

# 2019 Governance Outlook

PROJECTIONS ON EMERGING BOARD MATTERS

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## ABOUT THIS REPORT

The *2019 Governance Outlook: Projections on Emerging Board Matters* is designed to give corporate directors and senior executives a comprehensive overview of major business and governance issues likely to demand board focus over the coming year. The report begins with an introduction from NACD, highlighting survey findings about leading board priorities for 2019, and follows with four partner contributions that provide distinct insights and projections on the following themes: business risks, climate change, M&A, regulatory priorities, and board composition and succession.

Each partner contribution provides (1) an overview of key trends in a particular area of governance, (2) an outlook for how those trends will play out in 2019, and (3) relevant implications and questions for boards to consider. The *2019 Governance Outlook: Projections on Emerging Board Matters* is designed as a collection of observations to help corporate boards prioritize their focus in 2019 and increase their awareness of emerging issues, through both detailed topical analysis and coverage of broader governance implications.

# 2019 SEC and Other Regulatory Priorities

By Mark Miskinis, Consuelo Hitchcock, Ashley Elizabeth Corey, and Andrea Perdomo, Deloitte

The SEC has taken a number of actions designed to encourage more private companies to go public, or allow more flexibility for current public companies, without compromising investor protections.

The US Securities and Exchange Commission (SEC) chair, Walter Joseph “Jay” Clayton, has consistently emphasized in discussions about SEC priorities the need to give attention to all three prongs of the agency’s mission: “protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.” In meeting its oversight responsibilities, the SEC took action in a number of areas in 2018 that underscored its focus on facilitating capital formation while maintaining appropriate investor protections.

Consistent with its governance role, the board, as a whole or through its committees, should keep these priorities in mind as directors engage with management to understand how their companies are monitoring and adjusting to regulatory changes. This is especially important in the areas that are likely to be a continued focus for the SEC in 2019.

## Facilitating capital formation

Clayton made clear at the outset of his term in mid-2017 that making US capital markets more attractive, especially to growing companies, was among his top priorities. Since then, the SEC has taken a number of actions designed to encourage more private companies to go public, or that allow more flexibility for current public companies without compromising investor protections.

Some of those actions have expanded the availability of existing reporting accommodations to a broader group of companies. These include expanding the definition of Smaller Reporting Companies (SRCs) to allow more companies to take advantage of scaled disclosure requirements, as well as extending the availability of certain Emerging Growth Company (EGC) accommodations, such as providing a nonpublic review of IPO registration statements, to non-EGCs as well.

The SEC has also encouraged companies to utilize its process to request modifications to certain financial reporting requirements if those disclosures are burdensome to prepare and do not provide material, incremental information to investors.

In 2019 the SEC is likely to continue focusing on actions intended to support capital formation. For example, when the SEC adopted the expanded SRC definition, Clayton directed agency staff to consider whether reducing the number of companies that qualify as “accelerated filers” also might facilitate capital formation by reducing compliance costs (e.g., reducing the number of companies required to obtain auditor attestation on their internal control over financial reporting), while maintaining appropriate investor protections. That project is also included on the SEC’s regulatory agenda<sup>1</sup> for 2019, along with other projects, including one on earnings releases and interim reports for “ways to ease companies’ compliance burdens while maintaining appropriate levels of disclosure and investor protection.”

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<sup>1</sup>US Securities and Exchange Commission, [Agency Rule List – Fall 2018](#).

Boards should ask management to keep them apprised of regulatory accommodations that the company is considering utilizing in its capital raising efforts and should understand the considerations that went into that decision. Specifically, boards should consider the following questions when discussing this area with management:

- Is the company currently taking advantage of existing or new reporting accommodations in the capital-raising process?
- Has management considered the potential risks of using these accommodations, including potential shareholder or other market reaction?

### Disclosure effectiveness

For several years, the SEC staff has been reviewing the disclosure requirements for public companies with the aim of improving the disclosure regime for the benefit of both companies and investors. Notably, this initiative, which the SEC refers to as the “disclosure effectiveness initiative,” has crossed administrations. Former SEC chair Mary Jo White launched the initiative in 2013, and Clayton has maintained it as a priority under his leadership. The SEC took several actions related to this initiative in 2018, and the agency is expected to do so in 2019.

For example, in August 2018 the SEC approved a group of rule amendments to eliminate disclosure requirements that it determined had become redundant, duplicative, overlapping, outdated, or superseded. Clayton characterized the changes as being for the benefit of both public companies and investors, and part of the SEC’s efforts to ensure its requirements remain effective and efficient, even as the capital markets evolve.

The SEC has a number of other projects related to disclosure effectiveness in process, including a proposal to simplify the requirements related to when issuers of debt securities must include separate financial information of certain other entities (e.g., guarantors). The agency also has topics on its regulatory agenda<sup>2</sup> for 2019 related to making changes to certain industry-specific disclosures and modernizing reporting requirements related to significant acquisitions, as well as continuing a broad review of certain business and financial disclosure requirements in Regulation S-K, which is the central repository for nonfinancial statement disclosure requirements for public companies.

Boards should be aware of changes in disclosure requirements applicable to their companies and discuss with management how they intend to implement changes in a way that benefits both the company and its shareholders. As the SEC solicits input on new issues, boards should also consider discussing with management whether the company intends to

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At the outset of the disclosure effectiveness initiative, the SEC emphasized its belief that many companies could improve their disclosure under the current rules through more focus on material and relevant matters, eliminating redundant disclosures and tailoring generic disclosures to the company's facts and circumstances.

engage in the public comment process. In this regard, boards may consider discussing the following questions with management:

- Does the board have sufficient transparency into the company's assessment of the impact of proposed changes and implementation efforts and the challenges related to new reporting requirements?

Boards could also use these developments as an opportunity to discuss with management whether it has considered if the company's disclosure could be improved, even absent rule changes. At the outset of the disclosure effectiveness initiative, the SEC emphasized its belief that many companies could improve their disclosure under the current rules through more focus on material and relevant matters, eliminating redundant disclosures and tailoring generic disclosures to the company's facts and circumstances.

### Cybersecurity disclosure

In 2019, the SEC is expected to continue to focus on how cyber risks affect all parts of the capital markets. For public companies, this focus likely will be consistent with updated guidance the SEC issued in February 2018 regarding public companies' disclosure obligations related to matters involving cybersecurity risk and incidents, as well as the importance of cybersecurity policies and procedures.

That guidance emphasized that the frequency, magnitude, and cost of cybersecurity incidents make it important for companies to take steps to ensure they are informing investors about material cybersecurity risks, even if they have not yet been the target of a cyberattack. The guidance also addressed the importance of controls related to the identification and escalation of a cybersecurity incident to the appropriate levels within an organization, as well as the need to address cybersecurity incidents in insider trading policies.

More recently, in October, the SEC released an investigative report<sup>3</sup> that cautioned companies to consider cyber threats when they are implementing their internal accounting controls. The report focuses on the internal accounting controls of nine issuers that were victims of variants of schemes involving spoofed or compromised electronic communications from persons purporting to be company executives or vendors, commonly referred to as business email compromise scams.

The February guidance specifically addressed the importance of board involvement, stating "disclosures regarding a company's cybersecurity risk management program and how the board of directors engages with management on cybersecurity issues allow investors to assess how a

<sup>3</sup>SEC Investigative Report Release No. 84429, *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*, Oct. 16, 2018.

<sup>4</sup>US Securities and Exchange Commission, *Commission Statement and Guidance on Public Company Cybersecurity Disclosures*, Feb. 26, 2018.

board of directors is discharging its risk oversight responsibility in this increasingly important area.”<sup>4</sup>

Consistent with this focus by the SEC, boards are encouraged to not only understand the cyber risks their companies face, the controls in place related to those risks, and the reporting implications of those risks, but also should consider the importance of communicating to investors the board’s role in overseeing these risks. Accordingly, board members may consider asking the following questions:

- Does the company’s cybersecurity planning include consideration of timely disclosure of cyber-related issues?
- How timely and in what manner are cybersecurity incidents communicated to the board?
- Is there appropriate disclosure of the board’s role in the oversight of cybersecurity risk?

### **Implementation of new accounting and auditing standards**

After the significant effort to adopt changes to revenue recognition, many companies immediately turned their attention to the implementation of other new standards, including accounting for leases and current expected credit losses, which for public companies are to be adopted in 2019 and 2020, respectively. Based on observations of companies’ adoption of the revenue standard, the SEC staff has been publicly discussing its views on key adoption activities, including the need to focus on internal control considerations and disclosure obligations, including transition disclosure.

The SEC has also emphasized the important role of the audit committee in promoting an environment for management’s successful implementation of the new standards. It has specifically noted that audit committees should play a role in overseeing companies’ implementation, in order to help ensure that issues are identified and resolved in a timely manner.

In addition to the recently issued accounting standards, boards and their audit committees should also be aware of the Public Company Accounting Oversight Board’s new standard for the auditor’s report. The new standard is intended to make the auditor’s report more informative and relevant to investors.

A number of changes to the form of the auditor’s report have already gone into effect, but the most significant change—the identification and communication of critical audit matters (CAMs)—will begin to phase in for large accelerated filers in 2019, with the first such reports due for fiscal years ending on or after June 30, 2019.

CAMs are defined as any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that

- relates to accounts or disclosures that are material to the financial statements; and
- involves especially challenging, subjective, or complex auditor judgment.

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Audit committees are encouraged to engage with their auditor to understand when it will begin reporting CAMS related to the company's audit and what the reporting may look like for their company, and should keep the full board apprised as appropriate.



#### Views on SEC proxy processes and rules

The SEC hosted a roundtable on November 15, 2018, to hear views from different perspectives on a number of the commission's proxy process and rules, including these:

- **Proxy voting mechanics and technology:** panellists discussed current proxy voting issues, such as voting accuracy, transparency, and efficiency, as well as universal proxy cards. Participants shared ideas on how to improve in these areas, including by leveraging technology.
- **The shareholder proposal process:** the discussion centered on the appropriate ownership thresholds for shareholder proposals, as well as the potential benefits of additional guidance from the SEC regarding the determination to grant or refuse no-action relief to companies seeking to exclude a shareholder proposal.
- **The role of proxy advisory firms:** participants also discussed the extent to which proxy advisory firms influence voting decisions, how the firms address potential conflicts of interest in their business model, and the value of their proxy research.

In announcing the roundtable, Chairman Clayton noted that "[Shareholder engagement](#) is a hallmark of our public capital markets, and the proxy process is a fundamental component of that engagement." After considering the input from the roundtable, the SEC may consider whether to refine its rules and processes in this area.

Audit committees are encouraged to engage with their auditor to understand when it will begin reporting CAMs related to the company's audit and what the reporting may look like for their company, and should keep the full board apprised as appropriate.

More generally, boards should ensure that management has sufficient resources focused on the implementation of new standards and the related controls, and should discuss with management how the new standards may affect the company's disclosure. Boards may consider asking the following questions:

- Does the company have sufficient resources to implement new accounting standards and related internal controls?
- Has the external auditor discussed any key changes in auditing standards, including the implementation of CAMs, with management and the audit committee?

## Proxy issues

Heading into the 2019 proxy season, boards should also be aware of the SEC's recent focus on proxy-related issues. In addition to understanding the potential effect on their companies of any changes to the proxy process, boards should consider how the governance disclosure in a company's proxy compares to its peers. For example, in recent years, Deloitte has tracked S&P 100 companies' proxy disclosures and observed a trend toward more robust voluntary disclosure around the audit committee's oversight of the independent auditor and related issues. In engaging with management on the company's proxy process, the board may consider asking this question:

- Has the board recently taken a fresh look at the governance disclosure in the proxy and compared it to the proxy disclosure trends of its peers?

The SEC has frequently stressed the importance of board involvement and oversight in financial and securities-related matters. It is likely that 2019 will continue to bring regulatory change to public companies. As such, boards will need to stay vigilant and ensure that there are adequate policies and mechanisms in place to keep directors informed of these regulatory developments, and they will need to understand how management intends to address them.



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