EY Center for Board Matters

Board Matters Quarterly

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Building a better working world

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Board Matters Quarterly

In this issue

Independent directors: new class of 2018

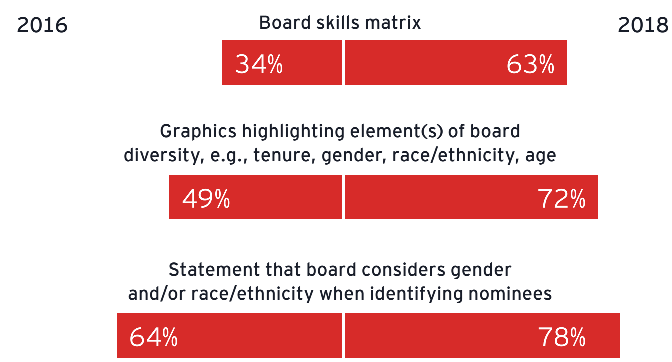
The EY Center for Board Matters took a close look at independent directors newly elected in 2018 by investors to Fortune 100 boards, and we are pleased to present the findings of our analysis of this "new class of 2018."

The report analyzes what these directors bring to the boardroom and how companies are showcasing those strengths, based on a review of corporate disclosures highlighting the skills, expertise and backgrounds associated with these new nominees. In the third year of this series, we also reviewed the same 83 companies' entering class of directors in prior years to enable consistent year-on-year comparisons. What follows is our perspective on the changes and trends we identified.

Our perspective: gradual change is underway

Given the limited number of board seats in the Fortune 100, and that newly added independent directors represent only around 10% of all independent Fortune 100 directors serving each year, boards appear to be making the most of these valuable board refreshment opportunities. We observe a continuing shift of attention from the more traditional director candidates (current and former CEOs) to individuals with a wider range of skills, expertise, backgrounds and personal characteristics — diversity across multiple dimensions. Nearly one-quarter of new directors were recognized for their experience in innovation, transformation and in navigating change, and 10% were highlighted for their ability to bring an investor perspective to the boardroom, including through experiences in asset management or active investment funds. Still, the limited opportunities for adding new directors mean that change continues to be gradual.

Fortune 100 board composition disclosures



Corporate statements that recognize the importance of board diversity appear increasingly common, but we continue to observe an opportunity for greater consistency and comparability in disclosures around board diversity, particularly across gender, race and ethnicity. We find, too, that companies are continuing to expand and refine disclosures to clarify how the disclosed director qualifications align with the company's strategy. The quality and extent of disclosure varies, and we estimate that 14% of the directors' qualifications language and reasons for nominations were clearly linked to company strategy, suggesting that this is an emerging disclosure trend. In one of the stronger examples, we saw a company highlight its nominee's areas of expertise, explain how these experiences contribute to the company's future strategy and link these elements to a brief description of broader industry transformations underway.

> "Boards are thinking differently about what makes an effective board candidate, and the supply of possible candidates is expanding significantly. This larger pool means boards can be even more selective about their short lists. At the same time, the responsibilities of being a public company director are continuing to increase and become more complex, and boards are setting the expectation that directors must be fully committed to being engaged and active. There is greater concern over the possibility of being "over-boarded" and "over-committed."

Observations on skills and demographics

In 2018, 71% of the reviewed companies added at least one new nominee and 27% added two or more. This represents an increase from prior years when the levels were generally steady at around 56% and 21%, respectively. For companies that added at least one new nominee in 2018, our review yielded the following observations.

71%
of companies added at least one new nominee in 2018.

27%
of companies added two or more new nominees in 2018.

Top 10 areas of expertise for the new class

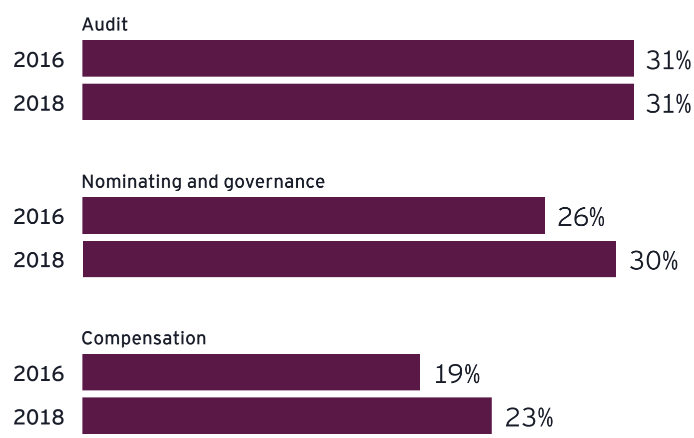
For a look at the skills being added to boards, we found that the areas of expertise most frequently cited in new nominations were: international business; corporate finance, accounting; and industry expertise. Around half of the new class was recognized for expertise in at least one of these categories. The next most common areas – technology; operations, manufacturing; and board service, corporate governance – were cited in 40% to 45% of new nominations. On average, 35% was recognized for experience in government, public policy, regulatory; risk oversight; strategy; or marketing, business development.

Top 10 most common expertise areas highlighted	
1	International business
2	Corporate finance, accounting
3	Industry
4	Technology
5	Operations, manufacturing
6	Board service, corporate governance
7	Government, public policy, regulatory
8	Risk oversight
9	Strategy
10	Marketing, business development

New class enhances career and gender diversity

Women continued to represent around 40% of new nominees, contributing to a slight increase in overall board gender diversity; in 2018, 27% of existing independent directors were women, up from 25% in 2016. Slightly less than half of the new class fits the traditional model of independent directors in years past (current and former CEOs) and that group remained predominantly male. The slate of non-CEO new nominees represented a different picture: this group reflected relative gender balance. Further, of those directors with noncorporate backgrounds, most were women.

Distribution of key committee assignments

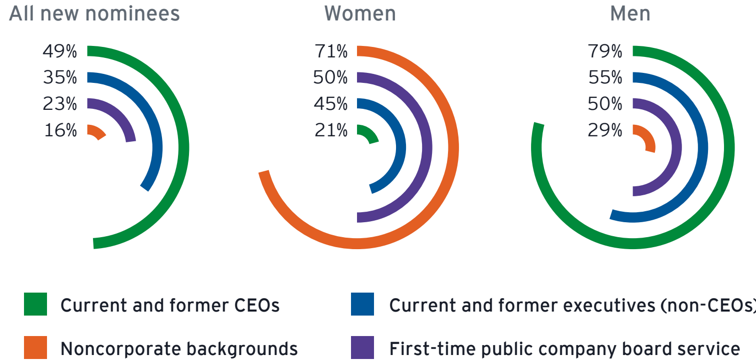


> "Although boards are adding more younger directors, the overall age of the boards remains high due to the portion of existing directors compared to the new class.

Audit and nominating and governance committee assignments most common

The most common committee assignments continue to be either the audit or nominating and governance committees. However, the 2018 entering class shows a more even distribution of committee assignments with growth apparent in the number of new appointments to nominating and governance committees, and in the number of new directors landing on compensation committees. A look at the portion of new nominees being designated audit committee financial experts found that while these "AC FEs" comprised 23% of the 2016 class, the level was lower in 2018 at 20%.

Backgrounds

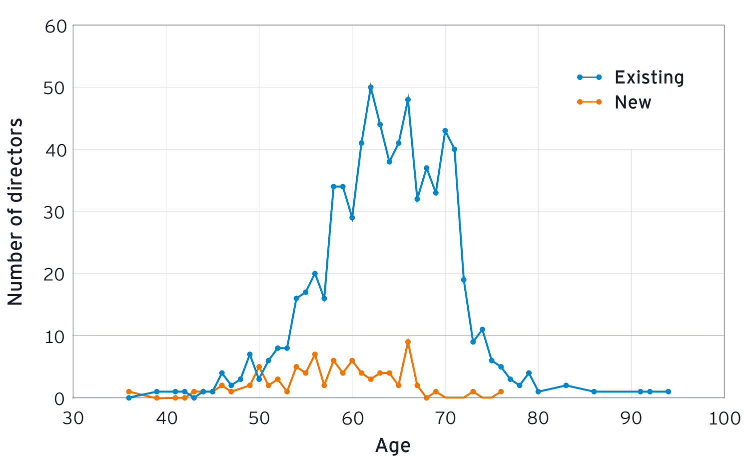


Percentages based on subsets. For example, 23% of the new class are first-time public company board members and half are women. Non-CEO executives include a wide range of roles such as CFO, COO and other EVPs. Noncorporate includes government or military, scientific or academic organizations and nonprofits.

New class of directors getting younger

The average age of the new class of directors has been getting younger each year. While the changes have been gradual and the numerical differences very slight, a look at the new nominees by age group shows a clear trend. The portion of new nominees under the age of 60 grew from 51% in 2016 to 58% in 2018, while the portion of those under 50 grew from 8% to 14%. Although boards are adding more younger directors, the overall age of the boards remains high due to the portion of existing directors compared to the new class.

Distribution of new class vs. existing independent directors by age



Questions for the board to consider

- Is the board proactively aligning director qualifications to the company's strategy and risk oversight priorities, including for the company's future state?
- Is the board considering board diversity across multiple dimensions, including skills and expertise, career background and personal characteristics (age, gender, race/ethnicity, geography, etc.)? In other words, does the board "refresh" or essentially "replace" perspectives? Does the board go beyond seeing diversity as a "check-the-box" concept?
- How effectively is the company communicating that its directors represent the best mix of individuals to guide the company? Would a third party read director qualifications disclosures in the way that the company intends?

2019 proxy season preview

Institutional investors tell us they want boards to help set the tone at the top for diversity and culture and better articulate how the company is investing in talent and transformation. They want to understand how companies are integrating business-relevant environmental and social considerations into a sustainable strategy that creates long-term value for a wide range of stakeholders. And they want to know how the board is overseeing emerging threats and opportunities amid continued market volatility and evolving risks.

Many investors are also further integrating environmental, social and governance (ESG) considerations into their stewardship programs and broader approach. For example, some asset managers are doing more to embed such factors into their investment processes and offering new ESG products and solutions; and asset owners are asking more questions around how their current and potential external managers are approaching ESG matters.

These are some of the themes emerging from our conversations with more than 60 institutional investors representing over US$32 trillion in assets under management, including asset managers (42% of participants), public funds (22%), labor funds (13%), socially responsible (13%) and faith-based investors (8%), as well as investor associations and advisors (3%).

This is the eighth year the EY Center for Board Matters has engaged with governance specialists from the investor community to learn about their priorities for the coming year. This report brings together investor input and draws on our tracking of governance trends across more than 3,000 US-listed companies, and focuses on:

- The top three areas investors want boards to focus on in 2019
- Opportunities for enhancing communications around long-term strategy
- Key factors investors use to assess board oversight of risk
- Tips for more effective engagement
- Shareholder proposal trends

Top three areas where investors want boards to focus in 2019

1. Board diversity — investors push for diverse directors as focus on board composition continues

Just over half (53%) of the investors we spoke with emphasized that board diversity, primarily inclusive of gender, race and ethnicity, should be a top board focus in 2019, up from one-third three years ago. An additional 19% cited diversity as part of a broader set of board composition considerations, including skill set, refreshment and assessment approaches.

Many investors said they want to see boards recognize and truly embrace the value of diversity to decision-making and performance, including by fostering an inclusive board culture as well as embedding diversity considerations into recruitment and assessment policies. They further shared that the dynamics of engagement conversations on diversity can reveal whether boards are "checking the box" or genuinely upholding diversity as a value.

Many investors also noted the value of board diversity in setting a tone at the top that reflects a dynamic and inclusive view of talent. Relatedly, more investors are also expanding their focus to senior executives. Fourteen percent of investors explicitly raised both board and executive diversity as an important focus for boards, up from 4% three years ago. Some characterized a lack of diversity among directors and executive leadership as a human capital risk, particularly given today's war on talent and the spotlight on corporate culture.

The push for diversity is occurring against a backdrop of slow-moving change in the boardroom. From 2017 to 2018, the percentage of women-held S&P 1500 directorships inched up two percentage points from 19% to 21%. That is double the annual one-percentage-point rate of increase we have observed since 2013. Assessing racial and ethnic board diversity continues to be challenging for investors given the lack of disclosure. Thirty percent of investors who want boards to focus on diversity told us they are asking companies for better disclosure of director demographics. However, some directors may not want to self-identify for personal reasons.

Key board takeaway

Consider whether the board's diversity and related communications (e.g., proxy disclosures regarding board composition and the role of diversity in board recruitment and assessment) set the appropriate tone at the top for the value the company places on diversity.

2. Company-relevant environmental and social issues, particularly climate risk

Around half (49%) of investors said a top board focus should be business-relevant environmental and social factors. That is, those that are most likely to impact the company's strategy, risk profile and brand, such as water management for food and beverage companies; access and affordability for health care companies; and plastic pollution for consumer goods companies. Generally, these investors want to understand how boards and management are connecting these kinds of environmental and social issues to their long-term success and embedding related considerations into their risk management and strategy setting. And they want to see this integration consistently communicated in company disclosures on strategy and risk.

Most of these investors — more than a third (38%) of investors overall — are specifically focused on climate change, which is up from 15% three years ago. Notably, the types of investors citing climate risk were evenly divided among mainstream asset managers, public funds, and faith-based and socially responsible investors, reinforcing the increasingly broad spectrum of investors focused on this issue.

The direct relevance of climate risk is different for each company, and most investors focused on climate are engaging heavy greenhouse gas (GHG) emitters, such as those in the industrial or energy sectors. Regarding these companies, investors raised the need for concrete and significant GHG reduction goals and climate scenario planning that tests the resilience of company strategy against a 2-degree Celsius or lower scenario — both core elements of the Financial Stability Board's Task Force on Climate-related Financial Disclosures' (TCFD) recommendations. Thirty-eight percent of investors citing climate change raised that they are actively asking companies to take these steps.[1]

Another key theme arising from the conversation on climate risk was the need for enhanced reporting. Close to half (46%) of the investors citing climate risk raised the TCFD as a reporting framework they support.[2] These investors noted the importance of such reporting for companies' strategic planning and risk management, and many noted that they are part of the Climate Action 100+, an investor-led initiative that promotes voluntary disclosure in line with the TCFD's recommendations.[3]

> "Investors seek board engagement, enhanced reporting and to understand how these considerations are embedded into strategy.

As for expectations around board governance of environmental and social factors, including climate risk, investor expectations may vary based on company-specific circumstances. Nonetheless, most investors told us they recognize effective oversight can come in different forms, such as charging a dedicated board committee or one of the key committees with related oversight, recruiting directors with business-relevant sustainability expertise, talking to external independent experts, or setting a clear and ongoing agenda for the board to discuss sustainability impacts.

Key board takeaway

Challenge whether the company's risk management processes, capital allocation decisions and strategic planning integrate business-relevant environmental and social considerations, and whether the company's reporting process consistently demonstrates this integration. Consider the extent to which key stakeholders support external frameworks, such as the TCFD and the Sustainability Accounting Standards Board (SASB), and how company disclosures align with these frameworks.

1 The Climate Action 100+ is a five-year investor-led initiative to engage key global companies on achieving the goals of the Paris Agreement.

2 The TCFD provides a framework for companies to report climate-related risks and opportunities through existing financial reporting processes and has developed recommendations structured around governance, strategy, risk management, metrics and targets.

3 The Climate Action 100+ is a five-year investor-led initiative to engage key global companies on achieving the goals of the Paris Agreement.

3. Human capital management — investors seek to understand how boards are governing talent and culture

More than a third (39%) of investors told us human capital management and corporate culture should be a top board focus, up from just 6% three years ago. While some are focused on particular issues (e.g., workforce diversity, pay equity), most are taking a broad view of the topic.

Several investors shared that recent business, technology and societal trends have played a role in them paying closer attention to human capital and culture, including a more discerning and empowered consumer base, radical shifts in the workforce and the growing importance of talent to an organization's intangible value in today's digital economy.

At a high level, these investors want to understand the role of human capital management in the company's long-term strategy and how the company is evolving, investing in and developing its talent to further innovate and meet future needs, particularly in industries or geographies where talent scarcities are on the horizon, such as technology and financial services. They also want to understand how companies are addressing, including how boards are assessing, potential cultural and workforce issues to support long-term strategy and enhance and protect the company's reputation, brand value and ability to attract the best talent.

Twenty percent of the investors citing human capital management seek increased disclosure around related topics, and some view the pay ratio as an opportunity for companies to provide deeper context around their investments in human capital.[4] Most told us that, at least for now, they are prioritizing dialogue over disclosure. Some even indicated that this kind of information need not be for public consumption, and that they are seeking assurance that boards are actively engaged in reviewing related metrics. Overall, there was consensus that investors would like to better understand how boards are engaged and exercising oversight in this space.

Key board takeaway

Assess how the board is governing around talent and culture, including how well the board understands the current culture, and whether the human capital metrics the board is reviewing and the quality and frequency of management reporting to the board are sufficient for robust oversight.

4 The Human Capital Management Coalition is a cooperative effort among more than 26 asset owners with more than US$3 trillion in assets under management. The group petitioned the SEC in July 2017 to adopt rules requiring issuers to disclose information about their human capital management policies, practices and performance.

Opportunities for enhancing communications around long-term strategy

We asked investors if they think most companies are doing a good job of balancing their investments for the short- and long-term. Nearly all qualified their responses, stressing that it is highly dependent on the company and acknowledging the market pressures that encourage short-termism. A quarter declined to answer, with most explaining that this is an evaluation they leave to their investment professionals and a few stating that this is a debate they avoid. But most revealing to us was this: nearly 20% said it is hard to answer the question because of the current lack of disclosure around long-term strategy.

Some of these investors applauded particular companies for doing a great job in communicating their long-term approach but noted that many companies maintain a heavy emphasis on the short-term, including businesses with what appeared to them to be unacknowledged and unmitigated long-term risks. Notably, some said that when there is external pressure, such as an activist waging a proxy contest, companies are very articulate about their long-term strategy, but there is opportunity to better tell this story as part of their regular communications.

Investors generally want to understand how companies are anticipating and responding to external market developments and industry trends. They would like to see that a company's identification of key risks and strategic opportunities includes environmental and social factors that impact the company's business sustainability, and they want to see consistent messaging across various communications (e.g., the 10-K, the sustainability report and investor presentations). They also want a clear picture of how short-term goals and executive pay tie into and support long-term strategy.

In order to assess whether companies are effectively balancing the short- and long-term, investors told us they are looking at:

- **The company's story**. Is the company consistently communicating a strategy around long-term growth? Is there a strong articulation of the company's purpose and how the company is managing its business to create long-term value?
- **Executive compensation**. Does the pay program promote longer-term focus or does it primarily emphasize a one-year time frame? Are companies rewarding innovation, investment in the company, and progress tied to environmental or social goals?
- **Capital allocation/stock buybacks**. How is the company investing in services, products, retraining or innovation that could build long-term value? And how do recent stock buybacks reflect the best use of cash?
- **Environmental and social metrics**. Is the company investing energy, focus and disclosures around long-term sustainability goals? Does company strategy address business-specific opportunities and risks on environmental and social matters?
- **Risk disclosures**. Does there appear to be an underappreciation of significant risks, such as environmental risks, cybersecurity or broader technology challenges?
- **Sell-side research**. Is the company articulating business planning for the long-term?

Key board takeaway

Assess opportunities for enhancing communication of long-term strategy, and how near-term goals and pay incentives support that strategy.

Five factors investors use to assess board oversight of risk

We asked investors if they are raising particular risk issues (e.g., cybersecurity, talent/human capital management, climate, geopolitical) in company engagements and how they are assessing board oversight of those risks. Most said they don't want to be prescriptive regarding board oversight; they want to see evidence that the board is engaged and to understand related oversight structures and procedures. Some of the key factors they raised included:

1. **Management reporting to the board**. Investors are interested in how management is reporting to the board on key risk issues at a high level and may raise related questions in engagement discussions, e.g., who from management is reporting, how often and what kind of information is discussed.
2. **Committee oversight**. Investors generally want to see that a board committee has responsibility over and is engaged on key risks, or that there are procedures in place to ensure sufficient attention to the issue by the full board.
3. **Director qualifications and use of outside experts**. Investors generally want the board to include relevant expertise tied to key risks the company is facing. They also want assurances that the board is accessing outside experts as needed to stay current on external developments and challenge internal bias, as appropriate.
4. **Directors' ability to speak to risks disclosed in the 10-K**. Several investors said they expect board members to be able to speak fluently on how they are overseeing key risks identified in the annual report and may raise related questions in engagement conversations.
5. **Explanation of differences between company's disclosed risks and external frameworks/ research**. Several investors said they often compare a company's disclosed risks to other benchmarks (e.g., industry research, ESG ratings reports, the SASB framework) and may raise questions about perceived gaps or areas of misalignment.

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Investors want a clear picture of how short-term goals and executive pay tie into and support long-term strategy.

Tips for more effective engagement

We asked investors what they wish were different about their engagements with companies. Close to a third (30%) said that overall engagement has improved significantly, with most citing increased director involvement and a more respectful approach as important developments. Still, 91% cited opportunities for continuing to improve the process. Here are some tips based on what we heard:

- **Avoid engaging for engaging's sake — engage as needed outside of proxy season and avoid discussing proxy advisory firm views**. Investors said companies come across as tone deaf when they reach out in the spring (when investors are voting thousands of company ballots) or with no clear agenda, and when they focus on the views of proxy advisory firms that investors do not rely on for voting guidance.
- **Have a mutually agreed-upon agenda and the right people on the call**. Having an agenda that benefits both parties provides for a richer conversation and allows both sides to prepare accordingly. Having the relevant decision-makers and subject-matter experts involved — including directors as appropriate — can make conversation more productive and efficient. Some investors noted that when boards rely solely on sustainability officers to discuss environmental and social issues, that may reinforce concerns that these issues are isolated from board discussions on strategy and risk. Similarly, when a compensation committee defers to management or the compensation consultant, this may raise questions about the extent to which the committee owns the pay philosophy and decision-making. Overall, many expressed frustration at IR playing a lead role in engagement, given the perceived lack of familiarity on company-specific governance and sustainability topics and focus on "canned" messaging.
- **Make the discussion more investor-specific**. The more the company understands the investor's approach and position on governance issues, the more focused the engagement. While many investors post their proxy voting guidelines and stewardship reports on their websites (and some send letters to portfolio companies identifying engagement priorities), many said they do not expect companies to do in-depth research before a meeting, but at least expect the company to understand whether they are talking to an active or passive manager, or an asset manager or owner. Further, several investors said they wish companies would review notes from previous conversations with them to help move the dialogue forward. Finally, recognize that some investors view the shareholder proposal process as an important part of investor-company engagement.
- **Be forthcoming about challenges and controversies, as well as changes made in response to feedback**. Several investors noted frustration around companies not directly raising challenges or controversies. They said that, when coupled with "all is well" type messaging, the communication raises concern that companies are obfuscating, which makes investors skeptical about what the company does share, and results in a missed opportunity for relationship-building. Conversely, companies that directly raise the challenges they face and discuss plans to address them build trust. Further, companies that reach out to share recent or potential changes made in response to feedback reinforce the value of engagement and relationship-building efforts.

One shortcut to understanding widely held investor expectations is the Investor Stewardship Group's (ISG) framework of corporate governance principles, which reflects the common corporate governance standards of ISG members, which include some of the largest US-based institutional investors and global asset managers.

Shareholder proposal trends

Shareholder proposal submissions in 2018 were down 20% from five years ago based on our tracking of proposals submitted at Russell 3000 companies. Over the same time period, the portion of proposals that were withdrawn (in most cases because the proponents and the companies reached agreement) held steady at around one-third of all submissions. Notably, average support for proposals that went to a vote on environmental sustainability topics (e.g., asking companies to report on sustainability, climate risk, energy efficiency, greenhouse gas emissions) grew from 22% to 31%.

More changes to the shareholder proposal landscape may be ahead. Following a November 2018 U.S. Securities and Exchange Commission roundtable, Chairman Jay Clayton identified improving the proxy process as a key 2019 initiative for the Commission, specifically including examination of the share ownership and voting thresholds that determine whether shareholder proposals can be submitted and resubmitted.

To set the context for proxy season 2019, here are the top shareholder proposal topics by average vote support in 2018, a year in which a total of 281 companies had shareholder proposals voted.

Top 20 shareholder proposal topics in 2018, based on average support received*

	Average support	Maximum support
Eliminate classified board	87%	96%
Adopt majority vote to elect directors	78%	98%
Eliminate supermajority vote	64%	87%
Allow shareholders to act by written consent	43%	86%
Report on sustainability	41%	80%
Allow shareholders to call special meeting	40%	94%
Address corporate EEO/diversity	39%	48%
Review/report on health care/medicine	32%	62%
Address political spending	32%	47%
Enhance pay-for-performance alignment	32%	48%
Address greenhouse gas emissions	32%	57%
Appoint independent board chair	32%	58%
Adopt/amend proxy access	32%	85%
Eliminate dual-class common stock	30%	41%
Limit post-employment executive pay	30%	43%
Address food/consumer products	28%	43%
Address lobbying activities	26%	41%
Address alternative, renewable energy	23%	46%
Address internet/data security risks	20%	36%
Address board diversity	18%	33%

*Where at least five proposals were voted. Accordingly, certain topics that received strong, and even majority support, in 2018 are not included (e.g., proposals to address climate risk averaged 42% support last year, but only 4 came to vote while 17 were withdrawn).

Conclusion

The ES of ESG is growing in prominence, and many investors want to understand how companies are embedding relevant considerations in their long-term strategy. Many investors also want boards to set the tone at the top for diversity and do a better job of articulating oversight of long-term strategy, including how the company is investing in and developing talent, living its values and navigating external risks.

While these high-level insights come from a broad range of investors, boards must remember that institutional investor views can vary significantly. Understanding the widely supported leading practices set forward in the ISG framework as a baseline and engaging key shareholders and reviewing their policies and voting records are paramount to understanding and meeting investor expectations.

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Many investors want boards to set the tone at the top for diversity.

Questions for the board to consider

- Does the board's makeup and culture reflect the company's broader commitment to diversity and inclusion? And how is the board challenging itself to find diverse director candidates and communicating those efforts to investors?
- Do the company's various reporting channels (e.g., proxy statement, annual report, sustainability report, quarterly reports and earnings calls) tell a consistent story about long-term strategy and related risks, including business-relevant environmental and social factors? Is it clear how the executive pay program and short-term performance goals support that strategy?
- How is the company investing in and developing its talent as the business evolves? What is the company doing to provide for its talent needs in 3–5 years?
- Does the board understand how the company's culture aligns with the company's purpose, values and strategy, along with any particular cultural strengths or opportunities for improvement?
- Is the board able to articulate how it oversees the key risk factors disclosed by the company in its annual report? And has the company considered how its disclosed risks align to those of peers and external frameworks such as SASB or the TCFD?
- Are there opportunities to make the company's shareholder engagement program more targeted and outcome-driven?

SEC top five priorities: what to watch for in 2019

The U.S. Securities and Exchange Commission (SEC) has a 2019 agenda that includes promoting capital formation, revamping the proxy process and monitoring company disclosures about cyber risks and incidents and the impact of Brexit, among other topics. SEC Chairman Jay Clayton has signaled his intention to follow through on priorities established in 2018 while also initiating several new ones discussed below.

This publication examines the elements of the 2019 SEC agenda with the greatest potential impact for issuers, boards and investors.

The SEC's timetable for accomplishing its agenda may be delayed because the agency was closed during the recent government shutdown that began on 27 December. The SEC resumed normal operations on 26 January and began addressing the backlog resulting from the shutdown. For example, the staff of the Division of Corporation Finance (DCF) announced that it would process filings and requests for staff action in the order received unless compelling circumstances require expedited treatment.[1]

As of 1 January, the Commission comprises four members, including Clayton. Following the departure of Commissioner Kara Stein, who took office in 2013 and whose term ended on 31 December 2018, all sitting commissioners are appointees of President Donald Trump. The White House has not indicated when it will nominate a candidate to fill Stein's seat, which is expected to go to a Democrat.[2] Despite the vacancy, the work of the Commission is expected to proceed as normal, with only three commissioners needed to form a quorum for the purposes of voting on Commission actions.[3]

1 See, for example, the statement from the SEC Division of Corporation Finance, 27 January 2019, https://www.sec.gov/page/corpfin-section-landing, accessed February 2019.

2 According to the Securities Exchange Act of 1934, the Commission may have no more than three members of the same party. As Clayton is an independent, the open seat could technically go to a Republican or another independent.

3 17 CFR §200.41.

Here is a snapshot of some key 2018 SEC activities that will likely continue to serve as a basis for 2019 priorities:

- Capital formation remained a high priority for Clayton, who has continued to voice concern about the low number of IPOs over the past decade — especially for companies that are in the earlier stages of their growth trajectories — and the negative consequences for retail investors with limited access to private markets.
- The SEC took several steps to entice companies to raise capital in the US public capital markets, including amending the definition of a smaller reporting company to allow more companies to qualify for certain scaled disclosure requirements and eliminating redundant and outdated disclosure requirements.
- Clayton and SEC Chief Accountant Wesley Bricker communicated the importance of high-quality financial reporting and highlighted the responsibilities of audit committees, boards and management in achieving high-quality financial reporting in light of the rapidly changing technological landscape, accounting and audit standard changes and increasing cybercrime.
- The SEC also maintained an active enforcement agenda in 2018 with a particular focus on cases affecting retail investors and those related to emerging technologies and products, such as initial coin offerings (ICOs).

2019 SEC key priorities

1. Capital formation remains a central SEC priority

Clayton remains focused on increasing the attractiveness of US public markets and continues to explore ways to expand investment options for retail investors while maintaining adequate investor protection. He has acknowledged that no single policy initiative[4] will reverse the decline in IPOs over the past two decades or expand investment options for retail investors; rather, he has suggested that the Commission will continue to take a multifaceted approach to facilitating capital formation in 2019.

Expected action in 2019: proposed rule to reduce internal control attestation requirements for certain smaller companies

Clayton has stated that a one-size-fits-all approach to disclosure has not been effective for smaller companies, as the expense, burden and complexity of current regulations can pose a barrier to entry to the public markets. To address this, the SEC will consider whether to exclude more companies from the requirements of Section 404(b) of the Sarbanes-Oxley Act of 2002, which requires certain

The SEC issued a four-year strategic plan in October 2018 that will guide its actions in the coming years:

- **Goal 1** — Focus on the long-term interests of Main Street investors, including by better understanding how a wider range of investors can participate in the capital markets. Some initiatives related to this goal include modernizing public company disclosures and expanding retail investment options.
- **Goal 2** — Recognize significant developments and trends in the capital markets, with an eye on effective resource allocation. This includes developing and maintaining an understanding of the evolution of the "cyber landscape."
- **Goal 3** — Improve the SEC's performance through enhanced analytical capabilities and human capital development. This includes investment in data and technology.

4 "Remarks on Capital Formation at the Nashville 36|86 Entrepreneurship Festival," Jay Clayton, 29 August 2018, https://www.sec.gov/news/speech/speech-clayton-082918, accessed February 2019.

public companies to obtain an auditor attestation of their internal control over financial reporting (ICFR).[5] This effort builds on a 2018 rule that raised the threshold for the size of a company that qualifies for other scaled disclosure requirements as a smaller reporting company.

Expected action in 2019: consideration of responses to proposed rule expanding "testing the waters" accommodations

In February 2019, the Commission issued a rule proposal[6] to allow all companies that are eyeing initial public offerings to "test the waters" by communicating with certain potential institutional investors earlier in the process of registration statement filing. This rule change would allow companies to get feedback about the attractiveness of the offering, reducing some of the uncertainty of going public. Currently, only emerging growth companies are allowed to do this.

Expected action in 2019: consideration of possible changes to quarterly reporting and earnings releases to reduce regulatory requirements and promote long-term investing

In December, the Commission issued a request for public comment seeking input on ways to reduce the administrative burden of quarterly reports while maintaining or enhancing investor protections, such as by allowing companies to satisfy quarterly reporting requirements through voluntarily provided earnings releases. In addition, the SEC asked whether the frequency of interim reports should be modified for all or some companies, such as smaller companies. The SEC also posed questions about how the quarterly reporting process affects corporate decision-making. In particular, the SEC is interested in whether the practice of providing quarterly earnings guidance creates an undue focus on short-term results and, if so, what rule changes might address such concerns.

> "
> The issue of facilitating capital formation and increasing the attractiveness of the public markets for smaller companies is one of my highest priorities as SEC Chairman. I am concerned that Main Street investors are bearing costs (and missing investment opportunities) as a result of the shrinking number of US-listed public companies.
>
> **Chairman Jay Clayton**
> "Remarks at the Equity Market Structure Symposium,"
> 10 April 2018

Expected action in 2019: concept release on potential changes to the private offering framework

The Commission expects to initiate a project to harmonize and streamline the private offering exemptive framework, which Clayton has stated is an important way for small businesses to raise capital but is "an elaborate patchwork" today. This will include soliciting input on changes to the accredited investor definition — a principal barrier to participation in private securities offerings — to consider whether retail investors should have greater access to these investment opportunities by focusing "more on the sophistication of the investor, the amount of the investment, or other criteria rather than just the wealth of the investor."[7]

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5 "Testimony on 'Oversight of the U.S. Securities and Exchange Commission,'" Jay Clayton, Committee on Banking, Housing and Urban Affairs, United States Senate, 11 December 2018, https://www.sec.gov/ news/testimony/testimony-oversight-us-securities-and-exchange-commission-0, accessed February 2019.

6 "Solicitations of Interest Prior to a Registered Public Offering," Securities and Exchange Commission, 19 February 2019, https://www.sec.gov/rules/proposed/2019/33-10607.pdf, accessed February 2019.

7 "Testimony on 'Oversight of the U.S. Securities and Exchange Commission,'" Jay Clayton, Committee on Banking, Housing and Urban Affairs, United States Senate, 11 December 2018, https://www.sec.gov/ news/testimony/testimony-oversight-us-securities-and-exchange-commission-0, accessed February 2019.

> "The SEC is committed to efforts to develop a regulatory framework that equally serves the neighborhood coffee shop that is looking to expand into a second location, the biotech startup looking to hire more scientists to cure cancer, the social media company looking to conduct its IPO, and the Main Street investor saving for their future.

Chairman Jay Clayton
"Remarks on Capital Formation at the Nashville 36|86 Entrepreneurship Festival," 29 August 2018

2. Disclosure is on the agenda

Expected action in 2019: proposed rules to streamline and modernize certain disclosure requirements

The SEC has placed several projects on its short-term agenda to streamline and modernize disclosure requirements. These include proposing amendments to Regulation S-X on the disclosure of financial information relating to acquired businesses and updates to Industry Guide 3 on bank holding company disclosures. Another project would modernize certain business and nonfinancial disclosure requirements found in Regulation S-K. This project would build on a concept release issued in 2016 covering a wide range of disclosure requirements.[8] DCF Director Bill Hinman also has indicated that he hopes the SEC will adopt the July 2018 proposal that would help streamline and simplify financial disclosures relating to guaranteed and collateralized debt securities.[9]

Expected action in 2019: scrutiny of company disclosures on Brexit and cybersecurity issues

Brexit

Clayton has expressed concern that the market does not fully understand the implications of the United Kingdom's planned exit from the European Union and that disclosures to investors may be insufficient. He also has noted that many uncertainties surround Brexit, including whether and when a deal will be struck between the EU and the UK and the terms on which the UK will leave the EU. Further, he has indicated that there is the potential for many companies' operations to be disrupted by a "hard" Brexit, and this possibility may be underestimated by both companies and investors. For example, a hard Brexit could mean that products must go through customs when traveling between the EU and the UK, adding significantly to the time and cost of trade between the two.

Cybersecurity

As cybersecurity has taken on greater prominence, Clayton and SEC staff continue to communicate concerns that public companies are not adequately disclosing their cybersecurity risks to investors. The DCF also will be closely reviewing cybersecurity-related disclosures to ensure that companies are following the interpretive guidance issued by the Commission in February 2018. That guidance emphasized the importance of disclosure controls and procedures so that information about cybersecurity incidents gets to management and those responsible for public disclosures in time to consider the public disclosure implications.

Clayton and DCF staff also have called out the need for board-level attention on cybersecurity and the related corporate governance disclosures, which must describe how the board oversees risk management, including cybersecurity risk. Company-specific disclosures also must be tailored to a company's circumstances rather than boilerplate.

Cybersecurity monitoring

To promote appropriate disclosures, the staff is monitoring cybersecurity incidents in the news and reviewing related company disclosures, reaching out to companies where necessary for additional information. DCF Director Bill Hinman has noted that disclosures in this area have been a "mixed bag."[10] (See the EY analysis of cybersecurity-related disclosures of Fortune 100 companies showing that the depth and nature of cybersecurity-related disclosures vary widely.)

8 "Business and Financial Disclosure Required by Regulation S-K," Securities and Exchange Commission, 13 April 2018, https://www.sec.gov/rules/concept/2016/33-10064.pdf, accessed February 2019.

9 "2018 AICPA Conference on Current SEC and PCAOB Developments," Ernst & Young LLP, December 2018, accessed January 2019.

10 "2018 AICPA Conference on Current SEC and PCAOB Developments," Ernst & Young LLP, December 2018, accessed January 2019.

Expected action in 2019: Dodd-Frank rulemaking

- Rule re-proposal on disclosure of payments to governments by resource extraction companies
- Implementation of rule requiring disclosure of hedging policies for employees, officers and directors

The SEC currently has several rulemakings on its short- and long-term agendas, which are required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). One with potential impact for issuers is a re-proposed rule to require resource extraction companies to disclose payments to governments. While the SEC adopted a final rule in 2016 to implement this provision of the Dodd-Frank Act, Congress overturned it in 2017.

With respect to other pending rules required by the Dodd-Frank Act that relate to executive compensation, Clayton has suggested that the Commission will implement them one by one because of the complexity and scope of the current executive compensation framework.[11] When prioritizing the order in which the rules will be implemented, Clayton said that the SEC will take into account whether market developments — such as companies voluntarily establishing mechanisms to claw back executive compensation following a material financial restatement — have already addressed the concerns underlying the Dodd-Frank provisions.

In December 2018, as required by the Act, the Commission issued a final rule to require companies to disclose their policies regarding whether employees, officers and directors are allowed to hedge direct or indirect holdings or grants of company securities.[12] Most large issuers must include this information in proxy materials for the election of directors in fiscal years that begin on or after 1 July 2019. Smaller reporting companies and emerging growth companies have an additional year to disclose this information.

3. Emerging technology continues to be a top priority

Clayton has stated that the SEC is seeking to take a "balanced regulatory approach" to FinTech developments — looking to support innovative technologies that could promote capital formation while also protecting investors.[13]

Expected action in 2019: **continued engagement with market participants on the interaction of the securities laws with FinTech**

In keeping with the SEC's strategic goal of innovating and being responsive to new developments and trends, the agency has signaled its intention to expand outreach to market participants regarding new technologies and their role in US capital markets, including through its Strategic Hub for Innovation and Financial Technology (FinHub). Established last October, FinHub helps connect investors and market participants to SEC personnel across the agency on FinTech-related issues, including distributed ledger technology (DLT), artificial intelligence and machine learning, automated investment advice and digital marketplace financing.

11 "Testimony on 'Oversight of the U.S. Securities and Exchange Commission,'" Jay Clayton, Committee on Banking, Housing and Urban Affairs, United States Senate, 11 December 2018, https://www.sec.gov/news/testimony/testimony-oversight-us-securities-and-exchange-commission-0, accessed February 2019. Dodd-Frank rules that the SEC still must finalize include requiring disclosure of executive pay compared with company performance and companies listed on stock exchanges to have clawback provisions for excess executive incentive compensation following a material financial restatement. Dodd-Frank Act Sections 953(a) and 954, respectively.

12 Dodd-Frank Act Section 955.

13 "Testimony on 'Oversight of the U.S. Securities and Exchange Commission,'" Jay Clayton, Committee on Banking, Housing and Urban Affairs, United States Senate, 11 December 2018.

Expected action in 2019: continued monitoring of FinTech companies' compliance with the securities laws and investigations by the Division of Enforcement where market participants fall short

The SEC continues to closely monitor ICOs and other FinTech-related market developments to assess whether US securities laws are being followed. During a February 2018 Senate Banking Committee hearing on virtual currencies, Clayton stated: "I believe every ICO I've seen is a security [offering]."[14] In September 2018 remarks, SEC Chief Accountant Bricker reminded issuers of the need to "continue to maintain appropriate books and records – regardless of whether distributed ledger technology (such as blockchain), smart contracts and other technology-driven applications are (or are not) used."[15] The divisions of Trading and Markets, Corporation Finance and Investment Management issued a statement in November to highlight that all market participants dealing with ICOs and digital assets must comply with the securities laws – including broker-dealers, exchanges and investment funds.[16]

The Division of Enforcement has investigated numerous companies offering digital assets and ICOs as well as those touting plans to use blockchain or DLT to inflate their stock prices.[17] Investigations involving hacking, account intrusions and failures to protect personal information are being prioritized. The division's annual 2018 report notes that "many" of its dozens of investigations involving ICOs and digital assets "were ongoing at the close of FY 2018," so additional settlements, administrative proceedings and court cases are likely to continue throughout 2019. The SEC also is coordinating with other regulators, such as the Commodity Futures Trading Commission (CFTC), to investigate digital asset securities issuance and trading.

> "Given the explosion of ICOs over the last year, we have tried to pursue cases that deliver broad messages and have market impact beyond their own four corners. To that end, we have used various tools — some traditional, such as the Commission's trading suspension authority, and some more novel, such as the issuance of public statements — to educate investors and market participants, including lawyers, accountants, and other gatekeepers.
>
> **Division of Enforcement Co-Directors**
> **Stephanie Avakian and Steven Peiken**
> Annual Report, Division of Enforcement

14 Stan Higgins, "SEC Chief Clayton: 'Every ICO I've seen is a security,'" Coindesk, 6 February 2018, https://www.coindesk.com/sec-chief-clayton-every-ico-ive-seen-security, accessed February 2019.

15 "Remarks before the AICPA National Conference on Banks & Saving Institutions," Wesley Bricker, 17 September 2018, https://www.sec.gov/news/speech/speech-bricker-2018-09-17, accessed February 2019.

16 "Statement on Digital Asset Securities Issuance and Trading," Division of Corporation Finance, Division of Investment Management and Division of Trading and Markets, US Securities and Exchange Commission, 16 November 2018, https://www.sec.gov/news/public-statement/digital-asset-securites-issuuance-and-trading, accessed February 2019.

17 SEC's 2018 Annual Report, Division of Enforcement, 2 November 2018, https://www.sec.gov/files/enforcement-annual-report-2018.pdf, accessed January 2019.

4. Expect renewed focus on the proxy process

The SEC is expected to take action regarding various aspects of the proxy process in 2019.

Expected action in 2019: SEC staff development of recommendations regarding how to improve the proxy process

Following a roundtable in November 2018 to consider the proxy process and shareholder engagement in light of recent changes in markets, technology and company operations, Clayton has identified three areas in which the SEC staff is formulating recommendations for the Commission to consider:[18]

- Proxy solicitation and voting process
  Clayton has suggested that "proxy plumbing" — the mechanisms through which companies and investors communicate with each other regarding matters on which shareholders vote by proxy — requires a major overhaul and that new technologies, including DLT, could be used to improve it. He has further noted that such an overhaul likely would take time, and the SEC may seek to take action in the short-term to make incremental improvements.
- Shareholder engagement through the shareholder proposal process
  Clayton has indicated that he believes the Commission should consider reviewing the ownership and resubmission thresholds and related criteria for shareholder proposals.[19] He has noted that "a lot has changed since" the ownership threshold was adopted 20 years ago and the resubmission thresholds were established in 1954.
- Role of proxy advisory firms
  Clayton has suggested that the Commission should consider addressing conflicts of interest at proxy advisory firms as well as mechanisms to ensure "that investors have effective access to issuer responses to information in certain reports from proxy advisory firms."[20] Another priority area is providing "greater clarity regarding the division of labor, responsibility and authority between proxy advisors and the investment advisers they serve."[21]

Notably, while the SEC currently has the authority to regulate proxy advisors, some members of Congress have pursued legislative reforms as well. For example, in November 2018, a U.S. Senate bill was introduced that would fold proxy advisors into existing regulations aimed at investment advisers, including periodic SEC examinations. Legislation on proxy advisors would have to be reintroduced in the current Congress to advance.

5. Enforcement continues to focus on retail investor protection, emerging technologies and individual accountability

Expected action in 2019: continued focus on securities law violations that significantly harm retail investors, relate to FinTech or involve gatekeepers, such as lawyers and accountants, and individual accountability, including executives and directors

SEC enforcement under Clayton continues to focus on retail fraud and digital technologies. The key goals of the Division of Enforcement include deterring securities law violations by pursuing cases that send important signals to the market, return lost assets to injured investors and hold individuals accountable.

18 "Testimony on 'Oversight of the U.S. Securities and Exchange Commission,'" Jay Clayton, Committee on Banking, Housing and Urban Affairs, United States Senate, 11 December 2018, https://www.sec.gov/news/testimony/testimony-oversight-us-securities-and-exchange-commission-0, accessed February 2019.

19 A shareholder must own $2,000 worth of a company's stock for one year to submit a shareholder proposal. Companies can exclude resubmitted shareholder proposals if they received less than 3% of shareholder votes if proposed once in the past five years, less than 6% of the vote if proposed twice during the past five years or less than 10% of shareholder votes if proposed three or more times within the past five years. 17 CFR §240.14a-8.

20 "Testimony on 'Oversight of the U.S. Securities and Exchange Commission,'" Jay Clayton, Committee on Banking, Housing and Urban Affairs, United States Senate, 11 December 2018, https://www.sec.gov/news/testimony/testimony-oversight-us-securities-and-exchange-commission-0, accessed February 2019.

21 Ibid.

Focus on retail investors: As articulated in its FY18 Annual Report, the division's first principle is "focus on the Main Street investor." More than half of the stand-alone enforcement actions brought by the SEC in FY18 involved wrongdoing against retail investors. The division's Retail Strategy Task Force (RSTF), created in September 2017, focuses on data analysis to generate investigative leads on practices in the securities markets that harm retail investors.

Inadequate disclosures by companies of cybersecurity risks and incidents: Clayton has emphasized to SEC registrants the importance of identifying and managing cybersecurity risks and, as noted above, the need to appropriately disclose those risks and incidents in SEC filings. The Commission brought charges for the first time against a public company "for failing to properly inform investors about what was then the largest known cyber intrusion in history."[22]

Prevention of cyber fraud through internal controls: The SEC has warned of frauds that exploit human errors and weak policies and procedures to compromise controls relating to payments, resulting in the loss of millions of dollars. In an October 2018 report, the SEC describes nine companies that experienced this type of fraud and the Division of Enforcement's consideration of whether the companies violated the securities laws by failing to have proper internal accounting controls.[23] While the SEC ultimately decided not to pursue enforcement actions against the companies, the report notes the importance of maintaining effective internal controls, which is required by the federal securities laws. The report also urges issuers to reassess the adequacy of their controls in light of emerging risks.

Holding individuals accountable: The Enforcement Division has observed that holding individuals accountable is a "key pillar of any strong enforcement program."[24] Avakian has noted a continued SEC emphasis on "individual accountability by pursuing charges against individuals for misconduct in the securities markets, including registered individuals, executives at all levels of the corporate hierarchy, including CEOs, CFOs and other high-ranking executives, and gatekeepers."

In FY18, the Commission charged individuals "in more than 70% of the standalone enforcement actions it brought."[25]

Going forward, we expect the SEC to maintain its focus on audit committees and other gatekeepers, such as lawyers and accountants, to protect the integrity of the capital markets.

Conclusion

Clayton has laid out a clear agenda for 2019 that builds on previous actions, which could result in significant rulemaking during the calendar year. Investors, issuers and board members may want to take advantage of opportunities to engage with the Commission through the comment process or direct contact to provide input as the SEC continues to demonstrate steady progress across its range of priorities.

22 SEC's 2018 Annual Report, Division of Enforcement, 2 November 2018, https://www.sec.gov/files/enforcement-annual-report-2018.pdf, accessed January 2019.

23 "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding Certain Cyber-Related Frauds Perpetrated Against Public Companies and Related Internal Accounting Controls Requirements," US Securities and Exchange Commission, 16 October 2019, https://www.sec.gov/litigation/investreport/34-84429.pdf, accessed February 2019.

24 Ibid.

25 "Measuring the Impact of the SEC's Enforcement Program," Stephanie Avakian, 20 September 2018, https://www.sec.gov/news/speech/speech-avakian-092018, accessed February 2019.

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A corporate crisis in today's world accelerates more quickly with a larger impact than ever before. The 24-hour news cycle and prevalence of social media contribute to the risk of destabilization. While prevention must always remain a priority, advance crisis preparation has become imperative for companies — and boards have a critical role to play. We invited Karen Golz, Chair of USA Gymnastics and an audit committee member of Analog Devices, Inc., and others to discuss their perspectives on how boards can help prime their organizations to react and recover from a crisis with resiliency and strength.

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