Governance Round-Up

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Bill Introduced to Revise Section 13 Beneficial Ownership Reporting

On March 17, 2016, legislation aimed at updating the Section 13(d) beneficial ownership reporting requirements was introduced in Congress. The Brokaw Act would reduce the initial Section 13(d) filing window for greater than 5% equity security acquisitions from 10 days to two business days and require disclosure of derivatives, short positions and other similar holdings. It would also broaden the definition of "beneficial ownership" to include any pecuniary or indirect pecuniary interest and broaden the category of "groups" required to file under Section 13(d) to include two or more persons acting as a partnership, limited partnership, syndicate, or other group, or otherwise coordinating the actions of the persons for the purpose of (i) acquiring, holding, or disposing of securities of an issuer; (ii) seeking to control or influence the board, management, or policies of an issuer; or (iii) evading, or assisting others in evading, designation as a "person" required to file.

Governance advocates have argued for years that the 10-day filing window is unnecessarily long, particularly given advances in reporting technology. There has also been growing concern that certain activist hedge funds collude in so-called "wolf packs" to accumulate positions in companies, including during the 10-day filing period or through derivative arrangements designed to avoid the current Section 13(d) reporting requirements altogether. However, some terms of the Brokaw Act have been criticized. For example, some have expressed concerns that the definition of "persons" that must file is somewhat vague and the extension of the disclosure rules to short sales and "indirect pecuniary interests" may be unnecessarily broad.

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DOJ Challenges Activist Use of HSR "Investment-Only" Exemption

In another area in which activist investors' reporting obligations have been scrutinized, the DOJ sued activist fund ValueAct Capital on April 4, 2016, for failing to make HSR filings in connection with its acquisition of $2.5 billion of stock in Baker Hughes and Halliburton after those companies agreed to merge. ValueAct acquired the stock, relying on the HSR filing exemption for acquisitions below 10% made "solely for the purpose of investment," with a view to increasing the likelihood that the deal would close, including by influencing the companies' decisions regarding concessions they might make to obtain antitrust clearance for the merger. According to the DOJ, ValueAct's intention was inconsistent with the "narrow" exemption for "investment-only" acquisitions. The DOJ said it intends to seek "significant" penalties and an injunction against future violations. ValueAct plans to contest the lawsuit. The Baker Hughes / Halliburton merger was terminated as a result of the DOJ's opposition.

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Nasdaq Proposes to Require Disclosure of "Golden Leash" Payments to Directors

Nasdaq recently proposed a rule change that would require listed companies to disclose so-called "golden leash" payments—that is, payments to directors and director nominees by the party nominating them. The proposed rule is intended to provide investors with more complete information about third-party compensation of directors and director nominees and is in large part aimed at remuneration structures adopted by activist hedge funds in recent proxy contests. Nasdaq noted that when shareholders privately compensate directors (which may include compensation based on achieving goals such as increasing share price over a fixed term), those arrangements can raise concerns with respect to conflicts of interest, the ability of such directors to satisfy fiduciary duties, and whether such arrangements may promote a focus by the director on short-term results over long-term value creation.

Under the proposed rule, a listed company would be required to disclose on its website or in its proxy statement for its next annual meeting (or, if it does not file proxy statements, its Form 10-K or 20-F) all agreements and arrangements between any board member or director nominee and any person or entity, other than the company, that provides for compensation or other payment (such as the payment of health care premiums) in connection with that individual's candidacy or service as a director, subject to limited exceptions.

The proposal was initially rejected by the SEC on technical grounds and was resubmitted by Nasdaq on March 16, 2016. In the resubmission, among other changes, Nasdaq clarified the application of the proposed rule to private equity employees who serve on public portfolio company boards as part of their employment. Guidance in the resubmission states that "a director or nominee for director being employed by a private equity fund where employees are expected to and routinely serve on the boards of the fund's portfolio companies and their remuneration is not materially affected by such service" is an example of an arrangement not raising the issues the rule is intended to address.

Despite the tweaks adopted by Nasdaq in its resubmission, some have expressed concern that the proposed rule is too broad and, more fundamentally, have questioned whether Nasdaq should adopt such a disclosure requirement rather than deferring to the SEC's authority over public company reporting and disclosure. The rule is subject to SEC approval and the comment period closed on April 26, 2016.

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SEC Issues Lengthy Regulation S-K Concept Release

On April 13, 2016, the SEC's Division of Corporation Finance released a lengthy concept release relating to the business and financial disclosures required by Regulation S-K. The release focuses on the following key areas of disclosure:

- Company business information (S-K Items 101 and 102);
- Company financial information and MD&A, including historical and forward-looking performance disclosure (S-K Items 303 and 304);
- Risk and risk management (S-K Items 305 and 503); and
- Company securities (S-K Items 201, 202, 701 and 703).

The concept release, which is part of the SEC's ongoing Disclosure Effectiveness Initiative, contains approximately 800 requests for comment covering myriad disclosure topics. The release reviews the historical rulemaking processes that resulted in the current S-K disclosure requirements and solicits feedback on whether and how the rules should be modified. The release touches on some recent themes on which the SEC has focused, including eliminating redundancies in rule requirements, the use of "layered" disclosure by companies, shifting from rules-based to more principles-based requirements, using technology more effectively and considering how the disclosure regime applies to different categories of issuers.

The concept release also repeats previously issued SEC guidance regarding disclosure improvements. Among the key takeaways for issuers:

- The SEC continues to seek improved analysis of material year-to-year changes and trends in MD&A. Companies are encouraged to clearly quantify and explain the factors underlying material changes in financial statement line items;
- MD&A disclosure should focus on material information while de-emphasizing (or, where appropriate, deleting) immaterial information;
- Companies should consider a "layered" approach to MD&A by providing an executive-level overview with a balanced, high-level discussion identifying the most important areas in which management is concerned in evaluating the company's financial condition and operating results; and
- Risk factor disclosure should be specifically tailored to the company's facts and circumstances, should more clearly identify the materiality of risks relative to others, and should not be generic or boilerplate.

The concept release is available on the SEC's website at http://www.sec.gov/rules/concept.shtml and comments are due within 90 days of its publication in the Federal Register.

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SEC Continues to Scrutinize Reporting of Non-GAAP Earnings

In remarks delivered at a March financial industry conference, SEC Chair White reiterated that the SEC may consider additional rulemaking or guidance with respect to the reporting of adjusted, or non-GAAP, earnings measures. The SEC is reportedly concerned that companies, recognizing how much better the non-GAAP earnings look, are giving more prominence to non-GAAP results on websites and other venues, and that the media may focus on non-GAAP reporting, but not on the accompanying disclosure required by the SEC's existing non-GAAP disclosure rules (item 10 of Regulation S-K and Regulation G). For several years, the SEC has issued comment letters questioning whether companies are giving "undue prominence" to non-GAAP financial measures. In addition, the SEC has questioned some more aggressive adjustments to GAAP measures under existing rules, including questioning the classification of certain expenses as non-recurring.

A recent *Wall Street Journal* article, reviewing 2015 year-end data, found that, based on pro forma or adjusted earnings figures, companies in the S&P 500 earned 0.4% more per share in 2015 than the year before. By comparison, based on GAAP earnings, S&P 500 earnings per share fell by 12.7%. That represents the widest difference since 2008, when companies took a record amount of charges.

It is unclear when, if at all, any new SEC rulemaking or guidance will be issued on the use of non-GAAP measures. However, companies can expect the SEC to continue to look carefully at non-GAAP disclosures.

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Proxy Season Update: SEC Refuses No-Action Relief on Shareholder Proposals Relating to Stock Buybacks and Climate Change

In mid-March, the SEC refused to concur with Wal-Mart Stores, Inc. in its bid to exclude a proposal from Amalgamated Bank calling for Walmart to adopt a policy that it will not include the impact of stock buybacks in the calculation of senior executives' incentive compensation. This proposal is similar to a well-publicized proposal that the AFL-CIO (and entities reportedly acting on its behalf) has submitted to a handful of companies (including IBM, Illinois Works, 3M and Xerox) asking them to adjust executive pay metrics to exclude the impact of stock buybacks. In addition to concerns that buybacks favor short-term results over long-term growth and investment, critics note that company executives may benefit from buybacks regardless of whether the company's underlying performance improves.

In addition, as reported in the *New York Law Journal* on April 14, Exxon Mobil Corp. will not receive relief from the SEC to omit a shareholder proposal from a group of investors led by New York State comptroller Thomas DiNapoli and the Church of England asking

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Exxon to explain how climate change will affect its business. While climate-related proposals are generally precatory and typically fail to receive a majority vote, their increasing prominence may keep alive a public debate on the need for increased disclosure regarding the long-term impact of environmental and social developments on a company's business. The SEC's recent S-K concept release, discussed above, discusses the possibility of more mandatory ESG disclosure requirements.

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Dual-Class Structures in the Spotlight

In 2015, a reported 13.5% of U.S. initial public offerings included some type of dual-class share structure. One of the most prominent U.S. IPOs to include a dual-class structure was Google Inc.'s 2004 IPO. Google co-founders Larry Page and Serge Brin hold Class B Shares, with 10 times the voting power of the company's Class a Shares, allowing them to control the company without owning a majority of the company's stock. Companies adopting dual-class structures are frequently high-profile technology companies where founders seek to keep a tight control over the company, often with the justification of promoting an environment conducive to innovation. However, the trend is not limited to technology companies.

Companies with dual-class capital structures have sought to extend founding stockholders' tenure of control by introducing a new, third, non-voting class of common equity, which can be used for acquisitions and management compensation without diluting the voting control by founders. Facebook recently proposed to add such a class of stock. Google did so in 2014.

Many large institutional investors have corporate governance guidelines and voting policies that favor one-share, one-vote structures, but the recent proliferation of dual-class and other "controlled company" structures has galvanized some investors to take further steps. In March, T. Rowe Price announced plans to vote against certain directors, such as lead independent directors and nominating and corporate governance committee members, at companies with dual-class stock during the 2016 proxy season. T. Rowe's policy appears to apply broadly to existing public companies as well as IPO companies. Representatives of TIAA-CREF and CalSTRS, as well as other influential institutional investors with broadly indexed holdings, have indicated that they welcome T. Rowe's position and are seeking avenues to influence dual-class and controlled companies.

The Council for Institutional Investors has long advocated for one-share, one-vote capital structures. In 2012, CII unsuccessfully petitioned the NYSE and Nasdaq to prohibit new listings of dual-class stock companies. CII recently issued a new policy statement urging companies that are going public to eliminate or sunset structures including unequal voting rights, classified board structures, super-majority voting requirements for bylaw amendments and lack of independent board leadership.

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CalPERS Updates Governance Principles to Address Director Tenure of 12+ Years

CalPERS recently updated its Global Governance Principles to incorporate specific guidance on director tenure and independence. The new guidance encourages companies to carry out rigorous evaluations either to classify a director with a tenure of 12 years or more as non-independent, or to provide a detailed explanation as to why the director continues to be independent. The update does not specifically address how or whether the update will affect CalPERS' voting on longer-tenured directors.

Please do not hesitate to contact us with any questions.

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