, the SEC is clarifying the situations that companies need to disclose. Several years ago, the SEC came out with guidance that there is no existing disclosure requirement for cyber security. Yet there are a number of places where the SEC and investors are looking for information about cyber security.

First is the risk factor section of financial filings. Given that cyber security is among the most significant risks that a company faces, the SEC increasingly expects disclosure about cybersecuity-related risks, including the current frequency of cyber incidents, the severity of prior events, and the potential cost of all consequences associated with past events. Some companies also opt to disclose cyber risks in other areas, such as the MD&A section, the description of the business and in the discussion of current legal proceedings.

In addition, the SEC has begun identifying companies that have experienced a cybersecurity problem—by following articles in the press—and reviewing the affected companies' disclosures to confirm that they are disclosing these events in their next periodic filing. Those that don't disclose minor events are likely to get a comment letter from the SEC. Those that fail to disclose material events could be subject to an enforcement action.

Last, it appears that the SEC is evaluating cybersecurity as it relates to internal controls over financial reporting. For example, under the rules that define internal controls, companies need to take reasonable steps to prevent—or detect—the unauthorized acquisition, use, or disposition of their assets if that could have a material impact on the financial statements. Things like customer data, intellectual property, or other assets stored within a company's IT system could all fall into that category and affect its control over financial reporting. This is a new interpretive approach—there is no rule regarding cybersecurity in the context of financial controls—but it has been reported that the SEC is pursuing this theory in some of its enforcement actions.

How Broadridge Can Help During Proxy Campaigns

The value in engaging with retail investors

According to Broadridge's Proxy Pulse publication, created in partnership with PwC's Center for Board Governance, the split between shareholders at most companies is typically about 70 percent institutional and 30 percent retail. Even more surprising, only about 30 percent of retail investors vote in proxy contests—meaning that only about 10 percent of a company's vote typically comes from retail, and that audience is generally favorable to management. Companies that engage the shareholder base the right way can swing proxy votes in their favor.

How companies can better engage with shareholders

There are several aspects to better engagement. The first is to gain a deeper understanding of shareholders in order to target them more effectively. Broadridge offers Shareholder Data Services to provide companies greater insight into share ownership, share ranges, vote history, voting projections, opportunity analysis, and vote timing – so companies can make informed, data-driven decisions and adjust their proxy communication strategy.

The second aspect is to optimize delivery to shareholders to increase the likelihood of voting. For example, the data indicates a shareholder's preference for receiving material and how likely they are to respond to different channels, such as hard copies versus electronic delivery. For hard copy distribution, printing options like Enhanced Packaging provide customized packaging and messaging designed to help increase engagement from the moment the proxy communication reaches the shareholders' mailboxes. For digital communications, companies can customize emails and voting pages through Broadridge's ProxyVote solution, to highlight their brand, tailor messaging and emphasize a specific call to action.

Finally, companies need to measure results and adjust engagement efforts accordingly. Reminder communications to a targeted group of shareholders can further help drive a successful vote outcome.

Consider a company Broadridge worked with recently. The company's goal was to reach 70% of shares voting favorably for a merger. However, two weeks before the meeting, the company still had many unvoted shares. It used shareholder data to determine which shareholders to target, sent enhanced packages to those people, and tracked the outcome during the critical days leading up to the vote. As a result, the company exceeded its goal.

In sum, success during proxy season requires a thorough understanding of how the new SEC rules will affect specific companies. For further details on the topics discussed in this article, and additional insights from the panel discussion, please review the Looking Ahead to Proxy Season 2016 webcast here or call +1 800 353 0103.
