Corporate Governance Hot Topics
Quarterly Update (January 25, 2017)

1. Corporate Governance Policies

- **CII Majority Voting FAQ**: On January 5, 2017, the Council of Institutional Investors issued an FAQ describing the various methods by which directors are elected and noting that only what it calls "consequential majority voting" places "ultimate authority in the hands of the company's owners". As described by CII, "consequential majority voting", which it now identifies as "best practice", not only requires an uncontested nominee to receive more 'for' votes than 'against' votes in order to be elected but also establishes a holdover period (90 to 180 days) after which an unelected director may no longer serve on the board. CII's "consequential majority voting" is stricter than the form of majority election at most S&P 500 companies, in which an incumbent holdover director who received fewer 'for' votes than 'against' votes must offer a resignation to the board, which may then choose to accept or reject it. CII stated it "currently accepts this form of majority voting if the company already has it in place, and the board has a good-faith commitment to replace unelected directors within a reasonable period of time". CII noted, however, that it viewed "plurality plus" (that is, directors being elected by a plurality but required by policy to tender a resignation for board consideration if they do not receive majority support) as a step in the right direction, but not the best way to elect uncontested directors" and encouraged plurality companies to skip plurality plus and go directly to consequential majority election. In 2016, Kenneth Steiner made a shareholder proposal at Pfizer Inc. seeking the adoption of a voting standard similar to "consequential majority voting", providing that directors failing to receive a majority vote be removed immediately, with the board able to implement a holdover period if critical to the functioning of the board. The proposal failed, receiving only 7% of the vote, with Institutional Shareholder Services opposing.

- **ISS Proxy Voting Policy Updates**: On November 21, 2016, Institutional Shareholder Services (ISS) announced updates to its benchmark proxy voting policies applicable to meetings held after February 1, 2017. For U.S. companies, the updates provide for negative vote recommendations for: directors at newly public companies that have classes of stock with unequal voting rights (or, as under existing policy, other materially adverse charter provisions such as supermajority vote requirements), absent a reasonable sunset provision and regardless of any commitment to put the provision to a shareholder vote within three years, which previously was sufficient; directors at companies that impose undue restrictions on shareholders' ability to amend the company's bylaws (relevant in the few states, particularly Maryland, that permit such restrictions); and non-CEO directors who hold more than five public company board seats (down from six). ISS also made other, less impactful changes. The updates followed ISS's release of its 2016 Annual Benchmark Voting Policy, which showed that a majority of investors favor tighter "overboarding" standards for U.S. Executive Chairs and adverse director recommendations following a dual-class initial public offering. The S&C memorandum discussing the updates is available here.

- **ISS Updates 2017 Pay-for-Performance Methodology for U.S. Companies**: Effective February 1, 2017, ISS proxy research reports will display a measure of the company's financial performance relative to peers based on a new weighted combination of six financial metrics—return on equity, return on assets, return on invested capital, revenue growth, EBITDA growth and cash flow (from operations) growth—each over a three-year period. The S&C memorandum discussing the updates is available here.

- **ISS Releases Updated Factors for QualityScore Governance Rating**: In November 2016, ISS updated its "QualityScore" governance system (previously named "QuickScore"), adding fourteen new factors and modifying the commentary following three other factors. The S&C memorandum discussing the updated factors is available here.

- **The Corporate Governance Reform and Transparency Act of 2016**: In May 2016, Representatives Sean Duffy (R-WI) and John Carney (D-DE) sponsored a bill (H.R. 5311) proposing to, among other things: require proxy advisory firms to register with the SEC; provide companies a reasonable opportunity to review draft proxy advisor recommendations; mandate that proxy advisors establish an ombudsman office to address errors in recommendations; and direct proxy advisors to disclose possible conflicts of interest. In September 2016, the Council of Institutional Investors (CII) submitted a letter, co-signed by thirty members and other organizations arguing against the bill. CII argued that, if adopted, the legislation would harm institutional investors who rely on and contract with proxy advisory firms for the firms' research, while also allowing companies substantial influence over the firms' reports.

2. Proxy Access

- **First Use of Proxy Access**: GAMCO Investors, Inc. and its affiliated funds filed a Schedule 14N in early November 2016 disclosing their nomination of a proxy access candidate for election to the board of directors of National Fuel Gas Company pursuant to the company's proxy access bylaw. The company rejected the nomination on the grounds that the funds did not satisfy the "passive investment" requirement of the Company's proxy access bylaw. The funds' nominee subsequently withdrew and the funds announced that they would not pursue proxy access.

- **Proxy Access – Substantial Implementation**: In September and October 2016, the SEC staff declined in *H&R Block*, *Microsoft*, and *Apple* to grant no-action relief on substantial implementation grounds where the shareholder was seeking to amend the terms of a previously enacted proxy access bylaw rather than seeking a new proxy access bylaw, and the company was not proposing to make further changes. The SEC staff confirmed that stance in November in *Walgreens*, *Walt Disney*, and *Whole Foods*. The companies in those three instances also advanced a new argument for exclusion; namely, that the staff should consider the proposed amendments as multiple proposals and thus that the companies should be able to exclude them under Rule 14a-8(c), which permits a shareholder to submit only one proposal per shareholder meeting. In each case, the staff rejected the argument. However, the staff granted no-action relief in *Oshkosh*, where the company amended its existing proxy access bylaw to address half the changes requested by the proponent before seeking no-action relief, including the reduction of the ownership threshold from 5% to 3%.

3. Board and Committees

- **Recent Hacking Incidents and Cyber Threats to Director Communications**: Recent hacking incidents highlight the need for public companies to review their director communication practices to ensure that they are current and that they appropriately balance security and efficiency. Public companies should periodically review their director communications practices in light of ongoing cybersecurity developments, regularly update directors on information security risks, company practices and response protocols in the event of compromise, and consider providing technology and security support for personal devices and home offices maintained by outside directors. The S&C memorandum discussing recent cybersecurity incidents, as well as potential steps for public companies to take in response to such incidents, is available here.

- **Pay Ratio Disclosure C&DIs**: In October 2016, the SEC staff issued five new C&DIs regarding the CEO pay ratio disclosure. Initial pay ratio disclosure will be required with respect to compensation for a company's first full fiscal year that begins on or after January 1, 2017. Pay ratio disclosure will require companies to disclose: the median of the annual total compensation of all employees other than the chief executive officer; the annual total compensation of the chief executive officer; and the ratio of these amounts. All of the new interpretations relate to determining the median employee for purposes of the ratio. The S&C memorandum discussing the new guidance is available here.

- **Board Composition and Dividend Payouts**: A recent study found a positive correlation between board diversity composition and the level of dividend payout, noting that an increase of ten percentage points in the fraction of female directors is associated with a 1.67 percentage point increase in the firm's dividend payout (the average dividend payout of the study's sample was 22.9%).

- **Proposed Confidential Voting Bylaw**: Frequent proponent John Chevedden has submitted proposals calling for management and the board to not have access to interim voting results on proxy matters. In numerous responses (see, for example, *Kohl's*), the SEC staff granted no-action relief pursuant to Rule 14a-8(i)(7) as relating to Kohl's ordinary business operations.

- **EY Governance Trends at Russell 2000 Companies Survey**: EY released a survey concerning governance trends at Russell 2000 companies covering the four-year period from 2012 to 2015. The survey's key findings included: Russell 2000 companies tend to have smaller, younger, and less diverse boards than S&P 500 companies; Russell 2000 companies are more likely to have an independent board chair, while S&P 500 boards are more likely to have an independent lead director; total compensation for Russell 2000 CEOs increased more rapidly than for S&P 500 CEOs; and investor opposition votes continue to be higher for Russell 2000 director nominees than for S&P 500 nominees.

4. Activism Update

- **S&C Comprehensive Review**: Shareholder activism remains a major force in corporate decision-making in 2016 but is increasingly occurring in an environment of robust, multi-faceted shareholder engagement, particularly at large companies. The total number of activist campaigns has remained high, due in large part to newer and often smaller activists targeting small and mid-size companies. The S&C 2016 U.S. Shareholder Activism Review and Analysis is available here.

- **SSGA Market Commentary**: In October 2016, State Street Global Advisors (SSGA) issued market commentary that raises concerns with companies taking actions that favor short-term interests at the expense of longer-term results, specifically in the context of settlement agreements between public companies and activists seeking board seats. SSGA set out the following concerns and observations: settlement agreements that are entered into quickly and without appropriate consultation with other shareholders deprive long-term shareholders of the opportunity to express their views; SSGA's review of the actions of the largest activists identified several red flags that raise questions about the long-term effects of activism, including increases in CEO pay and tying CEO pay to earnings per share, as well as undue focus on share buybacks, spin-offs and other financial engineering; and settlement agreements should include terms that protect the interests of long-term investors, which could include requirements that activists meet share ownership thresholds and hold shares for a defined period, and restrictions on share pledges by the activist. The S&C memorandum discussing SSGA's commentary is available here.

5. SEC Developments

- **Universal Proxy Access**: The SEC, by a 2-to-1 vote, proposed the mandatory use of universal proxy cards in all contested director elections at annual meetings of listed U.S. public companies. The proposed rule would enable stockholders in contested elections to vote by selecting directors proposed by the issuer and/or the dissident using a single proxy card to fill all available board seats. Comments on this proposal were due by January 9, 2017. Given this timing, it is unlikely that the proposed rules, if adopted, will be effective for the 2017 proxy season. S&C's discussion of the universal ballot proposal is here.

- **SEC No-Action Relief – Conflicting Shareholder Proposal**: On July 25, 2016, Medizone International, Inc. filed initial proxy materials, including a management proposal to increase the number of authorized shares of common stock by 105 million. On August 5, Medizone received a shareholder proposal to increase the number of shares available for issuance by only 55 million. Medizone sought no-action relief from the SEC staff pursuant to Rule 14a-(i)(9) on the grounds that the shareholder proposal directly conflicted with a management proposal to be submitted to the company's shareholders at the same meeting. The SEC staff concurred with the company and granted no-action relief.

- **Record SEC Enforcement**: On October 11, 2016, the SEC issued a press release announcing enforcement results for fiscal year 2016. The SEC recorded single year highs for: enforcement actions (868); Foreign Corrupt Practices Act-related enforcement actions (21); and money distributed to whistleblowers ($57 million). Overall, the agency obtained judgments and orders totaling more than $4 billion in disgorgement and penalties.

- **Non-GAAP Financial Measures**: The SEC staff issued new C&DIs in May 2016 regarding the use of non-GAAP financial measures, signaling a turn away from 2011 C&DIs in which the staff took a more liberal stance toward the use of such financial measures. The S&C memo discussing the updated C&DIs is available here. In the months following the release of the C&DIs, the SEC staff has intensified its monitoring of reporting companies' use of non-GAAP financial measures and has indicated its willingness to act through enforcement. Since May 2016, the staff has indicated concern about: the "equal or greater prominence" requirement, which requires companies to present the most comparable GAAP measures with equal to or greater prominence than the relevant non-GAAP measure; whether certain non-GAAP measures that companies denominate as performance measures are actually liquidity measures (such as Adjusted EBITDA), thereby preventing companies from presenting non-GAAP measures on a per-share basis; whether non-GAAP metrics are fully explained; and whether non-GAAP metrics are clearly labeled.

- **Contractual Interference with SEC Whistleblowers**: The SEC continues to monitor agreements that could chill whistleblower activity under Rule 21F-17. On January 17, 2017, the SEC announced a settlement with BlackRock Inc. based on separation agreements in which exiting employees waived their right to collect awards for reporting company misconduct. In September 2016, the SEC brought an action against AB InBev based on confidentiality provisions in a settlement agreement between the company and a whistleblower. The SEC asserted that AB InBev's separation agreement violated Rule 21F-17 because its confidentiality language did not contain an express carveout for SEC communications. The actions follow a fiscal year 2016 in which the SEC awarded $57 million to 13 whistleblowers.

- **Intrastate and Regional Securities Offerings**: The SEC adopted new Rule 147A, which allows out-of-state residents to access intrastate securities offerings so long as the issuer sells the securities to residents of the issuer's principal state or territory of business.

6. Selected Case Law Developments

- **Forum-Selection Bylaws Upheld**: On December 12, 2016, a Missouri state court rejected an attempt to circumvent a Delaware forum selection bylaw and dismissed a derivative action by stockholders of Monsanto, who had argued that enforcement of Monsanto's forum-selection bylaw would infringe stockholders' federal and state constitutional rights because jury trials are unavailable in Delaware Chancery Court.

- ***Salman* v. *United States*: Supreme Court Addresses Scope of Criminal Insider-Trading Liability for Tippees**: The Supreme Court resolved a split between the Second and Ninth Circuit Courts of Appeals in December 2016 and unanimously held that a tippee can be held liable for trading on material, non-public information received from an insider relative or friend even where the tipper received no direct financial benefit from disclosing the information. Affirming the Ninth Circuit's approach, the Court held that "a gift of confidential information to a trading relative or friend" satisfies the "personal benefit" requirement for an insider-trading violation. The S&C memorandum discussing the *Salman* decision is available here.

- **Director Access to Privileged Communications**: In *Del Giudice*, the United States District Court for the Southern District of New York held that directors of Delaware corporations have the right to access all communications between an attorney and the corporation during the director's tenure, even where the director is adverse to the company.

- **Price Maintaining Statements**: In *Vivendi*, the Second Circuit joined the Seventh and Eleventh Circuits in holding that a defendant may be liable for a misstatement that maintains a security's artificially high price, even if the misstatement does not cause an actual increase in the security's price.