Recent Developments Relating to Corporate Governance

July 17, 2018

Despite a political agenda packed with important issues like tariffs, immigration and a Supreme Court nomination, there have been a number of recent federal and state legislative developments relating to public company corporate governance topics that are of interest. In particular, the Senate Banking Committee has recently considered bills relating to the role of proxy advisory firms and disclosure of cybersecurity experience at the board level; there have been calls by lawmakers for regulation of executive sales following announcement of stock buybacks; the Senate Committee on Appropriations is proposing to direct the SEC to report on the decline in public companies; a bill implementing gender quotas on boards progressed through the California State Senate; and Delaware adopted a voluntary sustainability certification and reporting regime. While a number of these topics have received the attention of lawmakers over the past few years, it remains to be seen whether they will gain traction in the current political environment.

Senate Committee Considers House Bill Regulating Proxy Advisory Firms

The role of proxy advisory firms has continued to attract attention from industry participants and lawmakers alike. For example, in May this year, the American Council for Capital Formation released its **report** on the Conflicted Role of Proxy Advisors. Following that report, the Senate Banking Committee held hearings on June 28 which considered a bill passed by the House of Representatives in December 2017 that would regulate proxy advisory firms—**H.R. 4015**, the Corporate Governance Reform and Transparency Act of 2017.

The House bill is intended to enhance transparency in the shareholder proxy system by requiring proxy advisory firms—like Glass, Lewis & Co. and Institutional Shareholder Services, Inc.—to register with the SEC, disclose and manage actual and potential conflicts of interest, disclose codes of ethics, make publicly available their methodologies for formulating proxy recommendations, and provide companies with a mechanism to review draft reports and correct mistakes. The bill, which is in many ways similar to the Credit Rating Agency Reform Act of 2006, would also direct the SEC to withdraw two no-action letters issued in 2004 to Egan Jones Proxy Services and ISS. Those no-action letters effectively allowed registered investment advisers to rely on a proxy advisory firm's general conflict of interest policies, without the need to conduct specific due diligence as to conflicts that may affect the independence of the proxy advisor with respect to any particular voting recommendation.

Witness testimony at the Senate committee hearing was mixed in its support for the House bill. Several witnesses expressed strong support for the bill, arguing that regulation is warranted due to the substantial influence of proxy advisory firms, as well as an asserted lack of transparency, conflicts of interest and errors made by proxy advisors when developing vote recommendations. Others opposing the bill expressed concerns with the potential regulatory burden, and questioned whether the bill would achieve the intended aims of fostering accountability, transparency, responsiveness and competition in the proxy advisory firm industry.

Concerns similar to those raised in support of the House bill were also reflected in letters sent by six senators to **ISS** and to **Glass Lewis** in May this year, in which the senators requested information regarding their eligibility for exemption from the proxy rules, accuracy of reporting and potential conflicts of interest. Despite the continuing focus on the role played by proxy advisory firms, it seems unlikely that the bill will be enacted—at least in its current form—given the political environment and concerns around the regulatory burden of the proposed measures.

Senate Committee Considers Bill Requiring Disclosure of Cybersecurity Experience

In the same Senate Banking Committee hearings on June 28, the committee also considered a bill requiring disclosure of cybersecurity experience at the board level—**S. 536**, the Cybersecurity Disclosure Act of 2017—first introduced in the Senate in March 2017. The bill would not require companies to have cybersecurity experts on their boards. Instead, companies would be required to disclose whether such expertise exists and, if not, explain what cybersecurity steps were taken in evaluating board nominees.

Specifically, the bill would direct the SEC to issue rules requiring an issuer to:

- disclose in its annual report or proxy statement whether any member of its governing body has expertise or experience in cybersecurity, including details necessary to describe fully the nature of that expertise or experience, and
- if no member has such expertise or experience, describe what other company cybersecurity steps were taken into account by the persons responsible for identifying and evaluating nominees for the governing body.

If this bill is enacted, the key will be how "cybersecurity expertise" is defined. The SEC, in consultation with the National Institute of Standards and Technology, would be charged with defining what constitutes expertise or experience in cybersecurity. However, the bill already contains a fairly specific characterization, which includes "professional qualifications to administer information security program functions or experience detecting, preventing, mitigating, or addressing cybersecurity threats."

By mandating disclosure of cybersecurity experience at the board level, the bill would go beyond the SEC's cybersecurity guidance described in our February 2018 **client memorandum**. That guidance requires disclosure of cybersecurity risks and incidents, and advises companies to ensure that their disclosure controls and procedures take account of cybersecurity risks. While it would require disclosures about the nature of the board's role in overseeing cybersecurity risk to the extent that those risks are material to a company's business, it does not mandate specific disclosure of cybersecurity experience at the board level.

Support for the bill among witnesses at the Senate committee hearing was divided. Those who objected to the bill were supportive of efforts to enhance cybersecurity, but generally expressed the view that existing disclosure rules were sufficient, while those expressing support pointed to the importance of cybersecurity measures to investors and, in particular, the importance of board-level measures to address cybersecurity risk. Given the same bill was introduced in 2015 but failed to pass, it remains unclear whether the Senate bill will make it into law any time soon. Although high-profile cybersecurity incidents have ensured cybersecurity remains a focus, it may be unlikely that the bill will be enacted in light of the SEC's recent cybersecurity guidance which some have argued provides adequate protection for investors.

Calls for SEC Review of Rule 10b-18 and Corporate Stock Buybacks

In a **speech** delivered on June 11 before the Center for American Progress, SEC Commissioner Robert J. Jackson, Jr. called for restrictions on stock sales by executives during corporate stock buybacks, expressing concern that executives use corporate stock buybacks as an opportunity to monetize their equity-based compensation at elevated stock prices. In his view, this has the potential to undermine the purpose of equity-based compensation—namely to tie compensation to long-term performance.

Commissioner Jackson highlighted the magnitude of stock buybacks by U.S. corporations and the dramatic increase in equity-based compensation, and expressed concern that the rules providing a safe harbor for stock buybacks—which were adopted in 1982 and last updated by the SEC in 2003—may no longer adequately protect companies, employees and investors. He recommended that:

- at a minimum, the SEC should deny the Rule 10b-18 safe harbor to companies that choose to allow executives to cash out during a buyback, and
- corporate boards and their counsel should pay closer attention to the implications of a buyback for the link between pay and performance, and in particular that compensation committees should review the degree to which buybacks will be used to allow executives to cash out long-term performance incentives.

Following Commissioner Jackson's speech, 21 Democratic senators **wrote** to SEC Chair Jay Clayton asking the SEC to review Rule 10b-18 and "whether corporate insiders are exploiting buybacks to sell shares received as executive pay at inflated prices." Review of Rule 10b-18 would also appear to be supported by SEC Commissioner Hester Peirce, who agreed during her confirmation process, in response to questions raised by Senator Tammy Baldwin (D., Wis.), that a review of Rule 10b-18 would be "timely" given stock buyback activity in recent years.

SEC Budget Tied to a Report on the Decline in Public Companies

The Senate Committee on Appropriations, in its **report** on the appropriations bill for the 2019 fiscal year (which begins October 1, 2018), expressed concern with the decades-long decline in the number of public companies and initial public offerings in the United States. In approving the SEC's budget for 2019, the committee would require the SEC to issue a report within 90 days of approval on why the number of public companies is declining, with a focus on the greater burdens imposed by reporting requirements, and also "proxy rules and the impact of proxy advisory firms." The **report** of the House Committee on Appropriations on the bill does not include a corresponding directive, and the Senate committee's directive therefore remains subject to the reconciliation process for the appropriations measure.

California Bill Establishing Gender Quotas for Boards

California currently has a bill pending—**S.B. 826**, Corporations: boards of directors—that, if enacted, would require all public companies (including companies outside of California) with principal executive offices located in California (according to the company's Form 10-K) to have a minimum of one female director by December 31, 2019. By December 31, 2021, the applicable minimum number would be:

- three female directors, if the company has six or more directors,
- two female directors, if the company has five directors, and
- one female director, if the company has four or fewer directors.

The California Secretary of State would be authorized to impose fines for noncompliance equal to the average annual cash compensation for directors of the company, with the amount of the fine increasing to three times that number for second or subsequent violations.

The California State Senate passed the bill in late May this year by a 22-to-11 vote (six senators did not vote), and the bill is currently in front of the California State Assembly. Some critics of the bill have raised constitutional concerns, and at this point it remains uncertain whether the bill will be enacted.

Certification of Adoption of Sustainability Standards in Delaware

On June 27, Delaware's governor signed into law **H.B. 310**, the Certification of Adoption of Transparency and Sustainability Standards Act of 2018. The act takes effect on October 1, 2018, and establishes a voluntary certification and disclosure regime in Delaware which is intended to foster dialogue around sustainability and responsibility.

Specifically, the act allows a Delaware corporation and other entities organized in Delaware to obtain, on a voluntary basis, a "Certification of Adoption of Transparency and Sustainability Standards" from the Delaware Secretary of State. In order to obtain certification under the new act, the Delaware entity's board (or equivalent governing body) must adopt:

- sustainability and responsibility "standards," namely principles, guidelines or standards adopted by the entity to assess and report the impact of its activities on society and the environment, and
- "assessment measures" consisting of policies, procedures and practices adopted by the entity to assess its performance in meeting those standards.

In addition, the entity must make public on its website the standards and assessment measures it has adopted, and must also make public an evaluation of its performance at least annually. The act does not prescribe specific standards or assessment measures, and the Secretary of State will not make qualitative judgments regarding the standards and assessment measures adopted by the entity.

Although the decision to seek certification under the act is voluntary, entities that misrepresent their activities are subject to civil or criminal penalties. No fiduciary liability will arise in connection with the decision whether or not to seek or maintain certification, any failure to meet specific sustainability and responsibility standards, or the selection of any specific assessment measures.

The demand for a state-based certification and disclosure regime for sustainability is unclear. There are already widely-accepted voluntary frameworks for sustainability reporting—such as the Global Reporting Initiative's GRI Standards and the Sustainable Accounting Standards Board's materiality-focused guidelines—and companies are increasingly providing voluntary information about their sustainability practices under existing regimes or otherwise. Moreover, disclosure of information relating to sustainability matters in SEC filings is under consideration as part of the SEC's efforts to modernize its disclosure requirements in Regulation S-K, as outlined in the SEC's April 2016 **concept release** and discussed in our prior **client memorandum**.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Marcel R. Fausten	**212 450 4389**	**marcel.fausten@davispolk.com**
Joseph A. Hall	**212 450 4565**	**joseph.hall@davispolk.com**
Sarah K. Solum	**650 752 2011**	**sarah.solum@davispolk.com**