Corporate Governance Hot Topics

Quarterly Update (October 2019)

Boardroom Buzz

Three topics that are top-of-mind for directors this quarter:

- ➔ The Business Roundtable's Statement on the Purpose of a Corporation: New business or old business?
- ➔ The current political landscape for share buybacks: Will the 2020 election change the shareholder activism landscape?
- ➔ Directors' personal liability for regulatory compliance oversight: How much compliance policing must boards do?

1. Regulatory Developments

- **SEC Announces Changes to Rule 14a-8 No-Action Request Process:** On September 6, 2019, the SEC's Division of Corporation Finance announced that, beginning with the 2019-2020 shareholder proposal season, the Staff may respond orally instead of in writing to some no-action requests, and intends to issue written responses where it believes doing so would provide value. The Staff explained that if it chooses to respond orally, it will inform the company and the proponent of its response, which could be that the Staff concurs, disagrees or declines to state a view with respect to the company's asserted basis for exclusion, and that, if the Staff declines to state its view, it should not be interpreted as indicating that the proposal must be included in the company's proxy materials. The SEC's announcement is available here.

- **SEC Takes First Step on Proxy Reform:** On August 21, 2019, the SEC took the first step in implementing its previously announced agenda for proxy reform, issuing two releases aimed at improving the accountability of proxy advisory firms and the investment advisors who rely on them. In the releases, the SEC confirmed the proxy voting responsibilities of investment advisors and clarified that the federal proxy rules apply to proxy voting advice. The full text of the two SEC releases is available here and here, respectively, and the Sullivan & Cromwell memorandum summarizing the releases is available here.

- **SEC Proposes Changes to Regulation S-K Disclosure Requirements:** On August 8, 2019, the SEC proposed amendments to disclosure of business, legal proceedings and risk factors under Regulation S-K as part of its ongoing initiative to update and modernize its disclosure requirements. The proposed amendments provide a more principles-based approach to disclosure that gives companies greater flexibility in determining what disclosures are necessary. The proposed amendments also seek to require companies to disclose material information about human capital resources, a topic which has received increased attention from investors and other stakeholders in the last few years. Notably absent from the proposed amendments are disclosure requirements specifically related to climate risks, which regulators and investors have urged the SEC to consider in light of the growing importance of climate change to companies. This push for more regulated, standardized sustainability disclosures comes at a time when companies are increasingly making voluntary sustainability disclosures. The full text of the proposed rule amendments is available here.

- **SEC Issues Enforcement Action for Regulation FD Violations:** On August 20, 2019, the SEC announced that it had charged TherapeuticsMD with violations of Regulation FD based on the company's selective disclosure of material, nonpublic information to sell-side research analysts. The SEC issued a cease-and-desist order against the company and imposed a $200,000 penalty. This case represents the SEC's first stand-alone Regulation FD action in six years and may signal a renewed focus on Regulation FD enforcement. The SEC's press release announcing the charges is available here, and the full text of the cease-and-desist order is available here.

- **IAC Recommends Further Proxy Plumbing Improvements:** On September 5, 2019, the Investor Advisory Committee of the SEC issued a written statement to the SEC recommending four "short-term" improvements to the following areas of proxy plumbing: (i) end-to-end confirmation; (ii) reconciling ownership and voting information; (iii) shareholder identity and share lending; and (iv) adopting the universal proxy rule. The Committee had previously recommended that the SEC adopt the universal proxy system for contested elections back in 2013, which resulted in the SEC proposing rules to require their use in 2016. The proposed rule was never acted on after it received significant corporate opposition based on concerns that universal proxies might increase proxy contests by favoring dissidents. However, the Committee notes that such opposition has diminished significantly after evidence has emerged that a universal proxy does not in fact favor dissidents. This recommendation comes a few months after the Rice brothers took control of EQT Corporation in a proxy contest involving the first successful use of a universal proxy card for a control slate of directors in the U.S. The full text of the Committee's recommendations is available here.

- **FTC Settlement with Facebook Over Privacy Policies Imposes Unprecedented Penalties and Restrictions:** On July 24, 2019, the FTC announced the settlement of its investigation into the privacy practices of Facebook, Inc., arising from the Cambridge Analytica scandal, in which Cambridge Analytica, a British political consulting firm, as well as other app developers, were permitted to harvest personal information from Facebook users without their consent. The FTC alleged that Facebook deceived users about its data-sharing and privacy policies, and that its conduct violated an existing consent order from 2012 that prohibited Facebook from misrepresenting the extent to which users could keep their personal information private. As part of the settlement, Facebook has agreed to pay a record-breaking $5 billion penalty, restructure its privacy program and submit to independent monitoring of that program by a third party. The FTC press release announcing the settlement is available here and a Sullivan & Cromwell memorandum on the topic is available here.

- **DOJ Issues Guidance on the Evaluation of Antitrust Compliance Programs:** On July 11, 2019, Assistant Attorney General Makan Delrahim announced that the DOJ's Antitrust Division has decided to reverse its long-standing policy of insisting on guilty pleas for companies involved in criminal violations of the antitrust laws that do not otherwise qualify for leniency under the Division's Corporate Leniency Policy. This shift opens a new path to a potential deferred prosecution agreement for companies with "effective" antitrust compliance programs, measured under new guidance issued by the Division for evaluating such programs. As a result, the Division will now consider the adequacy and effectiveness of a company's antitrust compliance program when making its charging decisions. Delrahim's remarks are available here and a Sullivan & Cromwell memorandum on the topic is available here.

- **SEC Hedging Policy Disclosure Rules Take Effect:** The SEC's previously adopted hedging policy disclosure rule, which requires companies to disclose in their proxy statements for director elections any practices or policies regarding the ability of employees, officers or directors to engage in certain hedging transactions with respect to the company's securities, took effect on July 1, 2019. If a company does not have any such practices or policies, it must disclose that fact or state that hedging transactions are generally permitted. The full text of the final rule is available here.

2. Legislative Developments

- **State Initiatives to Increase Diversity on Boards Continue but May Face Challenges:** On August 27, 2019, the Illinois General Assembly passed a bill requiring publicly traded companies with principal offices in Illinois to report to the Secretary of State the number of women and minorities on their boards, as well as plans to promote diversity in the company. The bill also requires the University of Illinois to study the reported data and publicly publish a rating on each company's efforts to increase their board diversity. Similar bills have been introduced in New York and Maryland seeking to require boards to disclose the gender and/or racial diversity of their boards while bills seeking to mandate gender diversity have been introduced in Michigan, New Jersey and Pennsylvania. It remains to be seen whether such bills will pass, particularly in light of a recently filed lawsuit seeking to prevent the implementation and enforcement of California's gender diversity bill, which served as the model for each of these bills. The full text of the Illinois law is available here. The complaint challenging the California law is available here.

- **New York Enacts the Stop Hacks and Improve Electronic Data Security Act:** On July 25, 2019, New York's Stop Hacks and Improve Electronic Data Security Act ("SHIELD Act") was signed into law. The SHIELD Act amends the New York statute covering notification requirements for unauthorized acquisitions of private information and adds new requirements for businesses and persons that own or license private information of a New York resident to comply with reasonable data security protections. The full text of the bill is available here and the Sullivan & Cromwell memorandum on the topic is available here.

3. Litigation Developments

- **Delaware Courts Emphasize the Importance of *Caremark* Duties:** Two recent Delaware cases have reemphasized the importance of *Caremark* duties, which require directors, in order to satisfy their duty of loyalty, to make a good faith effort to oversee their company's operations by implementing board-level oversight and monitoring. On June 19, 2019, in *Marchand* v. *Barnhill*, the Delaware Supreme

Court held that directors may be found to have breached their duty of loyalty under *Caremark* if there is no board-level system in place for monitoring and reporting on key risks and compliance issues facing the company. Then, on October 1, 2019, the Delaware Court of Chancery in *In re Clovis Oncology, Inc.*, declined to dismiss a stockholder derivative suit on *Caremark* grounds after finding that, although the board had established a robust board-level compliance system with respect to clinical trials, it had consciously failed to monitor that system by ignoring clear red flags. In light of these cases, directors should ensure that their companies have reasonable compliance systems and protocols in place with respect to the key risks facing their companies and that they provide direction for managing and addressing key risks once identified. The full text of the *Marchand* case is available here and the Sullivan & Cromwell memorandum on the topic is available here. The full text of the *Clovis Oncology* case is available here, and the Sullivan & Cromwell memorandum on the topic is available here.

- **Court of Chancery Emphasizes the Importance of Reasonable Advance Notice Bylaws Requirements:** On August 14, 2019, in *Bay Capital Finance, LLC* v. *Barnes and Noble Education Inc.*, the Delaware Court of Chancery upheld the validity of an advance notice bylaw provision, and thereby precluded an activist from nominating a slate of directors based on the activist's failure to comply with the plain terms of the bylaw, which required the activist to be a stockholder of record in order to submit a notice of nomination. The court held that, because the activist owned shares only in "street name" on the advance notice deadline, its notice was defective and not timely and therefore could be disregarded by the company. While this case is consistent with Delaware case law upholding the validity of reasonable advance notice bylaws, another decision by the Delaware Court of Chancery emphasizes that such bylaws will not be enforced if they "unduly restrict the stockholder franchise or are applied inequitably." In that case, titled *Saba Capital* v. *BlackRock Credit Allocation Income Trust*, the court interpreted an advance notice bylaw to prevent a company from being able to disqualify an activist's board slate through the use of an onerous, overbroad questionnaire with an unreasonable deadline (*i.e.*, a 47-page, 100-question supplemental questionnaire that was due in five business days). The full text of the *Bay Capital* opinion is available here, and the full text of the *Saba* opinion is available here.

4. Corporate Governance, Surveys, Policies and Reports

- **S&C 2019 Proxy Season Review:** On July 12, 2019, Sullivan & Cromwell released a three-part 2019 Proxy Season Review memoranda, which summarizes significant developments related to the 2019 U.S. annual meeting proxy season including with respect to shareholder proposals, ISS negative recommendations and compensation-related matters. Among other things, the review found that there is growing shareholder support for ESP proposals and more detailed compensation plans and that employee activism (*e.g.*, walkouts and shareholder proposals) as a way to agitate for corporate change is also on the rise. In line with the growing focus on ESP proposals, several companies have added language to securities filings warning investors about the possible impact of gun violence. Part one of the 2019 Proxy Season Review, discussing key developments relating to Rule 14a-8 shareholder proposals is available here. Part two, discussing ISS negative vote recommendations, is available here. Part three, discussing compensation-related matters, is available here.

- **Business Roundtable Redefines the Purpose of a Corporation:** On August 19, 2019, the Business Roundtable adopted a new statement of purpose for corporations, signed by over 181 well-known CEOs, which calls for companies to serve all stakeholders, not just shareholders, by delivering value to customers, investing in employees, dealing fairly and ethically with suppliers, supporting the communities in which they operate and protecting the environment. The Business Roundtable

statement of purpose is available here and the Sullivan & Cromwell memorandum on the topic is available here.

- **ISS Releases Proposed Voting Policies for the 2020 Proxy Season:** On October 7, 2019, ISS released its proposed benchmark voting policies for the 2020 proxy season, which, for U.S. companies, included changes relating to sunset provisions for multi-class voting structures, share repurchase programs and independent board chair proposals. These changes came a month after ISS released the results of its 2019 Global Policy Survey pursuant to which ISS sought feedback from institutional investors, public companies, corporate directors and other stakeholders on emerging trends in corporate governance, executive compensation and other matters. Among other things, the survey found that a majority of both investor and non-investor respondents agree that gender diversity is an essential attribute of effective board governance for all companies and that a majority of investor respondents believe that companies should assess, disclose and mitigate climate risks, but that the respondents diverged in their views on director overboarding, combined CEO/Chair roles and the appropriateness of sunset provisions for multi-class capital structures. The full text of the ISS benchmark voting policy, which is open for comment until October 18, 2019, is available here, the full text of its 2019 global policy survey is available here and the Sullivan & Cromwell memorandum on the topic is available here.

- **ISS Releases Report on U.S. Board Diversity Trends in 2019:** On June 18, 2019, ISS released a new report detailing board diversity and director nomination trends. In general, the report found that board refreshment and diversity continue to increase, demonstrating that boards are continuing to view these areas as high-priority issues. The report also found boards are appointing more directors with non-traditional skillsets and qualifications (*e.g.*, sustainability, human resources and international expertise), likely as a result of the growing attention being paid to corporate data security and ESP practices. The full text of the ISS report is available here.

- **EY Releases Report on Audit Committee Disclosures:** On August 27, 2019, the EY Center for Board Matters released a five-page report analyzing voluntary audit committee proxy statement disclosures of Fortune 100 companies in 2019. The report found that audit committees continue to increase the amount of disclosures they are providing to shareholders across a wide variety of categories, including the role of the audit committee in selecting the lead auditor and the factors used by the committee when assessing the auditor's independence and qualifications. Looking ahead, EY anticipates more audit-related disclosures as PCAOB's CAM requirements take effect. The full text of the EY report is available here.

- **Chief Justice Leo Strine Proposes Corporate Governance Overhaul:** On October 1, 2019, Delaware Supreme Court Chief Justice Leo Strine released a proposal seeking to reform the American corporate governance system by aligning the incentives of those who control and influence large U.S. corporations (including corporate managers, directors and institutional investors) with the interests of worker-investors. Among other things, Chief Justice Strine calls on corporations to create board-level committees focused on the fair treatment of employees and to increase transparency on how they treat their employees. Emphasizing the importance of institutional investors in shaping corporate governance, the proposal also urges and seeks to incentivize institutional investors to consider the "economic and human interests" of their clients (who are usually worker-investors) by having corporations create quality jobs and act ethically and responsibly toward their consumers and the environment when making voting decisions, including by suggesting certain modifications to the tax laws. The full text of Chief Justice Strine's proposal is available here.

5. Proxy Advisory and Institutional Investor Updates

- **BlackRock Releases Its Quarterly Engagement and Voting Numbers:** On June 30, 2019, BlackRock released its Investment Stewardship Report for the Americas for the second quarter of 2019. Based on the report, BlackRock has engaged with fewer companies and has voted against managements' recommendations more frequently than it did during the same period in 2018. Governance issues were the most frequently discussed topics during BlackRock's engagements, followed by environmental and social issues. The themes covered during these engagements were consistent with BlackRock's 2019 focus areas included in CEO Larry Fink's annual letter to the CEOs of public companies, available here, including board diversity and effectiveness, compensation that promotes long-termism, corporate strategy and capital allocation, governance structures and climate risks. The full text of the Investment Stewardship Report is available here.

- **BlackRock Releases Report Downplaying the Role of Institutional Investors in Voting Decisions:** On July 24, 2019, BlackRock released a report discussing the impact of institutional investors on director elections, say-on-pay, M&A-related votes and shareholder proposals. Notably, the report states that the view that asset managers are determining the outcome of proxy votes is not supported by the data. According to the report, the vast majority of ballot items are won or lost by margins greater than 30%, meaning that even the three largest asset managers combined could not change the vote outcome. This report comes at a time when investors, regulators and other stakeholders are increasingly pushing for ways to better align institutional investors' investing and voting behavior with their clients' interests due to the significant influence the largest asset managers have on proxy voting outcomes. For example, James McRitchie recently submitted an SEC rulemaking petition seeking to amend the SEC's proxy voting record disclosure requirements to require real-time disclosure of mutual funds' proxy voting records in a user-friendly format in order to enable investors to easily compare each fund's voting record and invest in funds that vote in alignment with their values. The full text of BlackRock's report is available here and the full text of the SEC rulemaking petition is available here.