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GOVERNANCE ROUND-UP

SEC Permits Exclusion of Shareholder Proposal for Mandatory Arbitration

On February 11, 2019, the SEC issued a no-action letter permitting Johnson & Johnson to exclude from its proxy statement a shareholder proposal that would have required all shareholder lawsuits against the company to be resolved in private arbitration instead of federal court.

Hal Scott, a Harvard University law professor who serves as trustee of a trust that owns J&J shares, filed the proposal in December 2018. J&J sought to exclude the proposal on the basis that mandatory shareholder arbitration violates the anti-waiver provisions of federal securities laws, which preclude delegation of enforcement to arbitrators. The SEC had previously permitted companies to exclude similar proposals based on the potential securities law conflict. Scott argued, however, that the U.S. Supreme Court had since held that arbitration is an alternate forum for the vindication of rights conferred by federal law.

In January, the arguments shifted from federal securities law to state corporate law. Following the Delaware Court of Chancery's decision in *Sciabacucchi v. Salzberg et al.*, which held invalid a charter provision requiring claims under the federal securities laws to be brought in federal court, J&J obtained an opinion of counsel that the law of New Jersey, where J&J is incorporated, would also preclude mandatory shareholder arbitration. New Jersey Attorney General Gurbir Grewal subsequently sent the SEC a letter confirming that the proposal would violate state law.

The SEC granted no-action based on Attorney General Grewal's statement, though it expressed no view as to whether the statement was right or wrong and suggested that the parties should go to court if they want a definitive determination of the matter. The SEC also declined to comment on whether the proposal would violate federal law. In a statement supporting the decision, SEC Chairman Jay Clayton said he agreed "with the approach taken by the staff to not address the legality of mandatory shareholder arbitration in the context of federal securities laws in this matter, and would expect [the] staff to take a similar approach if the issue were to arise again."

On March 21, 2019, Professor Scott filed a complaint in the U.S. District Court for the District of New Jersey seeking a declaratory judgment that J&J violated the federal securities laws by excluding the proposal. J&J has not yet responded to the complaint.

U.S. Senators Propose Limitations on Stock Buybacks

Over the last few months, potential legislation that would impose limitations on corporate stock buybacks has received high-profile congressional support.

In an op-ed published in *The New York Times* on February 3, 2019, U.S. Senators Chuck Schumer and Bernie Sanders described their proposal for legislation that impose conditions on a corporation's ability to buy back its own stock. This proposed legislation would require a corporation to take specified actions as a pre-condition to buying back its stock, such as paying all workers at least $15 an hour, providing seven days of paid sick leave, and offering better pensions and health benefits to its employees. The senators also raised the possibility of limiting the payout of dividends, perhaps through the tax code, in order to avoid corporations issuing larger dividends in response to a limitation on stock buybacks. The op-ed followed a letter addressed to SEC Chairman Jay Clayton in June 2018, signed by over 20 U.S. senators (including Senator Schumer), expressing concern about the "accelerating pace" of stock buybacks and urging Chairman Clayton to open a public comment period to review the SEC's rules governing share repurchases under Rule 10b-18 of the Exchange Act.

In the wake of the Schumer/Sanders op-ed, Senator Marco Rubio offered his own plan to curb stock buybacks, proposing legislation that would eliminate the favorable tax treatment of buybacks by taxing them as dividends. Under current law, investors pay taxes on stock buybacks at the capital gains rate only when they sell shares in the buyback and have realized a gain, whereas dividends are taxed as ordinary income when received. In addition, foreign shareholders of a U.S. company generally are not subject to U.S. federal income tax on a stock buyback, but generally are subject to U.S. withholding tax on receipt of a dividend.

Following Rubio's proposal, in March 2019, Senator Chris Van Hollen, pointing to evidence from an SEC study indicating that stock buybacks benefit insiders to the detriment of long-term investors, said he would introduce legislation that would bar insiders from selling shares for a specified period after buyback announcements.

Most recently, on March 27, 2019, Senator Tammy Baldwin reintroduced legislation that would (i) repeal Rule 10b-18 under the Exchange Act, which facilitates stock buybacks by providing a non-exclusive safe harbor from liability under certain market manipulation rules when shares are repurchased in accordance with the rule's requirements, (ii) end corporations' ability to buy back their stock on the open market (although repurchases through tender offers would still be allowed) and (iii) require one-third of corporate boards to be directly elected by the company's employees.

NYC Comptroller Settles Lawsuit to Compel Inclusion of Shareholder Proposal

On January 23, 2019, New York City Comptroller Scott Stringer and the New York City Law Department announced the settlement of a lawsuit against TransDigm Group, Inc. The lawsuit, which was filed in the Southern District of New York in December 2018 on behalf of New York City's five public pension funds, alleged that TransDigm improperly excluded from its 2019 proxy materials the Comptroller's and the funds' September 19, 2018 shareholder proposal requesting that TransDigm adopt a policy with specific goals for managing greenhouse gas emissions.

On November 9, 2018, TransDigm sought no-action relief from the SEC, arguing that it could exclude the proposal under Rule 14a-8(i)(7) of the Exchange Act because it related to "ordinary business." Instead of following industry practice and submitting a response to TransDigm's no-action request, the Comptroller brought the suit to compel inclusion of the proposal and informed the SEC of the same.

TransDigm ultimately decided to withdraw its no-action request and settle with the Comptroller and the funds. As part of the settlement, TransDigm agreed to include the proposal in its 2019 proxy materials.

Citigroup Publishes Unadjusted Pay Gap Data Following Shareholder Proposal

On January 16, 2019, Citigroup published unadjusted (or "raw") pay gap data for its women and U.S. minority employees, which measures the difference in median total compensation as compared to men and non-minority employees, without adjustments for factors such as job function, level and geography. Citi's calculations revealed that the median pay for women employees globally is 29 percent less than the median pay for men employees, and the median pay for U.S. minority employees is seven percent less than the median pay for non-minority employees.

However, on an adjusted basis (accounting for factors including job function, level and geography), Citi found that its women employees globally are paid on average one percent less than what men are paid at Citi. Citi found no statistically significant difference between what U.S. minority employees and non-minorities are paid at Citi on an adjusted basis.

Citi's release of this pay gap data followed a gender pay shareholder proposal from investment management firm Arjuna Capital, which asked Citi to report to investors on the percentage global median pay gap between men and women employees across race and ethnicity, including base, bonus and equity compensation. Arjuna withdrew its proposal following Citi's publication of the pay gap data.

SEC Scales Back Disclosure Requirements

On March 20, 2019, the SEC announced final rules intended to simplify and modernize the Regulation S-K disclosure requirements for public companies, investment companies and investment advisers. The final rules were adopted pursuant to the Fixing America's Surface Transportation (FAST) Act of 2015, which required the SEC to take steps to eliminate duplicative, overlapping, outdated or unnecessary disclosure requirements. The rule changes are largely consistent with those proposed by the SEC on October 11, 2017.

Among other things, the changes:

- permit the omission of schedules to required exhibits if they are not material and are not otherwise disclosed in the body of the exhibit or in the base disclosure document to which the exhibit is attached;
- require the filing of an exhibit to Forms 10-K and 20-F with a description of all securities registered under Section 12 of the Exchange Act;
- update the confidential treatment request (CTR) process, allowing companies to omit personally identifiable information without submitting a CTR and to omit confidential information from material contracts filed as exhibits without submitting a CTR if the information is not material and would likely cause competitive harm if publicly disclosed;
- permit the omission of the discussion of the earliest of the three years in MD&A if such discussion was already included in an earlier SEC filing and the location of the prior filing is identified; and
- provide for a two-year look-back for the filing of material contracts by "newly reporting registrants"; all other registrants are required to file only those material contracts that are to be performed at or after the applicable filing.

We summarize these and other selected key changes in our client update issued on March 27, 2019: SEC Continues to Streamline and Update Disclosure Requirements.

The rules governing redaction of confidential information became effective on April 2, 2019. Most of the remaining final rules will become effective on May 2, 2019.

SEC Releases New C&DIs Related to Diversity Disclosure

On February 6, 2019, the SEC's Division of Corporation Finance released two identical Regulation S-K Compliance & Disclosure Interpretations (C&DIs), Questions 116.11 and 133.13, which clarify what disclosure of self-identified director diversity characteristics—such as race, gender, ethnicity, religion, nationality, disability, sexual orientation, or cultural

background—is required under Item 401 of Regulation S-K and, with respect to director nominees, under Item 407.

Item 401(e) of Regulation S-K requires a company to briefly discuss the specific experience, qualifications, attributes, or skills that led to the conclusion that a person should serve as a director of the company. Under the new C&DIs, if a board or nominating committee considered a person's self-identified diversity characteristics in assessing whether the person's experience, qualifications, attributes or skills were the right fit for the board, and such person has consented to the company's disclosure of those characteristics, then the discussion required by Item 401 should include, among other things, "identifying those characteristics and how they were considered."

Item 407(c)(2)(vi) of Regulation S-K requires a company to describe whether, and, if so, how, the nominating committee or the board of the company considers diversity in identifying nominees for director. Specifically, if the nominating committee or the board has a policy regarding the consideration of diversity in identifying director nominees, the company must describe how this policy is implemented. Under the new C&DIs, any description of diversity policies under Item 407 should include a discussion of how the company considers the self-identified diversity attributes of nominees as well as any other qualifications its diversity policy takes into account, such as diverse work experiences, military service, or socio-economic or demographic characteristics.

Vanguard's 2019 Proxy Voting Guidelines Focus on Board Composition

Vanguard Group recently announced changes to its proxy voting guidelines for U.S. companies effective April 1, 2019. Updates for the 2019 proxy season include three changes with respect to board composition.

- **"Overboarded" Directors**. Vanguard will now generally vote against (i) any director who is a named executive officer (NEO) and sits on more than one outside public company board (in these cases, Vanguard will vote against the director at each company where the director is a non-executive) and (ii) other directors who sit on five or more public company boards (in these cases, Vanguard will vote against the director at each company except, generally, the company where the director serves as chair of the board).
- **Board Diversity**. Vanguard will now vote in favor of a shareholder proposal if the proposal (i) seeks disclosure related to directors' diversity of personal characteristics (including gender, race and ethnicity) or skills and qualifications, and this information is not already disclosed or (ii) asks a company to adopt policies designed to ensure appropriate diversity on boards, and such policies do not already exist.

- **Independent Chair**. Vanguard will generally vote against shareholder proposals to separate the roles of CEO and chair absent significant concerns regarding independence or effectiveness of the board. However, in those instances where Vanguard believes a board's independent oversight of management or its responsiveness to shareholders has been lacking, Vanguard may support shareholder proposals to separate the roles of chair and CEO.

These updates follow similar changes to the voting guidelines of ISS, Glass Lewis and BlackRock.

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