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GOVERNANCE ROUND-UP

Looking Ahead to the 2020 Proxy Season

SEC Guidance on Excluding Shareholder Proposals

On October 16, 2019, the staff of the SEC's Division of Corporation Finance issued Staff Legal Bulletin No. 14K (CF) (the "Bulletin"), which provides additional guidance on how the staff will approach no-action requests seeking exclusion of shareholder proposals from company proxy statements on the basis of the "ordinary business" exception (Rule 14a-8(i)(7)) or deficient proof of ownership (Rule 14a-8(b)). Under Rule 14a-8(i)(7), a company may exclude a shareholder proposal if it "deals with a matter relating to the company's ordinary business operations." Under Rule 14a-8(b), to be eligible to submit a shareholder proposal, a proponent must provide the company with proof of continuous ownership of at least $2,000 in market value or 1% of the company's voting securities for at least one year before the proposal is submitted.

With regard to "ordinary business" exclusions, the Bulletin reiterated previous guidance in Staff Legal Bulletin Nos. 14I and 14J (CF), which encouraged board-level involvement in a company's exclusion determination under Rule 14a-8(i)(7) and a discussion of the board's analysis in a no-action request. The Bulletin offered additional guidance, including:

- When a shareholder proposal raises a policy issue that appears to be significant, a company's no-action request should focus on the significance of the issue to the company. The staff will not support the exclusion of the proposal if this burden is not met.
- A no-action request where significance is at issue should include a robust analysis substantiating the board's determination that the policy issue raised by the proposal is not significant to the company. If presenting a "delta" analysis, the analysis should clearly identify the differences between the manner in which the company has addressed an issue and the manner in which a shareholder proposal seeks to address the issue, and explain in detail why those differences do not represent a significant policy issue to the company.
- When a company seeks to exclude a shareholder proposal on the grounds of "micromanagement," the staff expects the company to explain in its no-action request how the proposal may unduly limit the ability of management and the board to manage

complex matters with a level of flexibility necessary to fulfill their fiduciary duties to shareholders.

With regard to Rule 14a-8(b) exclusions, the Bulletin cautioned companies not to apply an "overly technical reading" of a proponent's proof of ownership letter. Instead, companies should apply a "plain meaning approach" and should not seek exclusion where the language in the proof of ownership letter "is clear and sufficiently evidences the requisite minimum ownership requirements." In preparing a proof of ownership letter, shareholders need not follow the format of the sample letter contained in Staff Legal Bulletin No. 14F (CF). A copy of the Bulletin is available on the SEC's webpage.

New SEC Policy on Administration of Rule 14a-8 No-Action Requests

On September 6, 2019, the SEC's Division of Corporation Finance announced a new policy on the administration of Rule 14a-8 no-action requests. Commencing with the 2019-20 shareholder proposal season, the staff may respond verbally to no-action requests instead of in writing. The staff intends to respond in writing only "where it believes doing so would provide value, such as more broadly applicable guidance about complying with Rule 14a-8."

Consistent with the staff's historic practice, if a company requests no-action relief to exclude a shareholder proposal, the staff will inform the company and shareholder proponent of the staff's position, which may be that the staff concurs, disagrees, or declines to state a view with respect to the company's asserted basis for exclusion. The announcement emphasized that where the staff declines to state a view, "the staff is not taking a position on the merits of the arguments made, and the company may have a valid legal basis to exclude the proposal under Rule 14a-8." Accordingly, the company and the shareholder proponent should not interpret a staff declination as indicating that the company must include the shareholder proposal in its proxy statement. The announcement further suggested that, going forward, the staff may issue fewer written responses and more frequently decline to state a view on exclusion requests.

ISS and Glass Lewis Update 2020 Proxy Voting Guidelines

In November 2019, Institutional Shareholder Services ("ISS") and Glass Lewis each updated their proxy voting guidelines for the 2020 proxy season. Key updates are as follows:

- *"Abusive" share repurchase programs*: While ISS policy is generally to recommend a vote in favor of proposals relating to share repurchase programs, ISS said the following "abusive" practices could warrant a negative voting recommendation: (i) the use of

buybacks as greenmail or to reward company insiders by purchasing their shares at a price higher than they could receive in open market sales; (ii) the use of buybacks to boost earnings per share or other compensation metrics to increase payouts to executives or other insiders; and (iii) repurchases that threaten a company's long-term viability.

- *"Problematic" multi-class capital structures*: In addition to evaluating the overall governance structure of newly public companies, ISS will now separately evaluate "problematic" multi-class capital structures with unequal voting rights and no reasonable time-based sunset provisions. In assessing the reasonableness of a sunset period, ISS will take into account factors such as the company's lifespan, its post-IPO ownership structure and the board's disclosed rationale for the sunset period selected. ISS views a sunset period of longer than seven years to be *per se* unreasonable.
- *Exclusion of shareholder proposals*: Glass Lewis will now consider recommending that shareholders vote against all members of the Nominating and Governance Committee if, following a Rule 14a-8 no-action request: (i) a company excludes a shareholder proposal when the SEC declines to state a view on the exclusion; or (ii) the SEC verbally concurs with the company's rationale for excluding a shareholder proposal, there is no formal written record of this provided by the SEC and the company fails to disclose the verbal grant of no-action relief.
- *Evaluation of board committee performance*: Glass Lewis codified the following factors it will consider when evaluating the performance of board committees and, in turn, whether it will recommend a vote for or against the chair of a board committee or the entire committee: (i) with respect to the Audit Committee, whether fees paid to the company's external auditor for audit-related and non-audit-related services are disclosed; (ii) with respect to the Nominating and Governance Committee, whether director attendance records are disclosed and, if so, whether those records include sufficient detail to ascertain which directors failed to attend meetings; and (iii) with respect to the Compensation Committee, whether the board adopts a frequency for its advisory vote on executive compensation matters ("say-on-pay") that is different from what was approved by the shareholders.

These policy updates are discussed in further detail in our client update issued on November 19, 2019: 2020 Proxy Advisor Voting Guidelines: What to Watch For. The full text of the updated voting guidelines for ISS and Glass Lewis are available here and here, respectively.

SEC Proposes Amendments to Rules on Proxy Voting Advice and Shareholder Proposals

On November 5, 2019, the SEC proposed amendments to its rules on proxy voting advice and shareholder proposal submissions. The proposed amendments are part of the SEC's ongoing focus on improving the proxy process and the ability of shareholders to exercise their voting rights. They follow the SEC's November 2018 roundtable on the proxy process and the SEC's August 21, 2019 interpretation and guidance (the "Interpretive Release") in which the SEC stated that proxy voting advice provided by proxy advisory firms constitutes a "solicitation" under the Securities Exchange Act of 1934 (the "Exchange Act") and, as a result, is subject to the federal proxy rules.

The proposed amendments to the rules on proxy voting advice would impose additional disclosure and procedural requirements on proxy advisory firms, such as ISS and Glass Lewis, with the goal of ensuring that investors who use the firms' advice receive more accurate, transparent, and complete information on which to make their voting decisions. If adopted, the amendments would: (i) codify the SEC's Interpretive Release position that proxy voting advice constitutes a "solicitation" under the Exchange Act (and, as a result, is subject to the federal proxy rules, including the general anti-fraud rule); and (ii) impose additional disclosure and procedural requirements on proxy advisory firms. Proxy advisory firms would be required to make certain filings with the SEC under the proxy rules absent an applicable exemption. Even if an exemption from filing is available, proxy voting advice would remain subject to the proxy rule prohibiting false and misleading statements. The proposed amendments highlight the types of information that a proxy advisor may, depending upon the facts and circumstances, need to disclose to avoid violating the anti-fraud rule.

The proposed amendments to the rules on shareholder proposals would amend Rule 14a-8 to: (i) increase the ownership threshold for submission and resubmission of shareholder proposals; (ii) impose additional procedural requirements on shareholders proposing submissions and disclosure requirements on shareholders making proposals through representatives; and (iii) limit the number of shareholder proposals a single person can make directly or indirectly.

The proposed amendments, which are currently in a 60-day public comment period, are discussed in further detail in our client in depth issued on November 12, 2019: SEC Proposes New Rules on Proxy Voting Advice and Shareholder Proposals.

Delaware Court Allows *Caremark* Claims Against Directors

On October 1, 2019, the Delaware Court of Chancery in *In re Clovis Oncology, Inc. Derivative Litigation* denied a motion to dismiss a stockholder derivative lawsuit asserting *Caremark* claims against directors of Clovis, an early-stage biopharmaceutical firm focused on cancer treatments. *Clovis* follows the June 2019 Delaware Supreme Court decision in *Marchand v. Barnhill*, discussed in the previous issue of our Governance Round-Up (available here), which similarly allowed *Caremark* claims to withstand a motion to dismiss.

The suit alleged that Clovis improperly calculated an efficacy metric for a lung cancer drug under development by using "unconfirmed" responses instead of responses confirmed by subsequent scans for tumor shrinkage. The company repeatedly published inflated performance results based on this improper efficacy metric, including in connection with capital raising activities. When the drug's properly calculated efficacy metric later became public, Clovis's stock plummeted 70%, wiping out more than $1 billion in market capitalization.

To assert director liability under *Caremark*, a plaintiff must allege particularized facts that directors either: (i) completely failed to implement any reporting or information system or controls; or (ii) having implemented such a system or controls, consciously failed to monitor or oversee its operations, thus disabling themselves from being informed of risks or problems requiring their attention. In denying the motion to dismiss, the court in *Clovis* emphasized that the experimental lung cancer drug was a "mission critical product" involving "mission critical regulatory issues" and the board "consciously ignored red flags," such as the board's receipt of reports showing that management was improperly calculating the efficacy metric. While the directors acted with "hands on their ears to muffle the alarms," the company violated internal clinical trial protocols and associated FDA regulations.

While the focus in *Marchand* was on the first prong of *Caremark*, the court in *Clovis* emphasized the second prong, holding that even though the board had adopted an adequate oversight system, it failed to monitor that system properly or to take steps to address management's disregard of that system. The court noted that "when a company operates in an environment where externally imposed regulations govern its 'mission critical' operations, the board's oversight function must be more rigorously exercised."

This case serves as a reminder that to satisfy their *Caremark* duty, directors must make a good faith effort not only to implement an oversight system, but also to actively monitor it.

NYC Comptroller Launches "Rooney Rule" to Boost Board Diversity

On October 11, 2019, New York City Comptroller Scott Stringer launched the third phase of the Board Accountability Project, a campaign initiated in 2014 to make boards more "diverse, independent, and climate competent." The first phase of the campaign called on companies to adopt a proxy access bylaw permitting shareholders that have collectively held 3% of the company for at least three years to nominate up to 25% of the board. The second phase urged companies to adopt "board matrix" disclosure that describes the skills, gender, race, and ethnicity of individual directors. The third phase of the campaign calls on companies to adopt a policy requiring them to consider women and racial and ethnic minorities for open board seats and CEO appointments. The proposed policy is based on the National Football League's "Rooney Rule," adopted in 2003, which requires teams to interview minority candidates for head coaching and general manager jobs and equivalent front office positions.

To launch the third phase of the campaign, Comptroller Stringer sent a letter to 56 S&P 500 companies, including AT&T, Boeing, and Disney, which have not disclosed a diversity search policy that includes Rooney Rule language. The letter posits that "long-term shareowner value can only be created through strong corporate governance," and board diversity, including as to skills, experience, gender, race, and ethnicity, is a "hallmark" of such governance. The letter urges each company to adopt a diversity search policy requiring that the initial lists of candidates from which director nominees and CEOs are chosen include qualified women and racially and ethnically diverse candidates.

Comptroller Stringer oversees the New York City Retirement Systems, a collection of pension funds with over $200 billion in assets under management. The press release announcing the initiative states that Comptroller Stringer will file shareholder proposals at companies with a "lack of apparent racial diversity at the highest levels."

House Passes Bill Establishing Uniform Insider Trading Standard

On December 5, 2019, the U.S. House of Representatives passed the Insider Trading Prohibition Act (H.R. 2534) (the "ITPA"). The ITPA, sponsored by James A. Himes (D-CT), seeks to create a consistent standard for defining insider trading by adding a new section to the Exchange Act. "The present state of uncertainty around insider trading liability harms public confidence in the market," Rep. Himes noted in a press release announcing the bill's passage in the House. According to Rep. Himes, "a clear, concise legal standard on insider trading is necessary to ensure the ongoing health, transparency and honesty of our markets."

If approved by the Senate and signed into law, the ITPA would establish two grounds for insider trading liability under a new Section 16A of the Exchange Act: (i) trading while aware of material, nonpublic information; and (ii) communicating material, nonpublic information. Specifically, the ITPA would:

- prohibit a person from directly or indirectly trading any security, security-based swap, or security-based swap agreement while aware of material, nonpublic information relating to such security or any nonpublic information, from whatever source, that has, or would reasonably be expected to have, a material effect on the market price of any such security, if that person knows, or recklessly disregards, that the information was obtained *wrongfully*, or that making the trade would constitute a *wrongful* use of the inside information; and
- prohibit a person whose trading would be prohibited under the trading prohibition above from *wrongfully* communicating material, nonpublic information relating to a security or any nonpublic information, from whatever source, that has, or would reasonably be expected to have, a material effect on the market price of such security to any other person: (i) if the recipient of the information directly or indirectly trades in the security while aware of the information or communicates the information to another person who directly or indirectly trades in the security while aware of the information; and (ii) such direct or indirect trading while aware of the information is reasonably foreseeable.

"Wrongful" trading or communications of material, nonpublic information under the ITPA include those involving: (i) theft, bribery, misrepresentation, or espionage; (ii) a violation of a federal law protecting computer data or the intellectual property or privacy of computer users; (iii) conversion, misappropriation, or other deceptive taking; or (iv) a breach of a fiduciary duty, confidentiality agreement, contract, code of conduct or ethics policy, or any other relationship of trust for a direct or indirect personal benefit.

A copy of the bill, which was co-sponsored by House Financial Services Committee members Carolyn B. Maloney (D-NY) and Denny Heck (D-WA), is available here.

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