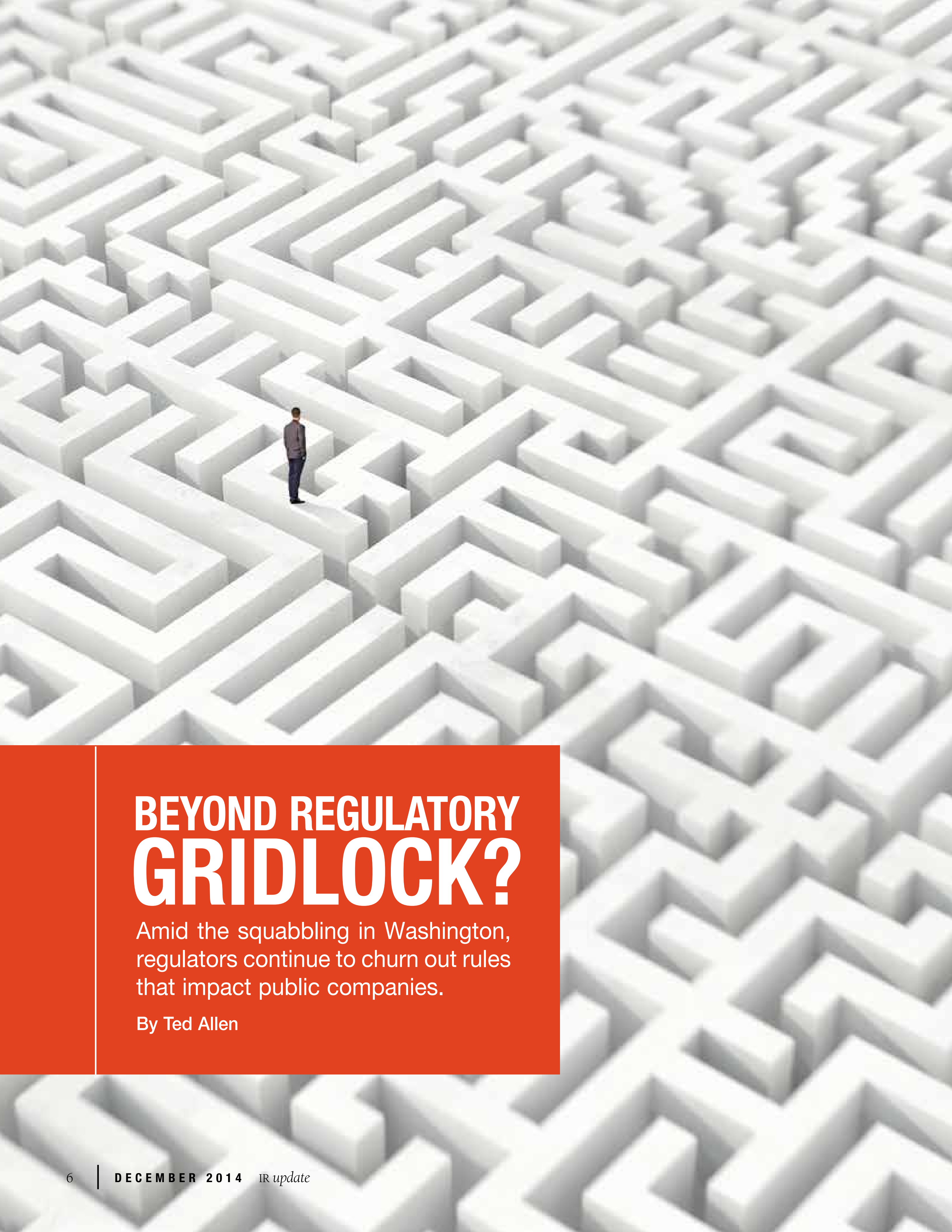

BEYOND REGULATORY GRIDLOCK?

Amid the squabbling in Washington, regulators continue to churn out rules that impact public companies.

By Ted Allen

With the midterm elections over, many of us hope that Congress and President Obama will get back to work and pass meaningful legislation in 2015 to help ease the regulatory burdens on U.S. companies, and perhaps, even make lives easier for IR professionals.

Of course, that probably won't happen.

While the Republicans won control of the Senate and expanded their hold on the House of Representatives, they still are far short of the two-thirds majority needed in both chambers to override a presidential veto, so any major legislation will need bipartisan support, which appears increasingly unlikely given the current environment in Washington, DC.

Over the past two decades, the gap between the prevailing Democratic and Republican views on many major issues has widened, as the influence of centrist lawmakers has waned. Instead of deal-making, there is more attention to grandstanding and scoring political points that will be fodder for campaign ads.

During 2014, Congress held hearings on the Benghazi attack, the Healthcare.gov website, corporate inversions, and other headline-grabbing topics, but passed little meaningful legislation. As of late September, Congress had passed just 125 substantive bills during its current two-year term, the lowest total in two decades, according to the Pew Research Center.

Of course, both parties blame each other for the gridlock; the Republican-controlled House has passed dozens of bills this term that have stalled in the Democratic-controlled Senate, while the Senate has approved a number of bills that are dead on arrival in the House. Both parties have held repeated "show" votes on bills (such as raising the minimum wage or repealing Obamacare) that have no chance of passing in the other chamber. Despite hopes by business advocates that Congress would approve bipartisan legislation to address some of the most onerous provisions of the Dodd-Frank Act, that hasn't happened.

The gridlock and bickering has even spread to the Securities and Exchange Commission. Over the past two years, there has been a noticeable increase in the public rancor among the five commissioners. The two Republicans, Daniel Gallagher and Michael Piwowar, have not been shy about criticizing new Dodd-Frank rules passed on a 3-2 vote by Chair Mary Jo White and the two Democratic commissioners.

At the same time, the two Democrats, Commissioners Luis Aguilar and Kara Stein, have publicly dissented from several high-profile enforcement settlements that Chair White supported. Both Piwowar and Stein are former Senate staffers, so perhaps it's not surprising that the SEC has become more politicized.

Regulatory Recap

Despite the legislative inactivity in Washington, regulators still have plenty of rulemakings to complete, and many of these rules will impact public companies. The SEC and other agencies are slowly making headway in their efforts to fully implement Dodd-Frank.

As of early October, 55 percent of the 398 required rulemakings had been finalized, while 24 percent had not been proposed, according to the law firm of Davis Polk & Wardwell. The SEC finalized several significant Dodd-Frank rules this year, including new regulations for money market funds, asset-backed securities, and credit-rating agencies.

Another Dodd-Frank mandate, the SEC's disclosure rule on African "conflict" minerals, survived a legal challenge mostly intact and took effect in June. As expected, companies have spent significant sums to assess their supply chains; a Tulane University Law School study estimates that companies collectively spent $709 million to prepare their 2014 disclosures.

However, many issuers will see their compliance costs skyrocket in 2016, when midsize and large companies can no longer rely on the "conflict minerals undeterminable" designation when they have difficulty tracking the components of their products.

Also in June, the Commission directed the national exchanges and Financial Industry Regulatory Authority (FINRA) to prepare a national market plan for a 12-month "tick size" pilot program, whereby small-cap companies can seek to have their share prices quoted and traded in 5-cent increments, rather than penny increments. According to the SEC, the program "should facilitate studies of the effect of tick size on liquidity, execution quality for investors, volatility, market maker profitability, competition, transparency, and institutional ownership."

In early November, the SEC published this plan for public comment; NIRI encourages members to provide their companies' views on the pilot program. The final plan likely will be released in early 2015.

In September, FINRA announced it would seek comment on new market structure rules that would increase oversight over algorithmic trading strategies and expand disclosure of trades executed through alternative trading systems. FINRA acted in response to several speeches by Chair White and greater media attention, including Michael Lewis's "Flash Boys" book, to high-frequency trading and dark pools.

New Executive Compensation Rules

One of the most closely watched SEC rulemakings is the CEO pay-ratio disclosure rule, which is scheduled to be finalized before the end of this year. NIRI and other corporate advocates have warned that the proposed rule would impose significant costs on issuers while generating disclosures that may confuse many investors and subject companies to unfair peer comparisons. In a comment letter, NIRI has asked the SEC to narrow the scope of the employees covered by the rule and allow companies to use existing federal wage data to calculate their pay ratios.

However, given the prescriptive language in the Dodd-Frank Act, it appears likely that the SEC will adopt a final rule that closely tracks the draft rule. If the Commission approves a final rule before the end of this year, companies with a December 31 fiscal year likely will have to make their first disclosures in the spring of 2016. Corporate groups probably will challenge the rule in court, but it may take more than a year until any lawsuit is decided, and companies should not count on that effort being successful.

While this mandate is likely more than a year away, IROs and their companies should start thinking about how they will communicate to investors about their pay ratios. It appears inevitable that the news media and labor activists will use these disclosures to embarrass companies with highly compensated CEOs and low-wage employees, and the proxy advisors likely will incorporate these ratios into their Say-on-Pay recommendations.

Finally, the SEC plans to propose a trio of Dodd-Frank compensation rules that relate to pay-for-performance disclosure, corporate clawback provisions, and anti-hedging policies.

Greater Institutional Transparency

The Dodd-Frank Act also includes a few provisions that would be helpful to issuers. The SEC is finalizing a long-awaited rule that would require all Form 13-F institutional fund managers to annually report their proxy votes on executive compensation matters. Currently, only mutual fund managers must disclose their proxy votes.

In addition, the SEC is required by Section 417 of Dodd-Frank to prepare a study of the costs and benefits of real-time short-sale position reporting by institutions, but it's unclear when the agency staff will complete this task. If this study recommends greater disclosure, it may help prod the SEC to revisit its outmoded disclosure rules for long positions.

In 2013, NIRI joined with the NYSE and the Society of Corporate Secretaries & Governance Professionals in a rulemaking petition to reduce the Form 13-F reporting deadline for equity ownership positions from 45 days to two days after quarter end. NIRI believes that this reporting delay prevents the timely release of material information to the market; that the arguments for maintaining a 45-day delay are unpersuasive given the advances in technology; and that more timely disclosure would promote more effective issuer-investor engagement.

Corporate advocates also have petitioned the SEC to provide more transparency around hedge fund activism. Under a 1968 law, activists can wait 10 days after accumulating a 5 percent stake before filing a Form 13-D. The law firm of Wachtell, Lipton, Rosen & Katz, which represents boards in proxy contests, is seeking a one-day notice period, a standstill after an activist reaches 5 percent, and an expanded equity ownership definition that includes derivatives.

Hedge funds and their allies have vigorously opposed these reforms. In October, Commissioner Gallagher said the SEC is reluctant to address these "thorny" issues and would not take action "any time soon."

Proxy Advisors and Proxy Voting

In a positive development for companies, the SEC issued a staff legal bulletin in June that places a greater responsibility on institutional investors to oversee the work of their proxy advisors. NIRI and other corporate groups have been urging the SEC for years to more closely regulate proxy firms and address proxy report inaccuracies, conflicts of interest, and opaque and one-size-fits-all voting guidelines. While the bulletin won't significantly change how proxy advisors interact with issuers, this guidance is a helpful first step that should prod investment managers to take a closer look at their reliance on proxy advisors to meet their voting responsibilities.

NIRI, together with the Society of Corporate Secretaries & Governance Professionals and the Business Roundtable, will continue to urge the SEC and lawmakers to do more to ensure that companies are treated fairly and investors receive accurate proxy advice. NIRI believes that the Commission should require proxy firms to register, allow all issuers to review draft reports prior to publication, and provide more transparency into voting policies and research processes.

NIRI also is hopeful that the SEC will finally address other important shareholder communication issues – such as end-to-end proxy voting integrity, the inability of issuers to negotiate proxy fees, and the elimination of the OBO (Objecting Beneficial Owners) designation – that were part of the SEC's 2010 proxy system concept release.

The SEC plans to hold a roundtable on proxy voting issues in early 2015. As part of this roundtable, Chair White said the SEC will consider a request by activists for "universal" proxy ballots that would allow investors to split their votes between management and dissident candidates.

Disclosure Reform

Another important SEC priority in 2015 will be completing its Regulation S-K disclosure reform project. Throughout the past year, Commission staff has been collecting input from market participants about ways to reduce redundancy while improving the effectiveness of corporate disclosures. NIRI board members met with the SEC staff in September and had a productive dialogue on how duplicative requirements and the fear of receiving a SEC staff comment letter or an investor lawsuit have led companies to produce longer, more repetitive, and more costly filings.

In a speech in early October, Keith Higgins, chief of the Corporation Finance Division, outlined some reforms under consideration, such as: modernizing the SEC's industry guides; reducing the overlapping disclosures required by Regulation S-K and GAAP; and providing companies "more flexibility" to provide disclosures they believe are material. Noting that technology can help deliver information to investors, Higgins said the SEC is considering a new "company file" approach.

"Under this system, perhaps in lieu of filing a periodic report, companies would be required to update information on the same time schedule as currently required for filings," Higgins explained. "The company page on sec.gov might display tabs such as 'business information,' 'financial information,' 'governance information,' 'executive compensation,' and 'exhibits' instead of a chronological list of filings."

Also this year, the Financial Accounting Standards Board released new guidance on revenue recognition and "going concern" reporting. FASB also is considering whether to simplify the measurement of inventory and whether to eliminate extraordinary items from income statement presentations. Meanwhile, the Public Company Accounting Oversight Board has sought public comment on a proposal to require the disclosure of the names of audit firm engagement partners and others who worked on a company's audit.

Governance Activists

In addition to Congress, the SEC, and other regulators, IR professionals should be aware of the evolving agenda of public pension funds, labor investors, and other governance activists. In the past year, these activists have been more vocal about their concerns over long-serving directors and board diversity.

While it appears unlikely that U.S. activists are ready to embrace strict tenure limits (such as the nine-year independence standard in the United Kingdom), or minimum gender diversity requirements (as Norway, Germany, and France have adopted), it is evident that investors are paying more attention to board composition. In a recent survey by Institutional Shareholder Services (ISS), 60 percent of investor respondents said they take diversity into consideration when evaluating a board. In May, State Street Global Advisors became the first large U.S. institution to adopt a proxy voting policy with specific guidance on tenure.

Companies probably will see more shareholder proposals seeking independent board chairs or proxy access bylaws in 2015. Investors submitted more than 60 independent chair proposals this year, and it appears likely that ISS, which opposed about half of the 2014 resolutions, will support significantly more of these proposals next year. Pension funds and other activists also filed a record number (20) of proxy access resolutions this year, and six proposals earned majority support, according to ISS. In early November, New York City's pension funds announced plans to submit proxy access proposals at 75 companies in 2015.

IR professionals should also be prepared for more demands for sustainability information. In September, the European Union released a directive that would require large companies (with more than 500 employees) to provide annual disclosure on various environmental and social issues starting in fiscal year 2017.

Activists also have been urging the World Federation of Exchanges to recommend new listing standards that would include such reporting. During the spring 2014 U.S. proxy season, activists filed 454 shareholder proposals (the most ever) on environmental and social issues, including 135 resolutions that relate to corporate political activities, according to the Sustainable Investments Institute.

It appears likely that these proponents will return with more filings in 2015. (For more on this topic, please see "How Green Are Your Disclosures?" in the September 2014 edition of *IR Update*.)

As the calendar turns to 2015, Washington will quickly shift its attention to the 2016 presidential elections, so it's unlikely that lawmakers from either party will want to strike any major legislative deals with a lame-duck president in his final years in office. Notwithstanding this gridlock, the slow regulatory process will continue, and IRO professionals should be watching. IRU

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