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Sweeping Regulatory Changes Affecting Director Elections, Executive Compensation and Climate Disclosures ... **What Can Go Wrong?**

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A very active Securities and Exchange Commission (SEC) recently enacted new regulations affecting director elections and executive compensation and is on the brink of requiring significant new climate-related disclosures. Combined with intense investor interest in these topics, the regulatory changes that companies are facing need to be handled with care to avoid increasing vulnerability to activism and lawsuits-- or even heightening the risk of reputational damage.

CONTESTED DIRECTOR ELECTIONS: WHAT IS THE NEW REQUIREMENT?

For shareholder meetings after August 31, 2022, the SEC now requires the use of a "universal proxy card" in contested board elections. While all sides will still distribute their own proxies and ballots, provided the issuer has received requisite notice, universal proxies now must include all director nominees regardless of the nominating party. So instead of choosing between competing board slates, investors now can easily pick and choose among all individual director nominees.

This change, long sought by activist investors and others, is expected to make it easier and more cost effective to wage board election contests, and more likely that at least one dissident nominee will be elected. In the end, this new requirement may increase the frequency, as well as success, of contested board elections.

WHAT CAN GO WRONG?

Every board seat is now potentially at risk. Against a backdrop of intense investor scrutiny of boards, and the fact that directors are being assessed according to a wide range of criteria from diversity, experience and competencies, and the ability to oversee an increasing array of topics including those under the environmental, social, and governance (ESG) umbrella, clearly this is more than a theoretical risk.

For this reason, companies must further step up their games, and not just "tell your best board story," but also make the best case they can for each individual nominee based on their qualifications and unique contribution to the board. Since by necessity boards operate largely outside the public eye, investors may rely too heavily on easily available and knowable metrics, such as gender, race, ethnicity, geographic origin, tenure and meeting attendance records, unless they are told a more nuanced story.

Given these new realities, we recommend that companies immediately revisit and, if needed, refresh all publicly available information about directors, rather than waiting until an actual board challenge emerges. Included among the information to review and revisit are director bios; skills matrices highlighting each director's unique qualifications; descriptions of key board processes, such as oversight of risk and ESG; director and board evaluations or assessments; new director recruiting and board refreshment efforts, and the board's role in investor engagement.

As is true with other forms of activism, telling a great story could help you prevail in an election contest. More importantly, though, a compelling story may serve as a deterrent to being targeted in the first place. What you want is for potential dissidents to conclude, "This company is not a soft target on this issue. Let me look elsewhere."

EXECUTIVE COMPENSATION: WHAT ARE THE NEW REQUIREMENTS?

In late August, the SEC announced its new Pay versus Performance (PvP) disclosure rules, effective for US issuers with fiscal years ending on or after December 16, 2022; emerging growth companies are excepted from this deadline. To comply, companies will first have to calculate, and then disclose, the compensation actually paid to the CEO and other Named Executive Officers (NEOs) for the past five years, as well as explain the relationship of this pay to specified financial performance measures.

Notably, this is the first element of proxy disclosure that will require Inline XBRL (iXBRL) data tagging, which increases the accessibility, easy analysis and comparability of such data.

As of now, most investors and proxy advisors have not announced significant changes to their existing pay for performance (PfP) or Say-on-Pay analyses or voting guidelines based on this new data, but this may well change by Year Two of these new disclosures.

At this point in time, most companies are indicating that they plan to comply, and to locate the disclosures in the back of the proxy, among other tables near the pay-ratio disclosure, and not call significant attention to the new disclosures. A handful of companies, in contrast, are indicating plans to embrace the new data and incorporate it into their primary PfP discussion in the CD&A section of the proxy.

WHAT CAN GO WRONG?

For years, many companies have been telling their PfP story prominently in the CD&A, including using a range of graphs comparing different measures of pay, such as SEC pay and realized or realizable pay, to a range of financial or operating metrics. Now they will also be providing additional, more standardized compensation data that is less subject to spin.

These new disclosures may support a company's existing PfP narrative, but when they conflict, companies should expect scrutiny and questions. Similarly, if current short- and long-term pay metrics are not listed among a company's three to seven most important performance measures used to link compensation actually paid to company performance, expect questions about that, as well.

Also, because of the analytical ease of iXBRL data tagging, it is hardly inconceivable that activist investors, class action law firms, and others will use the new data to compile lists of positive and negative PvP outliers. This data may be used to identify targets for activism, as well as provide statistical support for activist campaigns of others.

ESG REPORTING: WHAT IS PROPOSED?

In March 2022, the SEC proposed new climate-related disclosure requirements that would mandate that public companies provide certain climate-related financial data and greenhouse gas emissions metrics within public disclosure filings. This proposal would accelerate the movement of ESG reporting from a primarily investor-driven, voluntary regime, to a more regulated environment.

Originally expected to be finalized in Q4 2022, the release has been pushed back to early 2023 following an unprecedentedly active public comment period, The proposed rule thankfully does not create yet another materiality or reporting standard. As with the new PvP rules, the anticipated requirement of iXBRL data tagging will promote ease of analysis and comparability among data being provided.

The proposed SEC climate-disclosure requirement is consistent with intensifying investor interest in ESG topics generally. Investors want to understand how a growing range of non-financial risks might impact the success and thus value of the companies they invest in. For them, ESG is a form of long-term risk management. These investors increasingly demand material, quantitative, comparable, decision-useful (and let me now add "verifiable") information.

In fact, over one third of US actively-managed investment funds now use some form of ESG-related screening as part of their investment selection process, often using data from a range of ESG "rater and ranker" firms, either in whole or as one input into their own analysis. On the other hand, indexed investors (which by definition have to own companies that are part of an index they track) increasingly incorporate ESG factors into their stewardship activities over their portfolio companies.

We recommend that companies immediately revisit and, if needed, refresh all publicly available information about directors.

Despite their awareness of this investor interest, many US companies have complained that the lack of harmonization between competing materiality standards and reporting languages was hindering their efforts to commence their ESG and reporting journeys. Others indicated they were awaiting clarity from the SEC and other regulators before taking action.

The good news here is that increasingly regulators and standard-setting organizations around the world are coordinating efforts to create unified, comparable reporting standards to help investors and other stakeholders assess risks and make capital allocation decisions across their portfolios.

Here's a brief history of how this coordination got started. The harmonization of ESG reporting standards and frameworks truly began in 2020 with the merger of the International Integrated Reporting Council (IIRC) and the Sustainability Accounting Standards Board (SASB) to form the Value Reporting Foundation (VRF). The merger was characterized by the groups as "a major advancement towards building a more comprehensive and coherent corporate reporting system."

This harmonization (and the related alphabet soup of acronyms) continued last year at COP26 in Glasgow, Scotland, when the International Financial Reporting Standards Foundation (IFRS) announced the creation of the International Sustainability Standards Board (ISSB). Around this time, further consolidation took place, including with the VRF, Climate Disclosure Standards Board (CDSB) standards and elements of The Task Force on Climate-Related Financial Disclosures (TCFD).

Most recently, at COP27 in Egypt, the ISSB announced its "ISSB Partnership Frameworks," which are designed to assist reporting companies, investors, and other stakeholders in using these increasingly harmonized disclosure standards.

No matter what standards are used, companies are clearly stepping up the frequency, depth, and quality of their reporting. Research by the Governance & Accountability Institute, Inc. (G&A), a leading consulting firm on corporate sustainability and ESG, revealed all-time highs across the board in sustainability reporting for the Russell 1000 companies in 2021.

OTHER G&A FINDINGS INCLUDE:

- 81% of Russell 1000 companies published a sustainability report in 2021, an impressive increase from 70% in 2020
- The smallest half by market cap of the Russell 1000 index saw the largest increase in ESG reporting, with 68% publishing a sustainability report in 2021, up substantially from 49% in 2020
- The largest half of the Russell 1000 index (i.e., the S&P 500 companies) is nearing full participation in sustainability reporting with 96% publishing a report in 2021, an increase from 92% in 2020
- For the first time in 2021, SASB was the most-used reporting standard among the Russell 1000, with 67% of sustainability reports aligning with SASB, compared to 54% aligning with the Global Reporting Initiative (GRI)
- The use of TCFD doubled among Russell 1000 companies in 2021, with 34% of sustainability reports aligning with TCFD, compared to 17% in 2020

WHAT CAN GO WRONG?

Historically, most of the initial ESG reporting was developed by company marketing, public relations and investor relations departments, and was distributed via relatively unregulated web-site disclosures and reports, and not SEC-filed documents. Some companies asserting their good citizenship found their early efforts derided as greenwashing (a term for corporate claims that do not match corporate practices). In any event, the reporting was faulted for not being decision useful.

This type of aspirational disclosure – including projections that a company may or may not achieve -- increasingly gets a company into trouble and damages both reputation and credibility with everyone from investors to gadflies, activists, regulators, and the courts (lawsuits).

A change has come as ESG disclosures increasingly find their way into regulatory documents. For example, based on investor requests, many companies are including ESG program highlights, and discussion of board oversight and any ESG-related compensation metrics, in their proxies.

In our experience, thoughtfully selected highlights in a regulatory document are highly likely to be picked up by investors and can help move the needle with some of the raters and rankers. That said, these proxy highlights, as well as 10-K reporting on human capital, are bringing ESG disclosures squarely into the line of sight of the SEC and other regulators. Of course, the anticipated new SEC requirements will further catalyze this movement.

As ESG becomes more data driven and increasingly subject to disclosure through SEC-regulated channels, such as the 10-K and proxy statement, the stakes get higher – and more parts of your organization will become involved.

We believe that the day is coming when ESG data should receive the same degree of legal and financial review and disclosure controls as traditional financial data.

Many are analogizing this heightened volume and scrutiny of ESG disclosure to the Sarbanes-Oxley Act of 2002, which required public companies to have disclosure controls and procedures to ensure that information required by Exchange Act filings be recorded, processed, summarized, and reported in accordance with SEC rules. No question, Sarbanes-Oxley heightened the role of and discipline around financial reporting, and as a result companies expanded their disclosure teams to include attorneys, company management, auditors, and, ultimately, the board of directors. Many companies also established cross-functional disclosure committees that included the controller and a director of financial reporting, as well as representatives from finance, investor relations, and legal.

It's more important than ever to pay close attention to the potential liability that may arise from making ESG-related disclosures that are materially misleading or false. Such disclosures might include publicizing cybersecurity precautions, safety standards, and codes of conduct that subsequent events reveal are not as robust as advertised.

Companies should ensure statements in their ESG reports are supported by fact or data and should limit overly aspirational messages. Representations made in ESG reports may become actionable, so companies should disclose only what is accurate and relevant to their businesses.

THE FUTURE OF ESG DATA & REPORTING

Research by Diligent shows that most companies do not have the requisite data, processes, and technology in place to meet this new reality. They urge companies to start building an ESG infrastructure now, before the SEC acts and they are faced with the risks of mandated disclosures, in effect, leaving them at the starting gate relative to their better-prepared peers.

Once you figure out what information is material and what frameworks to report against, many other pieces fall into place. Knowing materiality and what constitutes strong reporting will clarify:

- **the data you will need**
- **how and where you will obtain necessary data**
- **how you will validate this data**
- **where you will store, update, and make this data accessible while keeping it secure**
- **what software will be needed to help you succeed.**

Once you have your ESG data management and reporting in place, remember that the end goal of the ESG journey is to make ESG part of the company culture. This means that attention to ESG should be imbued throughout all levels of the organization, placed at the center of business strategy, and integrated across company operations. Doing so can create a distinct competitive advantage for your company.

What these broad-ranging new developments, which are affecting board elections, executive compensation decisions, and ESG disclosures, mean for your company depends on the steps you take. If embraced and executed with care, these new regulatory requirements can elevate a company's reputation in the eyes of its investors and other stakeholders. On the other hand, if ignored or treated too lightly, they can expose a company, its executives and its board to additional scrutiny and risks.

WHICH SIDE WILL YOUR COMPANY BE ON WHEN THESE NEW REGULATIONS FULLY TAKE HOLD?

WHEN IT COMES TO ANSWERING THAT QUESTION, WE CAN HELP.

For further information, please contact
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