BREAD & CIRCUSES IN WASHINGTON

IR teams should start preparing for CEO pay ratio disclosure and other mandates.

By Ted Allen

Washington, D.C., can be seen as a three-ring circus.

Amid the pie fights on cable TV over the Iran nuclear agreement, Hillary Clinton's e-mails, the Freedom Caucus revolt in Congress, and the rise of unconventional presidential candidates in both major parties, you shouldn't overlook the significant regulatory developments in 2015 that will affect how companies interact with their investors.

Most notably, the Securities and Exchange Commission (SEC) took action this year on four new executive compensation disclosure rules that are mandated by the Dodd-Frank Act. The most controversial of these new regulations is the CEO pay ratio disclosure rule, which the SEC adopted in August.

Under this mandate, most companies will have to disclose the median of the annual total compensation of all employees of the company, and the ratio of that median to the annual total compensation of its CEO. This rule will likely lead to messaging challenges for IR professionals at companies with relatively high pay ratios, such as those in the retail, hospitality, and entertainment industries, as well as those issuers with a significant number of non-U.S. employees.

Here are the key elements of the final pay ratio rule:

- Issuers will have to provide their first pay ratio disclosures for compensation paid in the first fiscal year starting on or after Jan. 1, 2017, which means that many companies would make their first disclosures in the spring of 2018.
- About 3,600 U.S. companies will be subject to this rule, which exempts emerging growth companies, smaller reporting companies, and foreign private issuers.
- With a few exceptions, the pay ratio determination will include all employees, including non-U.S., full-time, part-time, temporary, and seasonal workers employed by the company or any of its consolidated subsidiaries. A company may exclude up to 5 percent of its total workers who are non-U.S. employees.

The SEC's two Republican commissioners, Daniel Gallagher and Michael Piwowar, opposed the pay ratio rule and argued that it will only benefit labor activists who wish to "name and shame" companies into cutting executive pay. The commissioners warned that U.S. companies would initially have to spend $1.3 billion to comply, and said the agency should have done more to reduce compliance costs, such as by limiting this rule to full-time, U.S.-based employees, which NIRI and other corporate groups proposed. Gallagher also argued that this mandate may violate companies' First Amendment speech rights. A federal appeals court has invalidated part of another controversial SEC rule about conflict minerals disclosure on similar grounds.

The U.S. Chamber of Commerce, which has successfully challenged the SEC's market-wide proxy access rule and other high-profile regulations, said in October that it would not pursue a lawsuit over the pay ratio rule at that time and instead would focus its attention on the ongoing litigation over the conflict minerals rule. Assuming that the conflict minerals ruling is not overturned or scaled back on appeal, the Chamber and other business groups could use the appeals court's reasoning in that case to support a future suit over the pay ratio rule.

Several bills have been introduced in the House of Representatives to repeal the pay ratio mandate, but it appears unlikely that such a bill could win enough support in the Senate to overcome a likely Democratic filibuster or override an expected presidential veto. While the prospects for repeal would improve if Republicans win the White House in 2016, public companies should not count on receiving political or judicial relief and should start thinking about how they will comply with this rule.

"You cannot underestimate the importance of this issue," compensation consultant Mark Borges said during an October conference hosted by the Society of Corporate Secretaries and Governance Professionals.

As companies prepare to comply with this rule, their IR teams should consider their potential messaging to investors if the pay ratio is expected to be higher than the company's peers. Issuers also will have to develop messaging for their own employees, some of whom may be upset when they learn that they earn less than the company's median compensation, noted Sharon Podstupka of Pearl Meyer & Partners. "You should take the time to sit down with your HR, legal, and finance teams to figure out the number you will present and what the reaction may be," she said at the Society conference.

Procession of New Mandates

In April, the SEC voted 3-2 to propose a new "pay versus performance" rule that would require most issuers to include a new chart in their proxy materials that would include the compensation received by its named executives, the company's one-year total shareholder return, and a comparison with corporate peers. Commissioners Piwowar and Gallagher argued that companies should have more flexibility to use alternative performance measures and longer time periods. In comment letters, NIRI, BlackRock, CFA Institute, and others said the rule was too prescriptive and could result in disclosures that are not useful to most investors. The SEC has not publicly stated when it will finalize this rule, but it's unlikely that companies would have to provide these disclosures before the 2017 proxy season.

As required by Dodd-Frank, the SEC has drafted a new rule that asks companies to annually disclose whether they permit employees and board members to engage in hedging transactions with company stock. In July, the SEC proposed another rule that would direct the national exchanges to adopt listing standards to mandate stricter and more expansive "claw back" policies to recoup incentive-based compensation after restatements. According to its regulatory agenda, the SEC expects to finalize both rules by April. However, most companies probably will not have to comply with the "claw back" mandate until at least 2017 because the exchanges would need time to draft new listing standards, solicit public comment, and obtain final SEC approval.

Meanwhile, the SEC is working to revive another Dodd-Frank disclosure rule that would require oil and gas companies to disclose resource extraction payments to foreign governments. A federal court struck down this regulation in 2013, but an advocacy group obtained a court order that directs the agency to prepare a new rule by June 2016.

As directed by the JOBS Act, the SEC approved a long-awaited pilot program in May to assess whether companies should be allowed to use wider "tick" size increments (such as 5 cents). The SEC will consider whether wider tick sizes would stimulate greater market-making activities in small-cap stocks, attract more investors, and improve liquidity and research coverage. The agency also adopted final Regulation A+ regulations and new "crowdfunding" rules, which are intended to provide capital-raising alternatives for small private companies and startups.

Proxy Battles

In June, SEC Chair Mary Jo White directed the SEC staff to prepare recommendations for a "universal proxy ballot" rule that would require companies to provide a single ballot during proxy contests that lists management and dissident nominees. Such a ballot would likely make it easier for dissidents to obtain board seats in short-slate contests. This measure has been endorsed by the Council of Institutional Investors, which represents public pension systems and labor funds, and is a priority of Democratic Commissioner Kara Stein.

In October, the SEC released a new staff legal bulletin about shareholder proposals. In that guidance, the agency said companies may no longer exclude a competing resolution filed by an investor that would conflict with a management bylaw proposal if shareholders could reasonably vote for both measures. As a result, companies will have more difficulty keeping proxy access resolutions off their annual meeting ballots, and IR teams should expect to see more of these proposals in 2016 and 2017. Proxy access resolutions went to a vote at more than 80 companies in 2015, and most earned majority support. "If you're a big company, you should be thinking about proxy access," says Beth Ising, a partner with the law firm of Gibson, Dunn & Crutcher. "Either you have received a proposal, or you will soon."

Political Theatre

During the Obama administration, there has been an uptick in politicization at the SEC, as evidenced by repeated 3-2 votes on key rulemakings and continued fights over the agency's agenda. On conflict minerals, CEO pay ratio, and other controversial rules, the SEC's two Democratic commissioners have joined with Chair White in supporting these new mandates over the vociferous objections of the Republican commissioners.

Over the past year, commissioners on both sides of the aisle have become willing to openly air their dissatisfaction with the priorities of Chair White, who oversees the agency's allocation of staff resources. Although enforcement cases typically are discussed behind closed doors, Stein publicly objected to waivers granted to several financial firms that were accused of rigging foreign exchange rates. Before leaving the SEC in October, Gallagher publicly called for greater oversight of proxy advisors, curbs on activism, and reform of the shareholder proposal rules, but the SEC has done little to address these concerns.

Meanwhile, White has faced growing criticism — including online petitions and a subway ad campaign — from activist groups and Democrats for her reluctance to force companies to disclose their spending on corporate political activities. Forty-four Senate Democrats and 58 House members have written White and urged her to propose such a rule. At the same time, Republican lawmakers in House have warned White not to proceed with such a mandate, which they view as "a waste of the SEC's finite resources." White also was publicly rebuked in June by Senator Elizabeth Warren, a Massachusetts Democrat, for not moving more quickly to finalize the pay ratio rule.

Unfortunately, it appears that the political squabbling at the SEC will continue. As of presstime, the nominees for two SEC vacancies were law professors with contrasting world views — the Republican nominee, Hester Peirce, is a former Senate staffer who has written papers that questioned Dodd-Frank, while the Democratic nominee, Lisa Fairfax, is a longtime proponent of shareholder democracy and board diversity. According to news reports, President Obama originally planned to nominate a well-regarded corporate lawyer (and a former SEC staffer) as the Democratic nominee, but Warren and activists objected to his representation of companies.

NIRI's Regulatory Priorities

In October, NIRI joined with the NYSE Group in a rulemaking petition that asks the SEC to implement Dodd-Frank provisions that call for institutional investment managers to disclose their short positions. Public disclosure of short-selling would help IR professionals better analyze market movements in their companies' securities and react to malicious rumors.

In addition, NIRI has renewed its efforts to require 13F filers to provide more timely disclosure of their long-positions. Under rules adopted more than 30 years ago, fund managers can wait until 45 days after the end of a quarter to report their holdings. NIRI, along with the NYSE and the Society of Corporate Secretaries, filed a rulemaking petition in 2013 that calls for a two-day reporting deadline. NIRI's Board met with SEC staffers in September and were encouraged that the staff appears to be more willing to consider alternatives to the current 13F regime.

NIRI also remains hopeful that the SEC will adopt rules in 2016 to require 13F filers to disclose their votes on compensation matters. Currently, only mutual funds have to disclose their proxy votes. The agency released draft rules in October 2010 to implement this Dodd-Frank provision, but this matter has languished since then.

NIRI is part of the Shareholder Communications Coalition, which includes the Business Roundtable and the Society and is urging the SEC to remove barriers to engagement, modernize the antiquated proxy voting system, and provide greater oversight of proxy advisors. The SEC extensively studied these issues in 2010, but the agency has done little to address proxy voting, which has become more contentious since the surge in hedge fund activism and the arrival of Say-on-Pay and proxy access. The coalition is asking the SEC to repeal its OBO-NOBO rule, which makes it expensive and cumbersome for issuers to communicate with their "street name" investors. Over the past year, the coalition has been working to educate House and Senate staffers and hopes to persuade a bipartisan group of lawmakers to urge Chair White to make these issues a more urgent priority. With universal ballots on the horizon, the proxy system will become more strained unless reforms are made.

NIRI will continue to follow these issues and advocate for regulatory changes that will help public companies. If you have any questions or concerns, we encourage you to contact your chapter's advocacy ambassador, NIRI Board members, or NIRI staff. Together, we can better understand what to expect next from the circus in Washington. IRU

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