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Welcome to the Houston Chapter's October Luncheon

How the National Election Results Will Impact DC and the SEC

Houston, Texas

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How the National Election Results Will Impact DC and the SEC

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Important Information

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Sean M. Donahue is a senior associate in the Washington, DC offices of Morgan, Lewis & Bockius LLP and a member of the firm's securities and shareholder activism defense practices.

Sean counsels public companies in high-profile proxy contests, activist shareholder campaigns, contests for corporate control and mergers and acquisitions (M&A). Sean also advises public companies and their boards of directors on the latest techniques for lessening a company's vulnerability to activist shareholders, board advisory matters, and the implementation of takeover defenses. As a former member of the staff of the US Securities and Exchange Commission (SEC), Sean also counsels public companies on securities regulation, corporate governance, capital market transactions, and NYSE and NASDAQ compliance issues.

Prior to joining Morgan Lewis, Sean served as an attorney-adviser with the SEC in the Division of Corporation Finance. While at the SEC, Sean worked on a number of transactional and securities compliance matters, including initial public offerings and M&A transactions. He uses his SEC experience to counsel public companies with respect to securities disclosure issues affecting initial public offerings, registered and exempt debt and equity offerings, and mergers and acquisitions, as well as reporting obligations under the Securities Exchange Act of 1934. Sean also uses his extensive experience with SEC disclosure issues, particularly those relating to contested solicitations and contested M&A situations, to advise public companies in connection with responding to activist shareholder campaigns.

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Paul Brace is the Clarence L. Carter Chair of Legal Studies in the Department of Political Science at Rice University. He has published research in the American Political Science Review, American Journal of Political Science, Journal of Politics, Political Research Quarterly, Polity, Social Science Quarterly, American Politics Quarterly, Legislative Studies Quarterly and other journals. He is co-author of Follow the Leader: Opinion Polls and the Modern Presidents (Basic Books, 1992), author of State Government and Economic Performance (Johns Hopkins University Press, 1993) and co-editor of The Presidency in American Politics (NYU Press, 1989) and American State and Local Politics (Chatham House, 1999).

He has served on numerous editorial boards including the American Political Science Review, the Journal of Politics, Political Research Quarterly, Social Science Quarterly, American Politics Quarterly, American Review of Politics, Albany Law Review, State Politics and Policy Quarterly, State and Local Government Review, and has served on the Law and Social Science Advisory Panel for the National Science Foundation. He has received awards for teaching (1989), advising (1996), mentoring (1999), best book (1993) and best conference paper (1996, 2000, 2005). Presently he is involved in a five-year project funded by the National Science Foundation to study American State Supreme Courts.

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Overview of the SEC and the Current Political Landscape

The Commission

- The Securities and Exchange Commission (SEC) was created by Section 4(a) of the Securities Exchange Act of 1934
- The SEC is composed of five commissioners
- SEC Commissioners are nominated by the President and confirmed by the Senate
- Not more than three of such commissioners can be members of the same political party
- In making appointments members of different political parties shall be appointed alternately as nearly as may be practicable
- Section 4(a) also provides for five year staggered terms, one expiring each year
- The Chairman of the SEC is appointed by the President

SEC Independence and Politics

- The SEC is an independent agency
- The SEC has received more political pressure from both Republicans and Democrats since the 2008 financial crisis
- During the 2008 election contest presidential candidate John McCain called for the firing of SEC Chair Christopher Cox
- Elizabeth Warren has expressed her “disappointment” with Mary Jo White in multiple forums most recently during Chair White’s June 2016 testimony
- The “revolving door” problem of Wall Street insiders going back and forth between law firms/financial institutions and the SEC
- Many 3-2 votes in last several years on both rulemakings and enforcement actions divided along party lines with Commissioners issuing dissenting statements

Current SEC Commissioners

- Mary Jo White – Chair since 2013 - Term expires 2019 - Democrat – Lawyer - most recently in private practice and prior to that U.S. Attorney for the Southern District of New York
- Kara M. Stein - Commissioner since 2013 - Term expires 2017 – Democrat – Lawyer – previously Staff Director of the Securities, Insurance, and Investment Subcommittee of the Senate Banking Committee
- Michael S. Piwowar – Commissioner since 2013 - Term expires 2018 – Republican – Economist – previously Republican chief economist for the Senate Banking Committee

Action by SEC Commissioners

- The Commission always acts as a whole; a majority (normally three of five commissioners) constitutes a quorum
- A majority of the quorum is sufficient for Commission action
- End result of quorum rules is that a single Commissioner can refuse to show up and effectively veto a Commission action when the Commission has three sitting Commissioners or less
- Sunshine Act requires that SEC rulemaking be done at an open meeting and that SEC circulate a Sunshine Act notice to the public in advance of the meeting
- Commission can take action by seriatim which is basically action by written consent in lieu of a meeting

Recent Developments

- SEC has been operating with three commissioners since January 2016
- Lisa Fairfax – Democrat – Law Professor and Hester Peirce - Republican - former Senate Banking Committee staffer nominated by President Obama in 2016
- Neither Nominee has been confirmed by the Senate
- Controversy over disclosure of corporate political spending has delayed confirmations
- Bringing the SEC up to full strength will likely need to wait until after the November Election

Potential Impact of 2016 Election

- If the Republicans win the White House SEC Chair Mary Jo White will likely be replaced
- Even if Democrats win the White House SEC Chair White may still be replaced given the sharp criticism she has received from Democrats during her tenure
- SEC Chair typically sets rulemaking agenda so choice of SEC Chair could have significant impact on regulation
- A new SEC Chair would likely want to bring in his/her own Division Directors, staff members, etc.
- Regardless of who wins the election it is likely that the Commission will be back at full strength sometime in 2017

Impact of Election on SEC Rules Regulating Public Companies

SEC Reporting Issues Impacting Public Companies that are unlikely to be Impacted by Election Results

Non-GAAP Financial Measures

- Updated compliance and disclosure interpretations issued in May 2016
- Most directly comparable GAAP financial measure must be presented with equal or greater prominence
- Non-GAAP adjustments must include sufficiently detailed explanations and may not be misleading
- SEC Division of Enforcement sweep letters requesting responses from companies for disclosure that "may have violated" non-GAAP rules

Proxy Access

- 284 companies have adopted proxy access (as of October 9, 2016)*
- Over 42% of S&P 500 companies have adopted proxy access (as of October 9, 2016)*
- To date no shareholder has used proxy access and it is currently unclear how prevalent the use of proxy access will be by institutional and/or activist investors
- As a result of SLB 14H (October 2015) which eliminated the ability of companies to make a conflicting proposal argument under Rule 14a-8(i)(9) companies shifted to making substantial implementation arguments under Rule 14a-8(i)(10) in 2016
- In the 2016 proxy season, the Staff granted a series of no-action letters to companies permitting exclusion from proxy statements of shareholder proposals requesting the adoption of proxy access where the companies had adopted proxy access provisions that "substantially implemented" such proposals
- The Staff agreed that companies had substantially implemented the shareholder proposals where they had adopted provisions granting proxy access to shareholders who held three percent of the company's stock for three years, even though the provisions adopted did not completely mirror the other terms of the shareholder proposals

*Source: FactSet SharkRepellent

Proxy Access (Continued)

- Companies that do not allow for proxy access may receive shareholder proposals requesting that proxy access be adopted
- Such companies may want to consider adopting their own proxy access provisions in order to incorporate the detailed aspects of proxy access that make sense, while at the same time satisfying the "essential objectives test" necessary to persuade the Staff that the shareholder proposal has been substantially implemented
- Alternatively, such companies may want to wait to adopt proxy access until they receive pressure from shareholders or receive a proxy access shareholder proposal
- Companies that have already adopted proxy access provisions may receive proxy access shareholder proposals during the 2017 proxy season that request amendments to specific features of their existing provisions that certain shareholders find objectionable
- H&R Block no-action letter (7/21/16) - Staff did not permit company to exclude from proxy statement a proxy access shareholder proposal as being substantially implemented by an existing three percent/three year proxy access bylaw
- H&R Block's proposal has been voted on and received about 30% support, with ISS recommending in favor and Glass Lewis recommending against
- Staff recently took same position in Microsoft no-action letter (9/27/16)

NASDAQ Golden Leash Rule

- NASDAQ Rule 5250(b)(3) requires disclosure of golden leash arrangements by NASDAQ-listed companies either in proxy statements or on company websites
- Requires disclosure of any agreements, arrangements or understandings (including indemnification agreements) between a director or director candidate and any person or entity other than the company relating to compensation or other payment in connection with candidacy or service as a director
- Exception for arrangements that existed before the nominee's candidacy, provided the relationship has been disclosed in a previous proxy statement
- But if remuneration materially increased specifically in connection with the person's candidacy or service as a director, the increase should be disclosed
- NASDAQ-listed companies need to add a question to D&O Questionnaires to cover golden leash disclosures

Say-on-Frequency Vote

- Rule 14a-21(b) requires a say-on-frequency vote every six years
- Many companies will need to include a frequency vote in their 2017 proxy because initial rules became effective in January 2011
- Reminder that need to disclose in Form 8-K within 150 days the company's decision regarding the frequency of the say-on-pay vote

Description of Proposals on Proxy Card

- Rule 14a-4(a)(3) requires that the form of proxy "identify clearly and impartially each separate matter intended to be acted upon"
- CDI Question 301.01 indicates that the proxy card must clearly identify and describe the specific action being submitted to a shareholder vote
- The following descriptions of shareholder proposals would not satisfy Rule 14a-4(a)(3) under the CDI:
- A shareholder proposal on special meetings;
- A shareholder proposal on executive compensation;
- A shareholder proposal on the environment;
- A shareholder proposal, if properly presented; and
- Shareholder proposal #3.
- In addition, it would not be appropriate to describe a management proposal to amend a company's articles of incorporation to increase the number of authorized shares of common stock as "a proposal to amend our articles of incorporation."

Disclosure Effectiveness

- Regulation S-X Release issued September 2015
- Regulation S-K Business and Financial Disclosure Release issued April 2016
- Regulation S-K Governance Disclosure Release issued August 2016
- The FAST Act also requires disclosure effectiveness studies on Regulation S-K
- In August 2016 SEC proposed rules to require hyperlinks for exhibits in filings

Form 10-K Issues

- The FAST Act permits the inclusion of a summary in the Form 10-K
- New Item 16 of Form 10-K is a voluntary disclosure item
- The SEC now permits the use of "Inline XBRL" so that XBRL would be included directly in the filing rather than as exhibits to the filing

Audit Committee Report

- Due to a reorganization of PCAOB standards, the old reference to PCAOB Auditing Standard No. 16 in audit committee reports will need to be changed in the 2017 proxy statement to Auditing Standard No. 1301
- SEC Concept Release issued July 2015 on Audit Committee Report
- More companies are adding voluntary disclosures to the audit committee report in the proxy, such as the following:
- Factors considered by the audit committee when assessing the qualifications and work quality of the external auditor
- The audit committee's belief that the choice of an external auditor was in the best interests of the company and its shareholders
- That the audit committee is responsible for the appointment, compensation and oversight of the external auditor
- Reasons for changes in fees paid to the external auditor
- How the audit committee considered the impact of changing auditors when assessing whether to retain the current auditor
- How the audit committee was involved in the selection of the lead audit partner
- That the company has three or more financial experts on their audit committee

SEC Reporting Issues Impacting Public Companies that could be Impacted by Election Results

Dodd-Frank

- House Financial Services Committee has approved Financial Choice Act
- Financial Choice Act would repeal and replace parts of Dodd-Frank including the pay ratio rule and the rule prohibiting incentive-based compensation for financial institutions
- Financial Choice Act still in the House and unlikely that it gets through the House before the election

Pay Ratio Disclosures

- The pay ratio rules are final but the disclosure is not required until the 2018 proxy statement
- The finalized rules require disclosure of:
- the median of the annual total compensation for all employees (except a CEO);
- the annual total compensation of the registrant's CEO; and
- the ratio between median annual total compensation and the CEO's annual total compensation.

Other Governance Provisions

- *Pay versus Performance Disclosures*
- Proposed April 2015, final rules have not been adopted
- *Compensation Clawbacks*
- Proposed July 2015, final rules have not been adopted
- *Hedging Disclosures*
- Proposed February 2015, final rules have not been adopted

Conflict Minerals

- Financial Choice Act would repeal conflict minerals rules
- Guidance Issued by Division of Corporation Finance Director Keith Higgins in 2014 still good guidance
- No company is required to describe its products as “DRC conflict free,” having “not been found to be ‘DRC conflict free,’” or “DRC conflict undeterminable”
- Independent private sector audit still necessary only when an issuer voluntarily chooses to classify a product as "DRC Conflict free" after due diligence

Resource Extraction and Mine Safety

- Financial Choice Act would repeal resource extraction and mine safety disclosure rules
- Resource extraction rules adopted in June 2017 require issuers to include in Form SD information relating to any payment made by the issuer, a subsidiary of the issuer, or an entity under the control of the issuer, to a foreign government or the US government for the purpose of the commercial development of oil, natural gas, or minerals
- Resource extraction issuers are required to provide information about the type and total amount of such payments made for each project related to the commercial development of oil, natural gas, or minerals, and the type and total amount of payments made to each government
- Under the final rules, a resource extraction issuer has "control" of another entity if the issuer consolidated that entity or proportionately consolidated an interest in an entity or operation
- Issuers should review their joint venture arrangements and related equity interests now to determine whether those arrangements entitle them to obtain the payment information that they will be required to disclose in Form SD, which includes disclosure of the proportionate amount of the eligible payments made by a resource extraction issuer's proportionately consolidated entities or operations
- Issuers may have difficulty obtaining sufficiently detailed payment information from proportionately consolidated entities or operations when the issuer is not the operator of that venture
- For future joint ventures, a non-operator issuer should consider providing in the joint venture agreement language requiring the other party to provide access to the information needed by the issuer to comply with the disclosure requirements of the final rules, including sufficiently detailed payment information for proportionately consolidated entities
- Must comply with rules and Form SD requirements for fiscal years ending on or after September 30, 2018

Corporate Political Spending

- August 2011 rulemaking petition from law professors has received over 1.2 million comment letters in support of proposal (most in SEC history)
- Democrats heavily in favor of rulemaking as part of campaign finance reform
- CPA-Zicklin Index gives companies a score on their political spending practices and a low score may put pressure on companies to provide disclosure
- Companies with low scores may find themselves targets of shareholder proposals, public campaigns, or other adverse publicity

The Brokaw Act

- Proposes revisions to Section 13(d) Beneficial Ownership Rules (March 2016)
- Would shorten the filing window applicable to the acquisition of a 5% stake in an equity security from 10 to 2 business days and require the reporting of significant "short" positions
- The legislation would also broaden the scope of the rules by recognizing that possession of a pecuniary interest in a security constitutes beneficial ownership, and by specifically targeting the covert collusion of activist "wolf packs"
- Provision that seeks to discourage "wolf packs" may not be effective because it does not provide a definition of what it means for persons to "coordinate" their activities with each other similar to the detailed "acting in concert" definition contained in many corporate bylaws
- The most glaring omission in the legislation is that it doesn't include anything relating to enforcement and does not help companies seek redress for 13D violations because they can't pursue monetary damages under 13D or even seek reimbursement of attorney fees
- Even if this bill became law, it may not have any real effect of discouraging activists from taking an aggressive interpretation of the 13D disclosure rules to avoid disclosing when they are acting in concert with each other

Universal Proxy

- Shareholders currently cannot vote on more than one proxy card in a proxy contest
- Universal proxy would allow shareholders to split their vote by allowing them to vote on both management and the dissident's proxy card in a proxy contest
- Some politicians and commentators have expressed the view that universal proxy will benefit activist investors because shareholders can more easily split their vote and vote for one or two of the activist nominees in a short slate contest while still voting for the majority of management's nominees
- However, if the dissident is running a control slate given that the proxy advisory firms often recommend that shareholders vote on the dissident's proxy card for at least some of the dissident's nominees, universal proxy may ultimately benefit public companies in a proxy contest for control by allowing shareholders to vote for some of the activist's nominees and some of the company's nominees

Thank you

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Thank You for Attending!

We hope to see you on November 10th at iPic Theaters!

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