Corporate Governance

In 32 jurisdictions worldwide

2015

GETTING THE DEAL THROUGH

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Global Overview

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Introduction

Corporate governance is no longer just a hot topic for rarefied conversation; it is a permanent element in corporate valuations. This year, we witnessed the continuation of many trends that we observed last year. In the United States, shareholder activism remained in sharp focus in financial markets, in the C-suite and in the boardroom, and shareholder engagement continued to be a front-and-centre and increasingly sophisticated industrial priority. The governance themes – proxy access, fee shifting by-laws, shareholder engagement and cybersecurity – were not new. What was new was the growing consensus on many of these issues or, at minimum, the growing consensus that these issues are here to stay and warrant board attention.

This year, the tactics and agenda of shareholder activists were also in sharp focus, as many began to question the long-term value proposition of their demands and the reality of their commitment to corporate governance. We may even be observing the beginning of a schism between the corporate governance agenda and the short-term returns imperative of the activists' agenda. BlackRock, the world's largest asset manager, recently sent a letter to the CEOs of every S&P 500 company stressing that companies should 'resist the pressure of short-term shareholders to extract value from the company if it would compromise value creation for long-term owners'. This may well signal recognition by some large shareholders that short-term financial gratification can be damaging to long-term value creation.

In Europe and Asia, we also saw many familiar themes. In the United Kingdom, this included changes to the corporate governance code, with amendments regarding risk management and disclosure requirements and shareholder responsiveness. Compensation issues also continued to be in the forefront. Last year, we discussed the adoption of CRD IV rules, which cap bonuses of certain bankers to 100 per cent of their fixed salary, or 200 per cent with shareholder approval. We noted that the UK government had sued to block the new rules, claiming, among other things, that the rules lacked legal basis. While the UK's challenge was ultimately withdrawn, criticism of and focus on CRD IV continues, as do discussions on compensation generally. In the European Union, we also saw continued focus on social, environmental and diversity issues, with the adoption of a new directive that will require companies to make certain social, environmental and diversity policy disclosures.

In Asia, there was continued focus on dual-class structures and risk management reforms in Hong Kong, and increased shareholder activism in Japan. In addition, in Japan, corporate governance reforms continued to be identified as central to greater economic growth as part of the 'third arrow' of 'Abenomics'.

Bank corporate governance

Worldwide, the financial sector remained the most interesting area in corporate governance this year. Corporate governance developments in this sector generally move faster and have deeper effects for many reasons, including because of increased scrutiny from regulators, lawmakers and the media. Financial institution corporate governance is a complex area. We will limit ourselves here to just a few of the recent, highest-profile issues.

Fiduciary duties

In June 2014, Federal Reserve Governor Daniel K Tarullo delivered remarks at the Association of American Law Schools concerning the intersection of financial regulation and corporate governance. During the course of his remarks, he briefly raised the question of whether the fiduciary duties of directors of regulated financial firms should be broadened or modified to reflect regulatory objectives. Although these remarks (despite their brevity and academic orientation) caused some commentators to ring the alarm bells, we believe that a doomsday reaction is off-base. First, we believe that much, if not all, of the 'regulatory objectives' that Governor Tarullo speculates should be reflected in a well-informed and careful fiduciary's decision-making process are likely already reflected as a matter of both law and practice. Fiduciaries of regulated financial institutions are certainly already required to take into account the regulatory environment and regulatory requirements when assessing the best interests of their institutions and their shareholders. Second, Governor Tarullo did not express a view on the merits of expanding fiduciary duties or propose any changes (instead, he expressly noted that his remarks were intended to encourage continued debates among scholars), and Governor Tarullo expressly acknowledged that modifications would be beyond the authority of the Federal Reserve.

Heightened expectations for risk management: increased scrutiny of bank directors

After the financial crisis, the US Office of the Comptroller of the Currency (OCC) developed a set of 'heightened expectations' to enhance its supervision and strengthen the risk management practices and governance of the largest national banks. In September 2014, the OCC adopted final, enforceable risk governance guidelines to formalise these expectations for insured national banks, federal savings associations and federal branches of foreign banks with more than US$50 billion in average total consolidated assets, as well as banks below that asset threshold in certain circumstances. These guidelines establish new, and much higher, minimum standards for designing and implementing a bank's own risk governance framework and the oversight of such framework by the bank's board of directors. Although the OCC stated that its final risk governance guidelines were revised in order to 'avoid imposing managerial responsibilities on board members,' there continues to be increased focus on the role of directors in risk management, as evidenced by the increased risk oversight responsibilities imposed on directors under the OCC's final guidelines.

The OCC's risk governance guidelines are not isolated rules; instead, they reflect a larger trend in increased supervisory focus on a banking organisation's risk management framework and corporate governance structure, as well as the responsibilities of the board of directors and senior management. Other indications of this trend include the Federal Reserve's Enhanced Prudential Standards (EPS), requiring bank holding companies, large foreign banking organisations and systemically important non-bank financial institutions to establish stand-alone, board-level risk committees and a global risk management framework and to satisfy other risk management requirements.

Taken together, these developments reflect a clear trend of bank directors facing increasing demands from regulators. In our experience, and as reported by the *Wall Street Journal*, it has become common for the Federal Reserve and other bank regulators to hold meetings with individual directors and attend board meetings. We believe this is an important area to monitor because of the potential impact upon director recruitment and retention and board cohesion.

Incentivising a culture of compliance

We believe that the next frontier in financial sector corporate governance will be a focus on regulating and reforming culture in financial institutions. In October 2014, the President and Chief Executive Officer of the Federal

Reserve Bank of New York, William Dudley, made a speech discussing how to enhance financial stability by improving culture in the financial services industry. President Dudley delivered his speech during a workshop hosted by the Federal Reserve Bank of New York on 'Reforming Culture and Behavior in the Financial Services Industry,' which brought together representatives from the industry, regulators and academia and emphasised the increased supervisory focus on culture. In the speech, he made a number of suggestions on compensation, identifying a 'proper' compensation system as 'an important tool for enhancing culture, promoting financial stability and rebuilding the public trust in the financial industry.' We expect a focus on bank culture to continue, and we believe that there will be great focus on the role of the board of directors in setting the tone at the top and holding management accountable for missteps. We believe that it is important to monitor developments in this area, and we hope that any ultimate regulation in this area will not allow short-term populist sentiments to undermine long-term policy formation.

Bank governance developments in the UK

Increased supervisory focus on corporate governance and culture in the financial sector is not limited to the United States; in the UK, there have also been developments of great import in this area, including regulations on remuneration and increased individual liability of non-executive directors of certain UK financial institutions.

In July 2014, the UK's Prudential Regulation Authority (PRA) published a policy statement amending the current Remuneration Code to subject any variable remuneration awarded to employees of PRA-regulated banks on or after 1 January 2015 to clawback for a period of at least seven years from the date on which it is awarded if there is reasonable evidence of employee misbehaviour or material error, or if the firm or relevant business unit suffers a material failure of risk management.

In addition, the UK Financial Conduct Authority (FCA) and PRA confirmed that non-executive directors of certain UK-incorporated financial institutions with specific responsibilities (such as acting as chairman of the board, lead independent director, or chairman of the audit, remuneration or nominations committee) will be subject to all aspects of the FCA's and PRA's Senior Managers Regime (the regime is currently expected to go into effect sometime in 2015). Accordingly, among other impacts, such non-executive directors will become subject to individual liability for regulatory breaches of the firm if the breach occurs in an area for which the non-executive director is responsible. This is coupled with a reversed burden of proof that assumes such director is guilty of misconduct unless it can be demonstrated that he or she took reasonable steps to avoid the breach. Further, under the Senior Managers Regime, such non-executive directors can be subject to criminal liability if their misconduct causes the insolvency of the institution and their conduct is deemed to fall 'far below' what could reasonably be expected of a person in the position. The UK regulators' focus on individual accountability of non-executive directors is another example of bank directors facing increasing demands from regulators.

United States

Shareholder activism

Last year, we observed how shareholder activism investing was increasingly considered a separate, legitimate asset class. This trend has continued. Current estimates for aggregate assets under management by shareholder activists range from US$120 billion to more than US$200 billion. The undeniable 'fire power' of shareholder activists, along with high profile activist campaigns at well-respected, large-cap companies (including Apple, DuPont, PepsiCo, Proctor & Gamble and Mondelēz), has further reinforced to boards and executive officers that no company is immune to shareholder activism.

Some in the corporate governance community have argued that the measure of shareholder activism's influence is not the number of proxy battles won or the percentage of public demands that have been satisfied (estimated by some to be nearly 75 per cent), but the fact that shareholder activists have inspired boards and executive officers to 'be their own activist' and preempt an attack by critically evaluating and adopting proposals that would be supported by activists. The Brunswick Group's 2015 annual global M&A survey presented at Tulane's M&A conference is an example of the perceived influence of shareholder activism. The survey of M&A practitioners from North America, Europe and Asia found that 62 per cent of dealmakers believe that shareholder activism will be the key driver of deal activity in 2015 (significantly outpacing factors such as board confidence, availability of credit and low interest rates and an improving economy).

We are concerned that shareholder activism is beginning to receive too much credit, and are beginning to question whether surveys (such as the survey mentioned above) could be pointed to as evidence of a frequency illusion. Directors and executive officers (with the assistance of their financial and legal advisers) have long devoted time to considering the strategic direction of the company they serve. The existence and substance of these conversations are nothing new, even if they are now framed in terms of shareholder activism, or if shareholder activism acts as the catalyst for raising certain topics. While M&A shareholder activism initiatives were front-page stories in 2014 (including Pershing Square teaming with Valeant in its failed hostile bid for Allergan), we expect that most day-in-day-out deal activity will continue to be driven not by shareholder activists (or fear of shareholder activism) but by directors and executive officers considering the strategic direction of the company and executing on that strategy. Although we expect shareholder activism to continue to be touted as an unprecedented force to be reckoned with, we believe that the actual impact of shareholder activists may be more circumscribed and that the outcome of shareholder activist campaigns (as recently demonstrated in Trian's failed campaign at DuPont) is not a foregone conclusion. We are not claiming that the emperor has no clothes; rather, the emperor is a mere mortal, not an omniscient, omnipotent and omnipresent force.

14A-8 proposals and proxy access

It is important not to forget that shareholder activism is not limited to the campaigns fought on the front page of the *Wall Street Journal* over share buybacks and spin-offs by activists with billions under management. Shareholder activism includes proposals submitted under Rule 14a-8. Under Rule 14a-8, a company is required to include a shareholder proposal in its proxy materials if certain eligibility and procedural 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). Submission of Rule 14a-8 proposals remains at an all-time high, and year after year we witness the tremendous resources that companies and boards devote to analysing and responding to these proposals.

This year, proxy access was thrust back onto the agenda in large part through Rule 14a-8 proposals. In 2011, the DC Circuit struck down Rule 14a-11, which would have granted proxy access (limited to 25 per cent of the board) to 3 per cent shareholders who held their shares for at least three years. Since the rule was struck down, we saw relatively slow company-by-company private ordering at work, with shareholder proposals fashioned after the vacated rule (often called 'SEC-style proxy access proposals') garnering the most support. (During the 2012 and 2013 proxy seasons, in total, only 39 shareholder proxy access proposals were voted on, of which only ten received majority shareholder support.) During the 2015 proxy season, private ordering ramped up dramatically; at least 90 companies received proxy-access proposals (75 of which were submitted by the New York City Comptroller), and well-known companies including, General Electric and Citi, proactively adopted proxy access.

Proxy access was also notable this year because of the SEC's reversal on permitting exclusion of a proxy access proposal at Whole Foods. In October 2014, Whole Foods submitted a no-action request to the SEC seeking to exclude an 'SEC-style' proxy-access proposal on the grounds (prescribed by Rule 14a-8) that Whole Foods management intended to present its own 'conflicting' proxy-access proposal to shareholders. The Whole Foods management proposal had a much higher ownership threshold (9 per cent for five years as opposed to 3 per cent for three years), did not aggregate holdings to achieve the ownership threshold and only permitted shareholders to nominate 10 per cent of the board (as opposed to 25 per cent). In December 2014, SEC staff granted Whole Foods' exclusion request, triggering a flood of similar requests from other companies. After the SEC came under fire from the Council of Institutional Investors and others for its decision, Chair Mary Jo White, in January 2015, directed the SEC staff to review the 'conflicting proposal' exclusion from Rule 14a-8. Shortly thereafter, the Division of Corporate Finance announced that it was withdrawing its Whole Foods no-action letter and would express no views on the conflicting proposal exclusion during the 2015 proxy season. Practically speaking, this development will lead companies and their advisors to conclude that the SEC will be hesitant to grant no-action relief.

We think it will be important to watch how companies who have received a proxy access shareholder proposal decide to respond, whether by (i) including the proposal on the ballot and either opposing it through an opposition statement and shareholder engagement, or supporting it, (ii) following General Electric's approach of proactively adopting proxy access or (iii) seeking court confirmation that it may omit the shareholder proposal. We are hopeful that best practices for proxy access will evolve to look more at the corporate governance 'forest' than 'trees' – that is, to worry less about percentages and one-size-fits-all approaches, and to instead critically analyse proxy access in the context of board composition, board refreshment, board tenure and shareholder engagement. We are skeptical that, in the short term, companies will choose proactively to adopt proxy access. We think most companies, given the choice, will concede to others the honour of early-adopter status and instead adopt a wait-and-see approach.

Continued influence of proxy advisory firms

In June 2014, SEC staff issued long-awaited guidance outlining the responsibilities of investment advisers that use proxy advisory firms and the proxy advisory firms themselves. This guidance requires proxy advisory firms to describe conflicts of interest in some detail, but to their clients and not the public. The guidance also makes it clear that investment advisers are required to vote in accordance with their clients' wishes (including not voting at all) and to establish policies and procedures to carry out their voting responsibilities. Although investment advisers may use proxy advisory firms to provide voting recommendations, they are required to undertake due diligence to ensure that the firms have the capacity and competency to adequately analyse proxy issues.

Overall, this guidance likely disappointed those seeking groundbreaking changes that would curb or diminish the influence of proxy advisory firms. We continue to believe that proxy advisory firm influence is 'here to stay' – as is resulting scrutiny. We also continue to expect that SEC rulemaking in this area will be in the long (not short) term. It will be interesting to see if, in the interim, proxy advisory firms respond organically to market pressure to increase conflict and methodology disclosure and, in the case of special-interest shareholder proposals, to bring their recommendations closer in line with shareholder voting.

Shareholder engagement efforts

Last year, we noted that companies had become more sophisticated at engaging with shareholders and with proxy advisory firms. In the past year, we have seen this trend continue, as companies increasingly devote substantial internal resources and engage external advisers to manage shareholder engagement efforts (even during the proxy off-season and in uncontested situations). This year, we think it is important to note (i) the continued high-profile, broad outreach by institutional investors to companies, (ii) the recent focus on director/shareholder outreach, and (iii) the increased focus on communicating effectively with shareholders in the proxy statement and using the proxy statement as an opportunity to disclose shareholder outreach efforts.

Last year, we noted that Vanguard and BlackRock had each recently sent letters to their investee companies discussing their views on corporate governance practices and, in the case of the BlackRock letter, shareholder activism tactics generally. We identified these letters as examples of large institutional investors, which had typically engaged in quiet outreach, taking an increasingly active and public role on corporate governance matters. We predicted that this trend would continue, and it has. In the last year, letters have become relatively commonplace. Among others, BlackRock, State Street, T. Rowe Price and Vanguard have sent well-publicised letters (and in some cases, multiple letters) to their investee companies on corporate governance topics. We expect that outreach by large institutional investors will continue, especially in light of the recent SEC attention to the responsibilities of investment advisers (discussed above). We also believe that the increasing corporate governance activity of institutional investors will lead many companies to conclude (if they have not already) that a dedicated team is necessary to manage shareholder engagement. Large institutional investors creating individualised proxy voting policies and routinely writing letters on corporate governance matters has resulted in a complex web of preferences for directors and management to wade through. At the same time, year-round engagement with shareholders and proxy advisory firms has become the norm, with companies producing sophisticated presentations in preparation for the meetings, even when there are no pressing issues to discuss. In addition, with shareholder ownership concentrated at many companies among a few institutional investors, and with institutional shareholders often voting in significantly greater numbers than retail investors, it is impossible to ignore the importance of institutional investor outreach.

Last year, there were also increasing calls from large institutional investors, including Vanguard, and from corporate governance groups, such as SDX, for directors to take a front-and-centre role in shareholder engagement. We think it is positive that, by and large, these requests for more director/shareholder engagement have recognised that director/shareholder engagement is not one-size-fits-all. Going forward, we expect that while there will be a focus on director/shareholder engagement, best practices will evolve to recognise that the utility and efficiency of director/shareholder engagement (from management's, the board's and the shareholder's perspective) depends on the company's current circumstances and the issues at hand.

Cybersecurity

Cybersecurity is squarely on board agendas. It seems that each week a well-known company announces a significant data breach. High-profile cyberattacks at Target Corp, Sony and JPMorgan underlined that cybersecurity risks, like other risks to a company's operations, are a key risk management responsibility of the board of directors. In addition, ISS's 'no' recommendation against seven of Target's ten board members served as a clear reminder of the extra scrutiny on directors following a data breach.

In the last year, the SEC has also focused on cybersecurity, including hosting a roundtable discussion on the issues and challenges cybersecurity raises for market participants and public policy. SEC focus was not unexpected; it followed President Obama's 2013 executive order 'Improving Critical Infrastructure Cybersecurity' and the issuance by the National Institute of Standards and Technology of the 'Framework for Improved Critical Infrastructure Cybersecurity' (commonly referred to as the 'NIST Framework'), intended to provide best-practice guidance on key areas related to cyberthreats. Presidential focus on cybersecurity has also continued. President Obama issued executive order 'Promoting Private Sector Cybersecurity Information Sharing' in February 2015 and issued executive order 'Blocking the Property of Certain Persons Engaged in Significant Malicious Cyber-Enabled Activities' in April 2015. We expect this focus to continue.

A detailed discussion of cybersecurity best practices and SEC cybersecurity-related disclosure requirements is outside the scope of this overview. From a corporate governance perspective, we think it is important to note that we expect cybersecurity to receive increased attention from boards which will, at many companies, raise the question of how best to educate directors and executives on cybersecurity threats and risk, and how best to prioritise (and potentially delegate to board committees) oversight of cybersecurity risks in the context of broader strategic risks facing a company and the company's risk appetite. In addition, we think it is possible that cybersecurity could prompt some boards to critically evaluate their current composition and question whether the board should include one or more directors with a background in or directly relevant to information technology, data security and privacy.

Exclusive forum and fee shifting by-laws

Exclusive forum provisions mandate that shareholder litigation be brought in an exclusive jurisdiction (in most cases, Delaware). In 2013 and 2014, more than 300 company boards unilaterally adopted forum selection clauses, some of which were adopted immediately before a major transaction to mitigate the now inevitable but almost always baseless plaintiffs' lawsuits attacking the transaction. We think it will be important to watch how a body of law develops in other states with respect to exclusive forum provisions, both inside and outside the context of a major transaction. We note that, in the case of Delaware, the Corporate Law Section of the Delaware State Bar has recently proposed legislation that would amend the Delaware General Corporation Law to expressly permit a corporation to include in its charter or by-laws an exclusive forum-selection provision specifying a Delaware court for intra-corporate claims and invalidating such provisions that choose a non-Delaware court as an exclusive forum. If this amendment is passed, it will be interesting to see if other states follow suit. It will also be interesting to watch the willingness of other states to honour Delaware law on this subject and the efforts by the plaintiffs' bar to challenge it. In general, when exclusive forum by-laws are adopted apart from any 'questionable' motivation (such as a pending transaction), the plaintiffs' bar seems generally willing to 'accept' their legitimacy.

Shortly after our overview went to press last year, Delaware's Supreme Court issued its opinion in *ATP Tour, Inc v Deutscher Tennis Bund*. In that ruling, the court upheld as facially valid a so-called 'fee shifting' by-law that imposed liability for legal fees on members of a non-stock corporation if the members were losing parties to intra-corporate litigation. Since the decision, at least 40 traditional stock corporations have adopted fee shifting by-laws, and six traditional stock corporations have gone public with fee shifting by-laws. We believe that most companies will continue to shy away from adopting fee shifting by-laws in light of the uncertainty in this area, and ISS's and Glass Lewis' announcements that they will likely recommend against directors at companies that adopt fee shifting by-laws without a shareholder vote. In March 2015, the Corporate Law Section of the Delaware State Bar Association proposed amendments to the Delaware General Corporation Law that would prohibit a stock company's certificate of incorporation or by-laws from containing a fee shifting provision. SEC Chair White recently noted that the SEC is keeping a close eye on evolving developments in this area. Keith Higgins, the Director of the SEC's Division of Corporation Finance, recently noted that the SEC's concern with respect to fee shifting by-laws is not intra-corporate claims but federal securities claims; he also indicated that this was something companies clearly would need to disclose. We plan to continue to monitor developments in this area, although we do not believe that fee shifting by-laws are likely to become an accepted part of the litigation landscape.

Pay ratio disclosure; say-on-pay

It has been more than four years since Dodd-Frank was enacted, and more than a year since the SEC issued a proposed rule to implement the 'pay-ratio' disclosure requirements under section 953(b) of the Act. The proposed rule would require many US public companies to disclose (i) median annual total compensation of all employees in the company (including all full-time, part-time, temporary, seasonal and non-US employees), (ii) annual total compensation of the CEO, and (iii) the ratio of the median annual total compensation of all employees to the annual total compensation of the CEO.

At the time of writing, the SEC still has not published the final rule. Although the delay is not unexpected (the SEC received over 126,000 comment letters on the proposed rule), it has garnered US congressional attention and debate, with Democrats writing the SEC to urge finalisation of the rule and Republicans writing to urge delay and further deliberation. The SEC has advised that it will not publish its final rule until October 2015 at the earliest, meaning that it is possible that calendar-year companies will not be required to disclose the ratio until their 2017 proxy statements. It will be interesting to see the final version of the rule, and ultimately the level of fanfare associated with pay-ratio disclosure.

Perhaps noticeably absent from this year's overview is an extended update on say-on-pay results. It is hard to dedicate even a paragraph to say-on-pay when, for another year, shareholders have overwhelmingly approved say-on-pay. (At the time of writing, only two Russell 3000 companies have had a failed say-on-pay vote in 2015, and average voting levels of approval were 91 per cent.) To be clear, high say-on-pay passage rates do not indicate that focus has turned away from compensation – compensation practices still remain a hot issue worldwide, with increased shareholder engagement on compensation matters and increased shareholder advocacy on compensation issues. In addition, say-on-pay vote policies themselves have remained in sharp focus in other jurisdictions, as countries (and the European Commission) consider whether to follow the lead of Switzerland and the UK and require binding say-on-pay votes.

Hedging policies and pay versus performance

Earlier in 2015, the SEC proposed long-awaited disclosure rules, mandated by the Dodd-Frank Act, that would require U.S. public companies to disclose (i) whether its employees, officers or directors are permitted to hedge the company's equity securities and (ii) the relationship between executive compensation and financial performance. Depending on the effective dates of these rules, calendar-year companies may be required to provide this disclosure as early as the 2016 proxy season. These rules represent continued examples of promoting corporate governance practices through disclosure.

We expect the hedging policy disclosure rule to impact company policy (especially at more 'established' companies), by making companies less amenable to hedging and any similar transactions involving the company's own equity. We think it will be interesting to see whether the final rule will continue to include rank-and-file employee hedging. It may not, given the views of Republican commissioners.

The proposed pay versus performance disclosure rule mandates that US public companies provide a new table, covering up to five years, that shows: (i) compensation 'actually paid' to the CEO, and total compensation paid to the CEO as reported in the Summary Compensation Table; (ii) average compensation 'actually paid' to other named executive officers, and average compensation paid to such officers as reported in the Summary Compensation Table; and (iii) cumulative total shareholder return (TSR) of the company and its peer group. The rule also mandates that companies provide disclosure of the relationship between executive compensation 'actually paid' and the company's TSR and the relationship between the company's TSR and peer group TSR. The rule is highly prescriptive in ways not mandated by the Dodd-Frank Act, and we expect commentators to draw this to the SEC's attention.

Perk disclosure

As discussed above, compensation issues have remained in the forefront; this includes a sharp focus on perks and perk disclosure. In Sweden, private corporate jet usage by major public company executives and directors (and their families and pets) and other corporate extravagances have dominated the headlines, prompting criminal investigations and the resignation of at least seven senior executives. The cases include a number of bad facts – in one case, a plane was reportedly flown empty just to pick up an executive's forgotten wallet. In the United States, while there has not been a similar large-scale perk scandal dominating the headlines, there have been examples of recent SEC enforcement and shareholder derivative suits related to perks.

In March 2015, the SEC charged the CEO of a Silicon Valley-based technology company, Polycom Inc, with using nearly US$200,000 in corporate funds for personal perks that were not disclosed to investors. The per-year omissions were relatively small amounts; three of the four years included in the complaint contained omissions of less than US$31,000. The alleged facts, however, painted an unsympathetic picture – the CEO was alleged to have fabricated (and instructed his administrative assistants to fabricate) expense reports so that he could fund meals, travel, clothing and gifts for his family and friends, including a nine-night trip to Bali so that he and several friends could 'inspect' a site for a potential company event. Also in March 2015, a derivative suit was filed in a US district court alleging that Nordstrom violated securities laws by not fully disclosing aircraft-related costs in its proxy statements and that the Nordstrom board breached its fiduciary duties in approving such transactions without fully analysing the actual expenses.

Although the facts in compensation cases that receive the most scrutiny from shareholders, regulators, the media and plaintiffs' firms tend to be extreme, these cases serve as a reminder that mistakes in compensation-related disclosure can be reputationally damaging in the extreme.

Whistle-blowers and confidentiality agreements

The SEC has recently been investigating workplace agreements out of concern as to whether they may impede whistle-blowing activity protected by the Dodd-Frank Act, and, in April 2015, the SEC announced its first enforcement action against a US public company, KBR Inc, which had been asking witnesses in internal investigations to sign a form confidentiality agreement. While the KBR case happened to involve a specific kind of confidentiality agreement, the SEC has made it clear that it is looking at this issue in employment arrangements more generally and that its concerns relate to companies within, as well as beyond, its regulatory purview. Not surprisingly, the issue has garnered the attention of the US Chamber of Commerce, which wrote a letter to SEC Chair White, expressing its view that the SEC's interpretation was a highly subjective interpretation of the whistle-blower rules.

While it is still in the early days for many companies, as they try to heed the SEC's concerns while legitimately protecting their confidential information and safeguarding their employment relationships, we believe that the SEC is focused on this issue and that the KBR case, as well as the spate of recent and sizeable whistle-blower bounty awards, will lead many companies and their advisers to conclude that it would be prudent for the company to review its code of conduct and employment arrangements to ensure there are express carveouts for reporting to and cooperating with regulators and law enforcement. We believe that confidentiality provisions will be permitted so long as there is a clear company policy (that is not undermined by any contract) that employees have the right to blow the whistle or cooperate with the government.

Europe

Changes to the UK Corporate Governance Code: risk management and disclosure, director pay, responsiveness to shareholder concerns

Last year, the UK Corporate Governance Code was amended. Although many of the changes were quite limited and beyond the scope of this overview, we will highlight some of the changes to director responsibilities, director compensation and shareholder engagement.

The amendments introduced new responsibilities for directors with respect to risk management and disclosure, including requiring that directors (i) confirm in the company's annual report that they have carried out a robust assessment of the principal risks affecting the company's business model, future performance, solvency or liquidity, (ii) monitor the company's risk management and internal control system on a continuing basis, and (iii) make a long-term viability statement in the annual report, which states whether the directors have a reasonable expectation that the company will be able to continue in operations and meet its liabilities as they fall due (drawing attention, in the statement, to any qualifications or assumptions as necessary). A focus on going concern and liquidity risk is not unexpected. These requirements stem from a final report on going concern and liquidity risk published in June 2012.

The amendments also included changes to director remuneration goals. In many ways, director remuneration raises many of the same issues as executive remuneration: aligning interests with the long-term interests of shareholders and ensuring that remuneration structures do not reward excessive risk taking. The amendments to the UK Corporate Governance Code, however, attempt to distinguish director and executive remuneration with respect to short-term success by deleting the goal that director remuneration should 'attract, retain and motivate' directors. Although taking issue with the phrase 'attract, retain and motivate' may surprise our non-UK readers, the phrase became associated with focusing too much (and at the expense of long-term success) on short-term profits. The code amendments also make it clear that companies may have director remuneration plans in place that provide for clawbacks in the event of specified trigger events. We think these developments are important to consider because of the differences between director compensation philosophies and practices in the UK and the United States.

The amendments also include a new provision that applies if a 'significant portion' of shareholder votes is cast against a resolution at a company's general meeting (even if the resolution is ultimately passed). In that event, a company is required to explain what actions it intends to take to understand the reason behind the opposition. The term 'significant portion' is left for the board's determination. This requirement is interesting because while ISS policies in the United States would require a board to implement a shareholder proposal that received majority support or face an ISS 'against' recommendation, the UK Corporate Governance Code extends to provisions that receive a 'significant portion' of support, but only require outreach disclosure, not implementation.

Required environmental, social, employee and diversity disclosure

In December 2014, an EU directive entered into force requiring that companies with over 500 employees include a nonfinancial statement in their annual report containing information relating to environmental, social, anticorruption, bribery and employee matters. In addition, under the directive, the corporate governance statement for certain companies must contain a description of the diversity policy applied to the company's administrative, management and supervisory functions with regard to age, gender, educational and professional background. The description must include the objectives of the policy, its implementations and results. As noted above, Rule 14a-8 proposals in the United States have largely focused on social and environmental issues, and one can anticipate that shareholder proponents in the United States will try to import similar disclosure requirements.

Asia

Hong Kong: continued focus on dual-class structure

In September 2014, Alibaba became the largest IPO in history, issuing approximately US$25 billion in shares. As we approach the anniversary of the IPO, discussions have continued in Hong Kong regarding dual-class structures. As we noted last year, Alibaba had wished to launch its IPO on the Hong Kong stock exchange using a dual-class structure that would enable the company's founders and management to maintain control. After reportedly more than a year of talks with Hong Kong regulators, Alibaba abandoned its plans to list on the Hong Kong stock exchange and ultimately listed on the NYSE. In August 2014, the Hong Kong stock exchange issued a 'concept paper' that was conspicuously non-committal about dual-class structures. At the time of this writing, the exchange is still studying the feedback it has received to the concept paper. We think it is too early to tell how this issue will play out and believe the debate over preserving the 'one-share, one-vote' principle in Hong Kong is far from over. The importance of the issue is clear: (i) dual-class structures are not limited to Alibaba – they are relatively common in technology companies in the United States, including Facebook and Google – and (ii) this issue demonstrates that corporate governance policies may not be viewed in a vacuum. The Asian Corporate Governance Association (whose members include large funds and institutional investors), for example, cited the fact that there are no class-action lawsuits in Hong Kong as one reason why dual-class structures may work in the United States but may not be appropriate in Hong Kong.

Hong Kong: risk management and internal control reforms; SFC Stewardship Code

In March 2015, the Hong Kong Securities and Futures Commission launched a three-month consultation period on proposed principles of responsible ownership. The principles, which were modeled after the UK stewardship code and the Australian 'Blue Book,' provide guidance on how institutional investors should fulfil their ownership responsibilities in relation to their investment in a listed company. The principles ask investors to (i) establish and report to their stakeholders their policies for discharging their ownership responsibilities, (ii) monitor and engage with investee companies, (iii) establish clear policies on when to escalate engagement activities, (iv) have clear policies on voting, (v) be willing to act collectively with other investors when appropriate, (vi) report to other stakeholders how they have discharged their ownership responsibilities, and (vii) when investing on behalf of clients, have policies on managing conflicts of interests. We think it will be interesting to watch how these principles, which take a 'comply-or-explain' approach, influence institutional investor behaviour in Hong Kong and, consequently, whether this results in more focus on and commitment to corporate governance practices in Hong Kong.

We also note that after a consultation period last year, the Hong Kong stock exchange will be rolling out risk management and internal control reforms in early 2016. These reforms are designed to institute a more concrete risk management and internal control concept into the Corporate Governance Code, and to define the roles and responsibilities of management and the board of directors with respect to these issues (including emphasising the board's responsibility to oversee an issuer's risk management and internal control system). We think these issues are especially important to watch in Hong Kong since Hong Kong does not have an independent audit regulator (such as the PCAOB in the United States, ASIC in Australia or FRC in the United Kingdom) and since many view the quality of financial reporting in Hong Kong to be highly varied.

Japan: reform continues to progress

Last year, there were significant corporate governance developments in Japan, including the introduction of the Japanese Stewardship Code in February 2014, the amendment of the Companies Act in June 2014 and the introduction of Japan's first draft Corporate Governance Code in December 2014. The Stewardship Code sets forth principles for institutional investors to engage in dialogue with listed Japanese companies. As of the time of writing, the Stewardship Code has been accepted by 184 institutions, including trust banks, investment managers, pension funds and insurance companies. (This number compares favourably to the UK Stewardship Code on which it is modelled, which had 40 signatories at launch and currently has 300 signatories.) The Companies Act amendments require, among other things, that a listed company appoint an outside director or explain at its annual meeting why it is not appropriate to appoint an outside director (mirroring the UK's 'comply or explain' approach to many corporate governance matters). Notably, especially in Japan where director interlock is common, directors of a parent company, executive directors of affiliate companies and close family members of a director may not be considered outside directors. The Corporate Governance Code, which is scheduled to take effect in June 2015, sets out principles of conduct and requires, among other things, that a company maintain better communications with shareholders, include outside directors on every board, use neutral external auditors and promote diversity. Well-known Japanese companies have already begun adopting their practices in response to these new requirements: Nippon Steel & Sumitomo Metal and Canon, for example, each elected two outside directors for the first time.

Although we believe that these reforms move Japan closer to US and EU corporate governance norms, there is still a long way to go, and we do not believe that change will happen overnight. These corporate governance developments are important to note, however, because of the attention they have received 'at the top' and because they have been characterised as central to greater economic growth: The reforms were promoted by Shinzo

Abe, the current Prime Minister of Japan, as part of the 'third arrow' of his economic growth policy of 'Abenomics.'

Increased attention in Japan to corporate governance was also visible in the formation of, and continued attention paid to, the JPX Nikkei Index 400. The index was launched 'to showcase Japan's most profitable, shareholder-friendly companies.' Although it may be easy to criticise the large size of the index and to second guess the selection metrics, the creation of the index is another example of how 'Abenomics' has led to more dialogue on how to improve shareholder returns and consequently attract more shareholder capital. We would note that there are signs that this focus may be impacting company actions. Largely in response to shareholder pressure to improve ROE, major Japanese listed companies engaged in significant share buyback programmes in 2014, resulting in the highest rate of buybacks since 2008.

Japan: shareholder activism 'catches fire'

Last year we predicted that shareholder activism in Japan would continue to increase as a result of increased foreign ownership and the growing legitimacy of shareholder activism as an asset class. That has happened: 2014 was a record year for shareholder proposals in Japan. One headline in the *Financial Times* even declared, 'Shareholder Activism Catches Fire in Japan'. A number of the shareholder proposals were from a single investor, the Children's Investment Fund of London. Daniel Loeb also recently followed his high profile (failed) approach to Sony with an approach to Fanuc, Japan's tenth-largest company by market capitalisation and the world's largest robot maker.

We continue to believe that it will be important to watch how activism evolves in Japan to attract the support of institutional shareholders and to work effectively with company management. We are sceptical that one-size-fits-all tactics will prove effective, given cultural and structural differences between Japan, on the one hand, and the United States and UK, on the other hand (eg, continued cross-shareholding relationships in Japan). We also believe that the ability of activist shareholders to attract the support of institutional shareholders will require strong circumstances and be a relatively slow process, since institutional shareholders in Japan have traditionally been unwilling to publicly challenge management or to vote against management recommendations. For activist campaigns to be successful, we believe that this support will be key even for companies, such as Fanuc, with a sizeable ex-Japan shareholder base. We also think it will be interesting to see what other UK and US activists set their sights on Japanese companies.

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Getting the Deal Through

Law Business Research

Corporate Governance
ISSN 1476-8127

THE QUEEN'S AWARDS FOR ENTERPRISE: 2012

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