Corporate Governance Hot Topics

Quarterly Update (August 4, 2017)

1. S&C 2017 Proxy Review Publication

- On July 17, 2017, Sullivan & Cromwell LLP published its annual comprehensive review of notable developments occurring during the 2017 annual meeting season. These include the following, which are discussed in more detail in the publication:
  - **Continued acceptance of proxy access leads to fewer proposals.** Fewer proposals to adopt new proxy access provisions came to a vote in 2017, largely because most companies that received such a proposal reacted by adopting a proxy access bylaw with terms consistent with market practice (*i.e.*, 3% ownership for three years, director cap of 20% of the board but no less than two, and a group limit of 20 shareholders). The proposals that did come to a vote generally passed.
  - **Attempts to amend proxy access terms were unsuccessful.** Nearly half the proxy access proposals that were voted on in 2017 sought to amend previously adopted proxy access bylaws, often to remove or loosen restrictions on group size. These have all failed.
  - **Continued focus on independent chair.** Proposals for the board to have an independent chair remained common and, as in the past, generally received significant support from shareholders (25-40%). However, once again, none of these proposals passed, confirming that shareholders are generally satisfied that a sufficiently empowered lead independent director can offset having a combined CEO and chair role.
  - **Greater focus on board diversity.** Board diversity—in particular, the inclusion of women on boards—received significant attention in 2017, including through institutional investor policies, shareholder proposals, company proxy disclosure and non-binding state legislative resolutions. This is likely to be a topic of continued focus in 2018.
  - **Social/political proposals remain common, but rarely pass.** Social policy proposals were dominated by those relating to environmental issues and to political contributions and lobbying, with proposals on gender pay equity on the rise. These proposals continue to be common, but rarely pass, though environmental proposals have increased in both number and support levels, and several relating to climate change passed at energy companies.
  - **Near elimination of compensation-related proposals.** Executive compensation-related shareholder proposals declined to a negligible amount, continuing a trend that began once mandatory say-on-pay became the main focus of executive compensation concerns.
  - **"Withhold" or "against" votes for directors.** Our analysis of negative recommendations on uncontested director elections by Institutional Shareholder Services demonstrates that new ISS policies to vote against directors at newly public companies with adverse governance provisions and at companies where shareholders cannot amend the bylaws yielded many negative

recommendations, but did not have a very significant impact on the election of directors. As in past years, directors who are seen as insufficiently responsive to a prior shareholder vote and directors with poor attendance suffer the greatest impact from a negative ISS recommendation.

- **Move toward annual say-on-pay votes.** Most companies had their second advisory vote on say-on-pay frequency in 2017, and the preference for annual votes over biennial or triennial votes was further solidified.
- **Continued strength on say-on-pay.** Public companies continued to perform strongly on say-on-pay, with support levels averaging over 90% and less than 1% of companies getting less than majority support. Our analysis of ISS negative recommendations on say-on-pay supports the continued importance of a pay-for-performance model, including performance standards that are clearly explained and deemed sufficiently rigorous by ISS.
- **Broad shareholder support for equity compensation plans.** Very few companies, and no S&P 500 companies, failed to get shareholder approval for an equity compensation plan, and overall support levels continued to average around 90%.
- The director elections discussed in the recent publication are uncontested elections at annual meetings. For a discussion of proxy contests and other shareholder activist campaigns, see our publication, dated November 28, 2016, entitled "2016 U.S. Shareholder Activism Review and Analysis."

2. Corporate Governance Policies and Reports

- **EY Report on Environmental, Social and Governance Reporting:** EY released its annual report on Environmental, Social and Governance practices ("ESG") and nonfinancial reporting on April 21, 2017. The report concluded that there is a global trend toward increased interest in nonfinancial information and also included a survey demonstrating investor dissatisfaction with the current ESG disclosures of global companies. For example, the survey found broad support for ESG-related themes that BlackRock chairman Larry Fink expressed in a February 2017 memorandum. More than 80% of the survey respondents agreed with four statements related to Fink's points: that CEOs should lay out long-term board-reviewed strategies each year; that companies have not considered environmental and social issues as core to their business for far too long; that generating sustainable returns over time requires a sharper focus on ESG factors; and that ESG issues have real and quantifiable impacts over the long term.

- **BlackRock's 2017-2018 Engagement Priorities:** In addition to more traditional priorities such as the interaction of executive compensation with long-term strategic goals and long-term corporate strategy, BlackRock's 2017-2018 Engagement Priorities emphasize its intent to engage with companies on issues such as board gender diversity and competency with respect to climate risk (where applicable). Specifically, BlackRock warned that it will hold nominating and/or governance committees accountable if a company does not make progress on diversity initiatives "within a reasonable time frame." BlackRock has published its Q2 2017 Investment Stewardship Report for the Americas, which highlights the extent to which climate risk and board gender diversity were, in fact, a focus of

BlackRock's engagement issues.

- **State Street Board Engagement:** In a March 2017 speech at the University of Delaware's Weinberg Center 2017 Corporate Governance Symposium, State Street Global Advisors (SSGA) President and CEO Ron O'Hanley expressly called on companies in which SSGA invests to increase the number of women on their boards, citing a study for the proposition that a full quarter of Russell 3000 companies do not have a single woman on their boards. The guidance indicated that SSGA will engage directly with companies to encourage the addition of more female directors and are prepared to vote against nominating committee chairs of boards that fail to do so. Mr. O'Hanley also stated that SSGA expects boards to actively think about ESG as a risk factor, and made environmental and social sustainability the focus of SSGA's 2017 asset stewardship engagement.

- **Investor Stewardship Group (ISG) Releases Corporate Governance and Stewardship Principles:** ISG, a collective of some of the largest U.S.-based institutional investors and global asset managers, released policy statements in February 2017 that set forth principles that ISG believes are fundamental to investor stewardship and to good corporate governance at U.S.-listed companies. With respect to corporate governance, ISG articulated the following principles: boards are accountable to shareholders; shareholders should be entitled to voting rights in proportion to their economic interest; boards should be responsive to shareholders and be proactive in order to understand their perspectives; boards should have a strong, independent leadership structure; boards should adopt structures and practices that enhance their effectiveness; and boards should develop management incentive structures that are aligned with the long-term strategy of the company.

- **U.S. Chamber of Commerce Recommendations on Shareholder Proposal Reform:** On July 25, 2017, the U.S. Chamber of Commerce's Center for Capital Market Competitiveness published Shareholder Proposal Reform: The Need to Protect Investors and Promote the Long-Term Value of Public Companies, which includes a number of recommendations to the SEC on changes to the Rule 14a-8 system, which the Chamber believes has "unnecessarily devolved into a mechanism that a minority of interests uses to advance idiosyncratic agendas that come at the expense of other shareholders." These recommendations include increasing the resubmission thresholds, requiring proponents to disclose their economic interests and objectives, and providing for broader or clearer guidance on several substantive bases for exclusion, including those relating to conflicting proposals, relevance and personal grievances.

3. Proxy Access Update

- **Fidelity Funds Reverse Stance on Proxy Access:** In January, the Fidelity Funds amended their proxy voting guidelines, indicating that they will no longer automatically vote against management and shareholder proposals to adopt proxy access, but will evaluate them on a case-by-case basis. The guidelines indicate that Fidelity generally will vote in favor of proposals that provide for: ownership thresholds of at least three percent (five, in the case of small-cap issuers); three-year holding periods; the number of shareholder nominees to be twenty percent of the board; and a limit of twenty shareholders that may aggregate their shares to form a nominating group.

- **SEC Staff Rejects Exclusion of Proposal for Unlimited Group Size in H&R Block**: On July 21, 2017, the SEC staff declined to issue no-action relief on substantial implementation grounds for a proposal requesting that H&R Block amend its proxy access bylaw to remove the 20-investor limit on group size for purposes of aggregating shares. As discussed in the S&C 2017 Proxy Season Review described in Item 1 above, in a number of letters issued on March 2, 2017, the SEC staff allowed the exclusion of proposals seeking to change the 20-investor limit to a 50-investor limit, based on quantitative analyses provided by companies showing that, given the size and duration of their shareholders' holdings, the proposal would not significantly change the availability of proxy access. The H&R Block letter suggests that, while the specific analysis will vary from company to company based on its particular shareholder base, it may be more difficult to exclude proposals that call for a total elimination of any group limit, as opposed to just an increase in group size. This may lead to more proposals of this type being submitted to companies, though as discussed in the S&C 2017 Proxy Season Review, none of the proposals to amend proxy access terms that has gone to a vote in 2017 so far has received majority support.

4. Public Company Updates

- **No-vote Common Stock**: Snap Inc. went public on March 2, 2017, becoming the largest tech IPO since that of Ali Baba in 2014. The Snap shares issued to the public had no voting rights at all. Its NYSE listing was the first for no-vote common stock since 1926 and caused a number of corporate governance advocates, including investor groups, institutional investors, proxy advisory firms and the SEC Investor Advisory Committee, to voice concerns.

  Recently, both S&P Dow Jones and FTSE Russell indicated that companies whose public shareholders have limited voting rights will no longer be eligible for inclusion in their most popular indices:

  - S&P announced on July 31 that, going forward, the S&P 500, S&P 600 and S&P 400 indices will no longer admit companies with "multiple share class structures." This would include companies like Snap that do not have voting stock held by public shareholders and companies that have the more common dual-class structure with insiders holding supervoting stock. Existing dual-class constituent companies, such as Facebook and Alphabet, would be grandfathered in. The new policy will not affect the S&P Global BMI Indices and S&P Total Market Index, which are intended to "represent the investment universe."
  - On July 26, 2017, FTSE Russell announced that it would bar companies from inclusion in its indices, including the Russell-3000, unless at least 5% of the voting rights are in the hands of unrestricted (free-float) shareholders. This would include Snap and companies like Blue Apron, which went public in June 2017 with less than 2% of voting rights held by public shareholders. Existing index constituents will have a five-year grace period to conform their voting structure.

  Other corporate governance discussion around the no-vote stock structure included the following:

  - The Council of Institutional Investors ("CII") raised the issue of whether no-vote shares should even be listed on a public exchange, arguing that such shares are more akin to preferred stock or derivatives than to voting common stock. CII argued that U.S.-based stock exchanges should:

- bar future no-vote share classes; require true and reasonable sunset provisions for differential common stock voting rights (that cannot be overridden by the controlling shareholder, as often happens in CII's view); and consider enhanced board requirements for dual-class companies to build greater confidence that boards can challenge founder managers or a controlling family.
- Proxy advisory firms, who have made their displeasure with dual-class initial public offerings clear, also commented on the no-vote shares. For example, ISS argued that companies with dual-class structures perform worse, have weaker internal controls and generate higher executive pay.
- The SEC Investor Advisory Committee discussed the no-vote shares at its quarterly meeting on March 9, 2017, including whether no-vote shares are entitled to the same level of disclosure as voting shares.

- **Auditor's Reports**: On June 1, 2017, the Public Company Accounting Oversight Board adopted Auditing Standard No. 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and related amendments to its auditing standards that are intended to make the auditor's report more informative and relevant to investors and other financial statement users by requiring new information about the audit. Most notably, the new standard, which was adopted substantially in the form reproposed in May 2016, adds a requirement for the auditor to identify and discuss, in the audit report, "critical audit matters" that were addressed in the audit. The S&C memorandum discussing the new auditing standard is available here.

5. Regulatory Developments

- **Financial CHOICE Act of 2017**: On June 8, 2017, the U.S. House of Representatives passed H.R. 10, the "Financial CHOICE Act of 2017," a Republican proposal that would substantially restructure the post-crisis regulatory framework and provide significant regulatory relief to certain highly capitalized banking organizations. See S&C's full memorandum here and the bill here.

- **Confidential Submission of Registration Statements Expanded**: On June 29, 2017, the SEC announced that the Division of Corporation Finance will permit all companies to confidentially submit draft registration statements for review in connection with initial public offerings, similar to the accommodation available to emerging growth companies ("EGCs") under the Jumpstart Our Business Startups Act (the "JOBS Act"). The expanded confidential submission process, which takes effect on July 10, 2017, will also apply to follow-on offerings made within one year of the effective date of an initial registration statement. The Division's announcement also permits non-EGC filers to omit financial information that the filer reasonably believes will not be required at the time the registration statement is publicly filed, consistent with the relief available to EGCs under the JOBS Act. In announcing the new policy, SEC Chair Jay Clayton stated that the SEC was "striving for efficiency in [its] processes to encourage more companies to consider going public, which can result in more choices for investors, job creation and a stronger U.S. economy." The S&C memorandum discussing the expansion of the confidential submission process is available here.

- **Department of Justice Releases List of Factors to Evaluate Compliance Programs**: The DOJ recently released a list of factors for use in compliance program evaluations, specifically with respect to whether to bring charges against or settle with a noncompliant corporation. The document included eleven specific topic areas to be considered, namely, analysis and remediation of underlying misconduct; senior and middle management; autonomy and resources; policies and procedures; risk assessment; training and communications; confidential reporting and investigation; incentives and disciplinary measures; continuous improvement, periodic testing and review; third-party management; and mergers and acquisitions. The full publication is available here.

- **Non-GAAP Financial Measures**: In May 2016, the SEC's Division of Corporate Finance issued new guidance in the form of Compliance and Disclosure Interpretations, or C&DIs, identifying a number of potentially problematic uses of non-GAAP financial measures. This 2016 guidance evidenced a more restrictive stance by the SEC staff, particularly as compared to SEC staff guidance issued in 2010 that was widely viewed as permitting greater flexibility. The 2016 guidance was also accompanied by public statements by SEC staff members as to their intent to increase scrutiny of non-GAAP measures used in SEC filings. To date, the SEC staff has publicly released close to 300 comment letters (containing over 500 comments) to nearly 250 companies challenging the calculation and presentation of non-GAAP financial measures in filings made subsequent to the issuance of this guidance. Based on our analysis of these comment letters, we have identified a number of areas of SEC staff focus during this period, in descending order of frequency:

    - failure to present GAAP measure with equal or greater prominence (C&DI 102.10)
    - inadequate explanation of usefulness of non-GAAP measure
    - misleading adjustments, such as exclusion of normal, recurring cash expenses (C&DI 100.01)
    - inadequate presentation of income tax effects of non-GAAP measure (C&DI 102.11)
    - individually tailored revenue recognition or measurement methods (C&DI 100.04)
    - misleading title or description of non-GAAP measure
    - use of per share liquidity measures (C&DI 102.05)

    As indicated above, five of these areas relate specifically to concerns addressed by the May 2016 guidance (with the comments usually citing the relevant C&DI), while the other two reflect continued focus on issues (explanation of usefulness and misleading titles) that have long been the subject of staff comment. This analysis suggests that the staff's efforts to monitor and enforce compliance with its May 2016 guidance is expanding, rather than replacing, its traditional areas of focus regarding non-GAAP measures.

    The S&C memorandum discussing the comment letters, and the challenges to non-GAAP financial measures therein, is available here.

6. Selected Case Law Developments

- ***Verble* v. *Morgan Stanley Smith Barney, LLC* – Supreme Court Declines to Resolve Circuit Split on SEC Whistleblowing**: In March 2017 the Supreme Court declined to resolve a split between the Fifth Circuit on the one hand (which held that Dodd-Frank protects only those whistleblowers that report misconduct to the SEC) and the Second and Ninth Circuits on the other hand (which held that Dodd-Frank also protects whistleblowers who only report internally).

- **Odebrecht SA Receives $2.6 Billion FCPA Fine**: On April 17, 2017, a federal judge in Brooklyn ordered Odebrecht SA to pay $2.6 billion to the governments of the United States, Brazil and Switzerland for violations of the Foreign Corrupt Practices Act ("FCPA"). Additionally, the order requires the company to retain an independent compliance monitor for three years. Odebrecht and its affiliate Braskem SA pled guilty in December 2016 to conspiracy to violate the FCPA. Notably, Odebrecht received discounts from its sentencing-guideline fine of more than $6 billion by (i) cooperating with investigators and (ii) demonstrating that the company could not pay a fine higher than $2.6 billion.

- ***Leidos, Inc.* v. *Indiana Public Retirement System***: On March 27, 2017, the U.S. Supreme Court granted *certiorari* in *Leidos, Inc.* v. *Indiana Public Retirement System*, No. 16-581. This appeal, which likely will not be decided until the first half of 2018 at the earliest, presents the question of whether non-disclosure of "known trends or uncertainties" under Item 303 of Regulation S-K may give rise to private liability for securities fraud under Section 10(b) of the Securities Exchange Act of 1934. The U.S. Supreme Court will address a split between the Second Circuit, which has held that, under some circumstances, non-disclosure under Item 303 of Regulation S-K could give rise to private securities fraud liability, and the Third and Ninth Circuits, which held that such non-disclosure does not create a private securities fraud claim. Although the Supreme Court's decision will not affect the obligation of registrants to comply with Item 303, it may have a significant impact on their potential exposure to securities fraud claims. The S&C memorandum addressing the case, and the potential implications its resolution has for registrants, is available here.

- **Privilege Waiver Through Use of Dropbox and Similar Services:** On February 9, 2017, in *Harleysville Ins. Co.* v. *Holding Funeral Home, Inc.*, a federal court in Virginia found that a party waived the attorney-client privilege and work product protection when the party put privileged documents on a non-password-protected document-sharing site on the Internet. The plaintiff, an insurance company, had shared a claim file with its investigator and with its counsel through an online file-sharing service. In document production, the insurance company produced an email containing a confidentiality notice that had been sent to the investigator, revealing the URL of the claim file. Opposing counsel then downloaded the claim file using the URL, accessing privileged documents. The court held that the insurance company had failed to take reasonable measures to protect the confidentiality of the material, as the claim file could be accessed through the URL without a password, and thereby had waived attorney-client and work product protection. The court also sanctioned defense counsel for accessing documents that he knew were not meant to be shared with him, but did not disqualify the firm because the now unprivileged documents would be available to new counsel. The case is a useful reminder that consideration should be given to ensuring documents are secure both for confidentiality and privilege reasons.

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