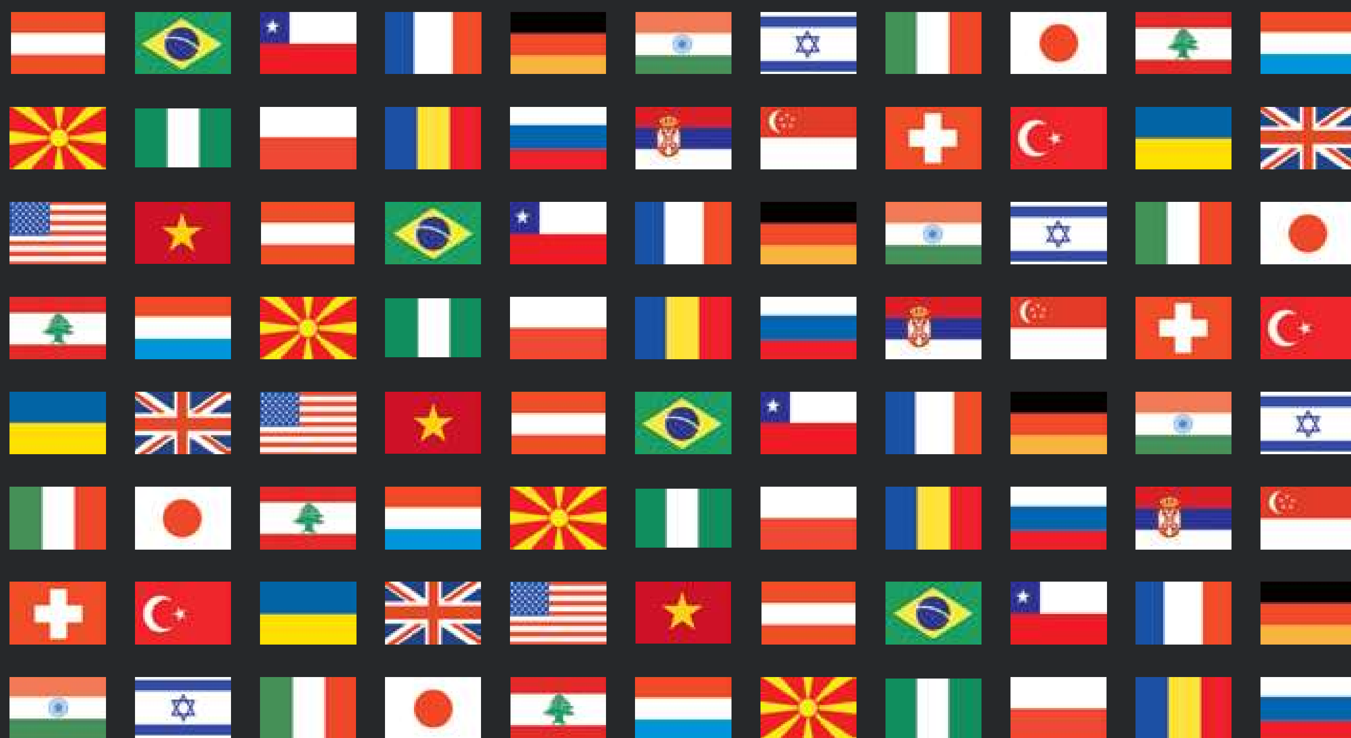
Corporate Governance



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Global overview

Arthur Golden, Thomas Reid, Kyoko Takahashi Lin, Laura Turano and Morgan Lee
Davis Polk & Wardwell LLP

Corporate governance remained a top priority in 2016, demonstrating both its importance and 'staying power' as an essential consideration for companies and their investors and advisers. In the following global overview, we endeavour to outline recent corporate governance developments, and to analyse their significance and likely near-term trajectory. Although our global overview outlines developments region-by-region, as a whole the overview highlights 'imports' and 'exports' of best practices and considerations among jurisdictions and the tendency for corporate governance standards to coalesce across jurisdictions.

United States

Shareholder activism

Shareholder activism faced significant financial and legal headwinds in 2016. Examples of these challenges include:

- Pershing Square's struggles with Valeant, which were both financial (the realisation of an over US$3 billion loss on its investment) and legal (a federal securities class action suit regarding their failed joint bid for Allergan);
- Eddie Lampert's losses with respect to his investment in Sears (with headlines even declaring 'How Sears Ruined its CEO Eddie Lampert's Hedge Fund');
- the US Department of Justice bringing an enforcement action against ValueAct for its failure to comply with the waiting period requirements under the Hart-Scott-Rodino Antitrust Improvements Act of 1976; and
- the US Securities and Exchange Commission (SEC) targeting activists for failing to adequately disclose beneficial holdings information.

In fact, after taking into account losses, withdrawals and redemptions, shareholder activist assets under management (AUM), as a percentage of total hedge fund AUM, declined in 2016 for the first time in several years, and activist hedge funds faced more withdrawals and redemptions than new investments for the first time since the financial crisis.

Against this backdrop, strong shareholder activist activity in the first quarter of 2017 has spurred a flurry of articles on shareholder activism's revival. So far in 2017, we have already seen:

- Jana Partners enter into a settlement agreement with Bristol-Myers Squibb and Tiffany & Co, and target Whole Foods;
- Carl Icahn and Nelson Peltz take large positions in Bristol-Myers Squibb and Procter & Gamble, respectively;
- Starboard Value target Tribune Media;
- Mantle Ridge enter into a settlement agreement with CSX Corporation; and
- Elliott Management enter into a settlement agreement with NRG Energy and target both BHP Billiton and Arconic (indirectly leading to the ouster of its CEO).

At the same time, we have also seen ValueAct announce plans to return US$1.25 billion to investors, stating that current valuations 'can only be justified by assuming cyclically high corporate margins will persist, a certainty of lower corporate tax rates and a risk-free rate that stays near all-time lows' and that ValueAct is sceptical of all of the above.

Although there is no doubt that shareholder activism is here to stay, we think that ValueAct's return of capital to investors is an important signal that the structural challenges of the asset class that were demonstrated in 2016 (eg, low investment diversification and liquidity challenges) may continue to cause headwinds in 2017, despite the announcement of new targets and settlements at the beginning of the year.

We also expect that there will be a continued focus on a target company's decision to settle with an activist. In the past few years, we have seen a rise in companies settling with activists in lieu of a full proxy fight, with 63 per cent of requests for board seats ending in settlement in 2016, up from 54 per cent in 2015. The value to a target company of a settlement agreement is often détente; in particular, the activist agreeing to a standstill. As more activist funds refuse to agree to meaningful standstills, we expect more target companies to ask 'what's in it for them' in agreeing to settlement agreements, which could have a potentially meaningful impact on market practice.

We will also be watching the New York City Pension Funds (NYCF) 'vote no' campaign against the election of one of NRG Energy's directors with interest. The director was one of the two nominees appointed to the NRG Energy board as a result of the company's settlement agreement with Elliott Management and Bluescape Energy Partners. NYCF argues that 'a deeply flawed process' allowed 'short-term activist investors' to appoint the director to the board and that the director's history of 'climate change denial' disqualifies him from sitting on NRG's board. In addition to appearing to be the first example of a large institutional investor criticising a shareholder activist settlement by launching a 'vote no' campaign, the campaign raises the interesting question of whether institutional investors will actively take the position that (at least for certain companies) some views per se disqualify someone from board service.

Universal proxy

In October 2016, the SEC proposed long-expected changes to the proxy rules to require, among other things, the use of universal proxy cards in the case of contested director elections at annual meetings. The universal proxy card would include the nominees of all parties to better simulate freedom in voting by allowing shareholders to vote for any combination of management and dissident nominees of their choice. Accordingly, each party in a contested election – management and one or more dissident shareholders – would distribute their own proxy materials but each proxy card would be required to include the nominees of all parties. At the time of writing, the fate of the SEC's universal proxy proposal is unclear. After soliciting public comment, the proposed rule is now under SEC review. Despite Carl Icahn's appointment as special adviser to President Trump, we think it is unlikely that the universal proxy will remain high on the SEC's agenda given the new SEC Chairman Jay Clayton, the composition of the rest of the SEC and the prohibition on its implementation by the Financial CHOICE Act of 2017 (a proposed alternative to the Dodd-Frank Act) (the Financial Choice Act, which was approved by the full House in June 2017). In any case, the universal proxy will not be in effect during the 2017 proxy season given the timing of the proposed rules.

SNAP and dual-class share structures

The SNAP initial public offering (IPO) sparked heated discussions on dual-class share structures. While dual-class share structures have existed for years, especially among telecommunication, media and

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technology companies, to preserve or provide voting power above economic participation levels, the SNAP voting structure (although not without precedent) has provoked a reaction which would go beyond addressing the SNAP situation. SNAP issued only non-voting shares in its IPO, retaining all voting power for its founders and a few pre-IPO investors. Following the SNAP IPO, the Council of Institutional Investors (CII) has asked that some major indices consider the possible exclusion of shares with no voting power from their core indices. In addition, reviving a proposal that the CII had previously made in 2012, in remarks before the SEC Investor Advisory Committee, the executive director of the CII asked the SEC to bar future no-vote share structures, and more significantly, require sunset provisions for differential common stock voting rights and consider enhanced board requirements to ensure that boards do not act as rubber stamps for founders, if the exchanges refused to bar dual-class voting structures.

Our view is that it is unfortunate that the SNAP IPO reaction has generated another wave of doctrinaire 'one size fits all' commentary on dual-class share structures. We believe any assessment of dual-class structures should be based on the specifics of the structure, the needs and governance profile of the company and, perhaps most importantly, the company's historic absolute and relative performance. We also think it is important, when developing a view on regulations or restrictions of dual-class structures to recognise the need for retail investors to have a sufficient range of investment choices in the public markets and the need for US markets to remain competitive with other countries, such as Hong Kong and Singapore, which are considering allowing dual-class structures to attract more public offerings.

Virtual annual meetings

In December 2016, the SEC granted 'no action' relief on HP's request to exclude a shareholder proposal from its proxy statement that would require the HP board to adopt a policy to initiate or restore in-person annual meetings. Although the granting of no-action relief was not unexpected, it did spark further discussion regarding virtual-only meetings as well as the attention of the NYC Comptroller, Scott Stringer, who in April 2017 announced that he would recommend that the NYCF vote against directors at companies that hold virtual-only annual meetings. In addition, Mr Stringer's office sent letters to the 17 companies in the S&P 500 that either held a virtual-only meeting in 2016 or have announced plans to hold such meetings in 2017, urging these companies to hold in-person or hybrid (in-person, with the option to join virtually) meetings.

The number of companies holding virtual-only meetings is small but growing, according to Broadridge Financial Solutions, Inc, the leading provider of these services; 154 companies conducted virtual-only meetings in 2016, up from 21 such meetings in 2012. This technology is not confined to the US. In 2016, Jimmy Choo plc was the first UK-listed company to hold a virtual-only annual meeting.

Given the limited number of companies that have shifted to a virtual-only format, we think it is still too early to assess the impact of a virtual-only format on shareholder engagement. The argument that a virtual-only format could be used to moot dissent or that something might be lost when management is no longer forced to be held accountable to shareholders face to face, could be constructively addressed with modifications to technology that make a virtual-only meeting more analogous to an in-person meeting rather than a requirement that meetings be held in person. Further, the reaction against virtual-only meetings assumes that traditional in-person meetings provide an adequate forum for a back-and-forth between a shareholder and management. In reality, these meetings are often dominated by the loudest voices in the room. By contrast, virtual-only meetings can provide the opportunity for questions from a wider range of shareholders to be addressed, with some companies continuing to answer and posting responses to questions, received during the meeting, after the meeting has concluded. We would also posit that resistance to virtual-only meetings too quickly dismisses the reality that a virtual-only format is being used successfully by companies on earnings conference calls and hints more of a generational divide and resistance to change than a legitimate concern about shareholder rights. It is difficult to argue that the future is not virtual.

14a-8 proposals: proxy access update, gender pay gap disclosure

A question at the top of the minds of many is whether the Rule 14a-8 regime will be overhauled by the Trump Administration. In April 2017, Representative Jeb Hensarling released a draft of the Financial Choice Act that includes changes to the shareholder proposal eligibility requirements. Currently, Rule 14a-8 requires a company to include a shareholder proposal in its proxy material if certain eligibility requirements are met (eg, that the shareholder owns at least US$2,000 or 1 per cent of securities entitled to vote on the proposal). Because of its low eligibility requirements, as currently constituted, Rule 14a-8 provides a low-cost mechanism for shareholders to provide 'feedback' on specific issues to management and the board. If enacted, the Financial Choice Act would eliminate the US$2,000 test, thus requiring a shareholder to hold at least 1 per cent of an issuer's securities entitled to vote on the proposal and increase the holding requirement from one year to three years. We anticipate that the proposed changes to the shareholder proposal eligibility requirements will elicit much opposition and debate. Despite the fact that only three individuals were responsible for approximately 70 per cent of the shareholder proposals brought by individual investors among Fortune 250 firms in 2016, we expect that the proposal will be viewed as an attempt to strip small shareholders of a valuable tool for engaging with large companies.

The potential power of the current Rule 14a-8 regime is demonstrated by the evolution of proxy access. Proxy access refers to the right of shareholders, who meet certain eligibility and procedural requirements, to include their nominees for director (subject to limitation) on a company's proxy card. In the span of only two years, proxy access has evolved from non-existent to widespread almost entirely as a result of successful (or threatened) Rule 14a-8 proposals. As of December 2016, just over 50 per cent of S&P 500 companies have adopted proxy access by-laws, a staggering development when compared to the mere six US companies that had such by-laws in December 2014. In 2016, we also witnessed the first proxy access director nomination, when the activist fund GAMCO Investors proposed a candidate for the board of the National Fuel Gas Company (NFG). GAMCO ultimately withdrew the nomination after NFG declared the nomination to be invalid on the basis that GAMCO did not satisfy NFG's proxy access by-law's 'passive investment' requirement. Even though the GAMCO nomination was withdrawn, we believe that it is noteworthy because it illustrates the importance of proxy access eligibility requirements, both for companies as they design and enforce such requirements, and for potential nominating shareholders as they plan their interactions with the companies they invest in.

Despite the rapid rate of proxy access adoption over the past two years, we continue to believe that proactively adopting proxy access does not immunise a company from a future proxy access proposal on more 'shareholder-friendly' terms and does not grant a company significantly greater freedom in choosing proxy access terms given that a relatively strong market consensus has developed on most terms. We also note that some market observers have commented that while the rapid adoption of proxy access should be applauded, the adoption of proxy access by-laws has been limited to the 'low-hanging fruit' (ie, those companies where there is least governance need for it) and has not made it to the companies whose shareholders, some believe, could most benefit from proxy access.

In the past few years we have also witnessed a rise in gender pay disparity shareholder proposals. While these proposals are not new, we believe that we may be approaching a tipping point. In April 2017, the NYC Comptroller announced that it had entered into settlement agreements with six healthcare and insurance companies (under which these companies agreed to disclose how they address gender pay equity) and that it had made similar proposals at three other insurance companies which would be going to a vote. While the NYC Comptroller has yet to announce a far-reaching campaign, we suspect that the success of this limited campaign and the prominence of gender-related issues generally (including the reaction to State Street's installation of the 'fearless girl' statue) could prompt others, if not the NYC Comptroller, to commence a broader effort to encourage companies to disclose information related to gender pay disparities or to make other gender-diversity related demands.

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Cybersecurity

In March 2017, the Cybersecurity Disclosure Act of 2017 was introduced in the Senate. Similar to the 2015 version of this bill, the current bill would require the SEC to issue rules requiring companies to disclose in their annual reports whether any director has expertise or experience in cybersecurity and, if not, to disclose 'what other cybersecurity steps taken by the reporting company were taken into account by such persons responsible for identifying and evaluating nominees for any member of the governing body, such as a nominating committee'. The new SEC Chairman, Jay Clayton, who in private practice advised companies on cybersecurity matters, has publicly supported the bill. It is still too early to tell whether the current version of the bill will be more successful than the 2015 version, and as we noted last year, implementation in any event would likely not occur for years. However, we do not anticipate the issue of board fluency with cybersecurity matters going away. Due to the headline grabbing nature of data breaches, companies are well advised to regularly discuss cybersecurity at the board level and consider experience in overseeing cybersecurity matters to be a valuable credential for board membership.

Executive compensation

Dodd-Frank: executive compensation rulemaking at a standstill

Last year it was widely expected that the SEC would issue final rules implementing the clawback rule and the 'pay versus performance' and hedging disclosure rules of the Dodd-Frank Act. The SEC had proposed rules on these topics in 2015. In brief:

- the 'clawback' rule would require companies to implement clawback policies to recover incentive compensation received by current or former executive officers in the event of certain financial restatements;
- the 'pay versus performance' rule would require companies to provide in their SEC disclosure a new table, covering up to five years, that shows the relationship between compensation actually paid to the CEO and other named executive officers, to cumulative total shareholder return (TSR) of the company and its peer group; and
- the hedging rule would require companies to disclose whether employees, officers or directors are permitted to hedge the company's equity securities.

In addition, last year the consortium of regulators mandated by the Dodd-Frank Act to jointly issue guidelines or regulations that prohibit incentive compensation that the regulators determine encourages inappropriate risks by covered financial institutions reproposed a rule that was significantly more prescriptive than the rule that was originally proposed in 2011.

Most do not expect the Trump Administration to push for finalisation of any of these rules, especially given the perception that they are inconsistent with President Trump's Executive Order setting forth the core principles regulating the financial system, as well as the possibility that some of these rules will be amended or eliminated by the Financial Choice Act.

Say-on-pay

The fate of the already finalised say-on-pay and pay ratio disclosure rules is also unclear. While the former has been targeted for revision by the Financial Choice Act so that a shareholder vote would only be triggered when material changes are made to the compensation of an issuer's executives, since the rule was finalised in 2011 it has become well-accepted corporate governance practice. Additionally, many companies view the say-on-pay vote as a safety valve that allows shareholders to express their disapproval with executive pay practices without voting against incumbent directors. Given the support that the practice has with institutional investors and the advisory nature of the votes, we are sceptical that the say-on-pay rules will be meaningfully revised, at least in the short term.

Pay ratio disclosure

The prognosis for the pay ratio rule is less clear. Adopted in 2015 following more than 287,000 comments from the public, the final rule requires the following disclosures: median annual total compensation of all employees (not including the CEO); the annual total compensation of the CEO; and the ratio of the median annual total compensation of all employees to the annual total compensation of the CEO. While the rule is final, the compliance date begins in 2018 for companies with a fiscal year ending on 31 December and thus, unlike say-on-pay, the disclosure is not part of existing market practice.

In February 2017, then-acting SEC Chairman Piwowar asked for public comment on any 'unexpected challenges' that issuers have experienced as they prepare for compliance and whether any relief is needed. Comments to date mirror the criticism the rule faced prior to finalisation: that it imposes a substantial administrative burden on issuers and that the scope of individuals required to be included in the calculation is overly broad. It will be interesting to see whether the SEC opts to repeal the final rule or whether the rule will be modified to address the latest round of comments. At a minimum, the SEC may push back the compliance date to prevent unnecessary spending by issuers as they prepare to make the disclosures in 2018. Notwithstanding a March 2017 letter from several US Senators to Mr Piwowar, opposing any delay in the implementation of the pay ratio rule and a request by four Senators that Mr Piwowar be investigated for exceeding his authority by reopening the comment period, a delay is still possible. We also think it will be interesting to see if the SEC or other cities will be influenced by the decision of the city of Portland, Oregon to impose a surtax on companies where the pay ratio exceeds 100:1, with an additional surcharge where the ratio exceeds 250:1.

Clawbacks: enforcement under Sarbanes-Oxley and a push toward private ordering

Despite the presumed demise of the Dodd-Frank Act clawback rule, we expect to see an increased focus on the clawback of executive compensation. We predict that the source of this focus will be twofold: SEC enforcement actions and the scope of misconduct covered by existing company clawback policies. Section 304 of the Sarbanes-Oxley Act authorises the SEC to force a CEO or CFO to reimburse the company if incentive- or equity-based compensation was received during the 12 months following the issuance of misstated financial statements. While the scope of this tool is narrower than the rule proposed under the Dodd-Frank Act (it is limited to the CEO and CFO versus all executive officers and requires the SEC to demand a clawback instead of the company) this provision has become a potentially powerful tool for the SEC. As we noted last year, since the passage of the Sarbanes-Oxley Act in 2002, the clawback standard under section 304 has evolved from a fault-based standard to a strict liability approach. In August 2016, this approach was supported by the Ninth Circuit in *SEC v Jensen*, where the court found that section 304 allows the SEC to 'seek disgorgement from CEOs and CFOs even if the triggering restatement did not result from misconduct on the part of those officers'. We will be interested to see whether this endorsement will embolden the SEC to increase the frequency with which it brings clawback actions where neither the CEO nor the CFO committed the misconduct that triggered the restatement.

For many companies, the retail sales practices at Wells Fargo highlighted the importance of clawback policies. Wells Fargo used its policy to claw back millions following the revelation of the use of fake accounts and again after the completion of an independent investigation. While the size of the clawback attracted headlines, a closer look revealed that the 'clawback' was limited to compensation not yet paid to the CEO and the former executive responsible for the business division, prompting some to query whether the market standard on clawback policies needed to be expanded to empower companies to claw back compensation already paid in order for such policies to serve as a more effective deterrent for corporate malfeasance.

In this regard, recent research by Willis Towers Watson found that the clawback policies of most companies mirror the Sarbanes-Oxley section 304 standard and are only triggered following a material financial restatement, with large banks being the exception with policies that cover a broader range of actions and consequences, including misconduct that might cause reputational harm or a material failure of risk management. At least two companies will face shareholder proposals during the 2017 proxy season requesting that these companies broaden the scope of their existing policies. In the case of one company, the proposal urges the company to go beyond 'willful misconduct' and cover negligent or supervisory failures. We expect that the combination of the increasing validation of the SEC's strict liability interpretation of section 304 and the public scrutiny of clawback policies following the events at Wells Fargo will lead some companies to stress-test their

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existing policies and consider what should happen under potential misconduct scenarios.

Whistleblowers and confidentiality agreements
The scope of the anti-retaliation protections under the Dodd-Frank Act continues to divide the federal courts. As we reported last year, in 2015 the Second Circuit determined that employees are entitled to protection if they report securities-related wrongdoing internally without also reporting such misconduct to the SEC, which is at odds with a 2013 Fifth Circuit decision. In March 2017, the Ninth Circuit joined the Second Circuit and ruled that the Dodd-Frank Act covers employees who report concerns internally. The conclusion of the Second and Ninth Circuits potentially expands the scope of employer liability and reinforces the need for companies to create and enforce clear internal reporting procedures. We continue to believe that this issue will eventually find its way to the Supreme Court, given the growing circuit split and the ambiguity it creates for company policies and potential liability. We also note that the Financial Choice Act proposes to limit the scope of whistleblower awards by prohibiting co-conspirators from receiving such awards.

Following the first SEC enforcement action regarding confidentiality agreements that impede whistleblowing activity protected by the Dodd-Frank Act, we pointed to this issue as a possible area of focus of the SEC. We suggested that many companies would and should view the 2015 action as incentive to review their codes of conduct, company policies and employment agreements to ensure they contain express carveouts for reporting potential securities laws violations to, and cooperating with, regulators and law enforcement. Our prediction has been confirmed by the SEC. In an interview with the *Wall Street Journal*, the Chief of the SEC's Office of the Whistleblower stated that this issue 'is going to remain a focus of my office in 2017 and I expect that you will see additional cases brought under this authority'. While the recent enforcement actions implicated a wide range of companies (from Anheuser-Busch InBev to BlackRock), the message is consistent and clear: company policies, severance and other agreements that may be perceived as chilling the willingness of individuals to communicate directly with the SEC regarding possible securities law violations and come forward to the SEC will not be tolerated. Further, the Anheuser-Busch InBev inquiry illustrates that a formal company policy of encouraging whistleblowers will not cleanse an agreement that seeks to limit communications with the SEC. We will be interested to see whether the Trump Administration will continue to prioritise such actions.

Europe

Required environmental, social, employee and diversity disclosure
Starting in 2018, public interest companies (which includes large EU-listed companies, banks and insurers) with over 500 employees must include a non-financial statement in their annual report covering their policies and the main risks and outcomes relating to the following topics: environmental; social and employee; respect for human rights; anti-corruption and bribery issues; and diversity in their board of directors. This obligation stems from a December 2014 EU directive, which EU member states were required to implement by December 2016. In addition, under the directive, the relevant companies must include a description of the diversity policy applied to the company's administrative, management and supervisory functions with regard to age, gender, and educational and professional background. This description must include the objectives of the diversity policy, its implementation and results during the course of the reporting period. If a company does not have a diversity policy, the company must explain the lack of such a policy. The directive also requires that the European Commission provide non-binding guidelines to assist companies covered by the directive in the preparation of these new disclosures. In January 2016, the European Commission launched a four-month public consultation on the guidelines in an effort to receive input from stakeholders. The non-binding guidelines were scheduled to be released in spring 2017.

In recent years, ESG-related shareholder proposals have become increasingly frequent in the US. We are interested to watch how this newly required disclosure in the EU influences and inspires shareholder proposals in the US.

Shareholder rights in EU companies
In March 2017, the European Parliament voted to approve amendments to the existing EU Shareholders' Rights Directive. The directive applies to companies that have their registered office in an EU member state and whose shares trade on an EU regulated market. Under the new rules, shareholders of EU listed companies will have the right to vote on the remuneration awarded to company directors, first through a vote on the remuneration policy which lays down the framework within which remuneration can be awarded to directors, and second through a vote on the remuneration report describing the remuneration granted in the prior financial year. These rules are intended to enable a stronger link between executive remuneration and company performance. The vote on the remuneration policy will in principle be binding; however, EU member states will have the option under the new rules to opt for a non-binding advisory vote.

The new directive would also enable companies to identify their shareholders more easily and introduce rules that would make it easier for shareholders to exercise their rights, including the right to participate and vote in general meetings. Institutional investors and asset managers will also be required to develop and publicly disclose a policy describing how they integrate shareholder engagement in their investment strategies or explain why they have chosen not to do so. This will place onto an EU statutory footing what some countries already require through stewardship codes (such as the UK Stewardship Code).

The new directive was formally adopted by the European Council in May 2017 and EU member states have until 10 June 2017 to transpose the new requirements into national law. Because the UK may not be part of the EU by the time of that deadline, we do not yet know whether the UK will continue to apply this and other European legislation.

UK: narrative reporting on the impact of referendum to leave the EU
Following the referendum vote in favour of the UK leaving the EU, the Financial Reporting Council (FRC) provided guidance on how companies should approach the disclosure of the effect of Brexit in the narrative reporting section of their financial reports. While the FRC acknowledged that Brexit would not impact all businesses to the same extent, the FRC emphasised the need for high-quality narrative disclosures that convey management's view on the outlook of the business. The July 2016 guidance encouraged companies to consider the effect of Brexit, and its associated risks and uncertainties, on their business models and markets in which they operate. The FRC cautioned against the use of boilerplate disclosures. Although the impact of Brexit remains uncertain, the FRC guidance should be a reminder to all companies that while they are not expected to be fortune tellers, companies should be providing disclosure that is timely, informative and increasingly company-specific as the economic and political effects of Brexit become more certain.

UK: continued focus on executive remuneration
All signs point towards executive remuneration remaining in the spotlight in 2017. Last year, shareholders at three UK companies voted against executive pay reports presented for non-binding shareholder advisory approval, and shareholders at one UK company voted against the executive pay policy presented for binding shareholder approval. Approximately half of all FTSE 350 companies are expected to submit their executive pay policy to a binding vote in 2017. Binding votes on executive pay policies are required at least every three years for UK-incorporated listed companies, and in 2017 these votes come amid both UK government and institutional investor focus on excessive executive pay. Any vote against the executive pay policy by shareholders would mean that a company would have to continue to use its existing shareholder-approved executive pay policy.

In July 2016, shortly after becoming Prime Minister, Theresa May spoke of the 'unhealthy and growing gap between what [big] companies pay their workers and what they pay their bosses' and suggested that binding shareholder votes on remuneration should occur every year, not every three years as is currently the case. A wide-reaching green paper was later released by the UK government in November 2016 soliciting feedback on a number of issues related to corporate governance reform, including numerous proposals to ensure executive pay is better aligned with a company's long-term performance. Beyond increasing the frequency of binding votes on the executive pay policy, the green paper presents a number of reforms for discussion, including:

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- requiring company pay policies include a cap on annual pay and requiring a binding vote if actual pay exceeds the cap;
- making all or some elements of the executive pay report subject to a binding vote;
- introducing stronger consequences for a company losing its annual advisory vote on the executive pay report;
- requiring institutional investors to disclose their votes on executive pay;
- facilitating and encouraging retail investors to exercise their individual right to vote and publicising the voting decisions of individual investors as a group; and
- requiring the disclosure of the pay ratio between the CEO and wider workforce.

The UK government is expected to publish the results of the consultation later in 2017. With the UK general election scheduled to take place in June 2017, the make-up of the next UK government is uncertain, however, we fully expect corporate governance reform and executive pay to remain a key area of focus.

Institutional investors are joining the chorus against perceived excessive executive pay with a number of institutional investor bodies and investors publishing policies or voting guidelines setting out their expectations around executive remuneration for 2017.

In January 2017, BlackRock sent a letter to the chairmen of all companies in the FTSE 350, demanding an end to executive pay that outpaces that of ordinary employees. The letter is critical of the use of benchmarking as a justification for generous compensation packages and calls for companies to provide more fulsome disclosure on their arrangements with compensation consultants. This letter comes after BlackRock announced before Parliament in December 2016 that it would vote against remuneration committee chairmen who fail to rein in executive pay.

Separately, in October 2016 the Investment Association, an association of institutional investors who manage over £5.7 trillion on behalf of clients in the UK and around the world, published revised principles of remuneration together with an open letter to the FTSE 350 outlining new shareholder expectations on executive pay that seek for these companies to, among other things:

- better justify executive pay and any increases;
- include maximum limits on each element of remuneration (including salary) in remuneration policies;
- disclose performance conditions for annual bonuses (or retrospective disclosure where such conditions are commercially sensitive);
- disclose pay ratios between the CEO and median employee;
- justify differences between pension contribution rates for executives and the general workforce; and
- implement clawback policies that allow for the forfeiture of unvested awards and recovery of monies already paid in circumstances that are clearly disclosed to shareholders.

Given the uncertainty that surrounds some of the executive compensation provisions of the Dodd-Frank Act, we will be interested to see whether institutional investors will seek to fill the void of US government regulation by exercising their vote to force SEC-regulated companies to justify and provide increased disclosures on their executive pay.

UK: corporate governance and stewardship codes

In February 2017, the FRC announced that it will undertake a 'fundamental review' of the UK Corporate Governance Code. This willingness to refresh the Corporate Governance Code comes as no surprise in light of the UK government's focus on corporate governance, illustrated by the corporate governance green paper released in 2016. As with prior updates to the Corporate Governance Code, the FRC will seek input from a range of stakeholders representing a wide variety of sectors. This consultation is expected to occur in the second half of 2017. In addition, the FRC announced that it is considering possible revisions to the UK Stewardship Code in 2018.

UK: diversity on boards and beyond

In November 2016, two UK government-sponsored commissions released their findings on the ethnic and gender diversity of UK boards. Both reports set voluntary targets and set forth recommendations for consideration by UK companies.

The Parker Review, which reports on the ethnic diversity of UK-listed companies, proposes that by 2021 each FTSE 100 board and by 2024 each FTSE 250 board should have at least one director of colour and these companies should identify and present for consideration at least one candidate of colour for each board vacancy. The Parker Review provides a two-prong path to reaching this goal: first that companies should focus on developing a pipeline of ethnically diverse candidates through mentorship and encouraging such candidates to assume leadership positions internally and with external organisations, and second the UK government and regulatory bodies should require companies to disclose their efforts to increase ethnic diversity on the board and within the organisation generally. As of March 2016, only about 1.5 per cent of the total director population among the FTSE 100 are UK citizen directors of colour. The Parker Review was published in consultation format and a report containing the final recommendations is expected to be published later in 2017.

The Hampton-Alexander Review follows up on the Davies Review for Women on Boards which in October 2015 proposed a voluntary target of a minimum of 33 per cent women's representation on the boards of FTSE 350 companies by 2020. The Hampton Alexander Review goes beyond boards and addresses the underrepresentation of women in leadership positions of FTSE 350 companies and proposes a voluntary target of a minimum of 33 per cent women's representation on the executive committees and direct reports to the executive committee of FTSE 350 companies by 2020. To reach these targets, the Hampton Alexander Review calls for a combination of voluntary disclosures by FTSE 350 companies along with the implementation of mandatory disclosure requirements by the UK government and the FRC through an amendment to the UK Corporate Governance Code. In addition, the Hampton Alexander Review calls for institutional investors to include gender balance in their assessment of corporate governance by, among other things, implementing a clear voting policy on gender balance that could include voting against the re-election of the chair of the board (or chair of the nomination committee) when a company does not have sufficient measures in place to address gender imbalance.

We are particularly interested to see how institutional investors will respond to the call by the Hampton Alexander Review to use their vote to address concerns regarding gender diversity and whether this will embolden institutional investors to exercise such influence beyond FTSE-listed companies. Given the many variables that impact a company's ability to promote women and ethnically diverse candidates, we hope that such voting policies are nuanced and provide sufficient discretion.

In January 2017, the Pensions and Lifetime Savings Association (PLSA) published its 2017 corporate governance policy and voting guidelines where it recognised the positive progress in recent years towards meeting the Davies Review target of 33 per cent of women on boards but indicated that there is still considerable room for improvement in some cases. The PLSA noted that shareholders could consider a vote against the chair (or chair of the nomination committee) if there was no clear evidence that diversity is being sufficiently considered by the board, with progress towards the targets of 33 per cent women representation and one director of colour on the board acting as useful benchmarks.

It is also worth noting that, starting in 2018, large UK-listed companies will be required to include in their annual corporate governance statement a description of their diversity policy and the policy's objectives, how it is implemented and the policy's results in the reporting period (or an explanation of why the company does not have a diversity policy).

Asia

Hong Kong: dual-class structures

The debate regarding dual-class shares is not confined to the United States. Less than two years after the board of the Hong Kong Securities and Futures Commission (SFC) brought the market consultation on dual-class shares to an abrupt halt, it appears that the SFC is prepared to take a second look at this issue. As we have chronicled, the drive for dual-class structures on the Hong Kong Stock Exchange (HKEx) came after Alibaba's decision to launch its IPO, the largest in history, on the New York Stock Exchange instead of on the HKEx, after the HKEx refused to permit the use of weighted voting rights in the company's control structure. Following the Alibaba IPO, the HKEx issued a

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concept paper to solicit investors' views on permitting the use of dual-class structures with this paper to be followed by a second round of market consultations, when the SFC announced that it did not support primary listings with dual-class structures. After this unprecedented announcement, many (including ourselves) concluded that we would not see dual-class listings on the HKEx in the near term. However, in late 2016, the chief executive of the SFC surprised many by stating that the SFC had not ruled out the possibility of reviving discussions regarding dual-class share structures. This apparent reversal came after Alibaba announced that it would consider taking its online payment unit Ant Financial public in Hong Kong 'only if [Alibaba] think[s] the city is ready'. In early 2017, HKEx announced that it would issue a new consultation paper to solicit opinions on the establishment of a new trading board and that such discussions would cover the possible inclusion of dual-class structures on the new board.

As we noted last year, in halting the initial consultation on dual-class shares the SFC acknowledged that the discussion was spurred by competition from US exchanges for the listing of mainland China businesses. It also appears that another rival of the HKEx, Singapore, is poised to introduce dual-class shares after its Prime Minister approved the introduction of such structures.

Hong Kong: enforcement under the SFC and HKEx

Last year witnessed an increase in enforcement actions brought by the SFC and the HKEx. Based on recent statements by both regulators, it appears we can expect this increased activity will continue through 2017.

In December 2016, after a five-year break, the SFC re-launched its *Enforcement Report* newsletter and announced a new enforcement approach which will include a focus on high-priority cases that pose the 'greatest risk' to the Hong Kong markets and the use of specialist teams to cover such cases. The newsletter also highlighted enforcement priorities of the SFC with the top priority being corporate fraud and misfeasance, with such misconduct being linked to the loss of billions in market capitalisation and damage to the integrity and reputation of the Hong Kong markets. This new approach is in line with a speech given by the new head of the Enforcement Division of the SFC, Thomas Atkinson, in which he listed 'company-related issues' at the top of the SFC's priorities, noting that these issues often relate to companies located in China which present investigatory challenges since most of the evidence and witnesses are located in mainland China and not Hong Kong. His remarks ended by noting recent collaboration with mainland Chinese regulators with the aim of building a long-term relationship between the regulators of both jurisdictions.

In February 2017, the HKEx released a policy statement on the enforcement of the Listing Rules. While the policy statement unsurprisingly highlights the rationale behind enforcement: deterrence, education of the market, cultivation of a compliance culture and enhanced corporate governance, it also includes specific reminders to the directors and senior management of listed companies. These reminders, which include, among other things, an articulation that directors are expected to fulfil fiduciary duties and emphasise the importance of training and education strongly suggest that the HKEx is concerned that some of their issuers are not aware of the basics of corporate governance which are incorporated in the Listing Rules, with such concern primarily directed at mainland Chinese companies (which would be consistent with the remarks of the SFC enforcement head). We will be interested to see how these two regulators utilise their enforcement powers to address and educate listed companies and whether this will require closer collaboration with mainland Chinese authorities.

Japan: further implementation and refinement of reform

It has been two years since the implementation of the Corporate Governance Code in Japan. This mandatory code requires all companies listed on Japanese securities exchanges to submit corporate governance reports detailing their compliance with the code or explaining the reason for their non-compliance. The level of compliance by listed companies has increased since the inaugural reports were released in 2015. This progress is reflected in the December 2016 analysis by the Tokyo Stock Exchange of more than 2,500 governance reports, which found that 20 per cent (up from 11 per cent in 2015) of companies were in full compliance with the principles of the code. Of the companies that were not in full compliance, approximately 65 per cent (slightly down from 2015) were reported to be in compliance with at least 90 per cent of the principles. One principle which continues to have a high non-compliance rate is the obligation to evaluate the board and provide a summary of such evaluation (nearly 45 per cent of companies explain non-compliance with this principle). While such evaluations are commonplace in the US, this practice was not prevalent among Japanese companies prior to the implementation of the Corporate Governance Code. A lack of board evaluations may be attributable to the famously deferential Japanese corporate culture.

One of the practices closely associated with this culture of deference is the target of ISS Japan proxy voting guidelines. *Sodanyaku* or *komon* involves former senior executives (often former company presidents) serving in an advisory role for several years after the end of their formal employment by the company. This practice attracted headlines during the Toshiba accounting scandal, which revealed the behind-the-scenes influence of the former chairman on the current chairman of Toshiba. The presence of these senior advisers is thought to limit the willingness of current executives to make changes contrary to the policies established by the senior adviser out of deference to the adviser. While ISS admits that its recommendation to vote against the proposal of amendments creating new senior adviser positions will not impact most companies (since most already have such policies in place), we will see whether this policy will encourage companies to either abandon this practice or provide further disclosure about the role of such advisers.

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Japan: shareholder activism

The number of activist campaigns increased from nine in 2015 to 15 in 2016 with both foreign and Japanese activist funds increasingly targeting small-cap and mid-cap companies. We believe this trend is attributable to the Stewardship Code, which seeks to encourage shareholder engagement; recent high-profile successes such as Daniel Loeb's engagement with Seven & I Holdings (the parent of Seven-Eleven Japan); and the requirement under the Corporate Governance Code that companies annually evaluate and disclose the objective and rationale for cross-shareholding structures. Cross-shareholding structures exist when Japanese companies own controlling or substantial stakes in each other, such as between banks and their clients, insurance companies and policyholders and companies in the same sector or group. Adopted to strengthen the ties between companies, this practice makes it difficult for activists to gain support from such shareholders that often have close ties to management and are not inclined to support activist campaigns. While it is still too early to tell the pace with which this cross-shareholding disclosure requirement will result in the unwinding of these positions, we note one recent example of such unwinding in the February 2017 announcement that Fujitsu's biggest shareholder, Fuji Electric, plans to sell approximately US$1 billion of the electronics maker's stock, and Fujitsu plans to sell its 10 per cent stake in Fuji Electric as part of a plan to unwind their cross-shareholdings.

Brazil

As we previewed last year, the Brazilian Securities and Exchange Commission (CVM) led representatives from 11 self-regulatory capital market entities in developing a unified corporate governance code. Released in November 2016, the unified code follows the well-travelled 'comply or explain' format and covers issues such as board of director duties, remuneration and incentive structures, internal controls and conflicts of interest. The CVM is currently in the process of updating its rules in order to incorporate the principles and practices of the unified code.

In addition, the Novo Mercado listing of the BM&F Bovespa stock exchange, a listing created in 2000 and composed of 130 companies with 'higher' corporate governance standards, is in the process of tightening its regulations. Announced in March 2017, the proposed changes would require companies listed on the Novo Mercado to, among other things, have at minimum the greater of 20 per cent or two independent directors, establish an audit committee that includes at least one independent board member and one expert (with such committee producing an annual report), and maintain a minimum 25 per cent or 15 per cent free float.

Finally, in October 2016, the Associação de Investidores no Mercado de Capitais, an association of Brazilian institutional investors, released the country's first stewardship code. The code calls on investors to carefully manage and monitor the securities held for the benefit of others by operating in accordance with seven principles which include the implementation and disclosure of a stewardship programme, considering ESG factors when making investment decisions and the transparent exercise of voting rights through adequate disclosure and explanation of votes cast.

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