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GETTING THE DEAL THROUGH

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Corporate Governance
2016

Publisher
Gideon Roberton
gideon.roberton@lbresearch.com

Subscriptions
Sophie Pallier
subscriptions@gettingthedealthrough.com

Senior business development managers
Alan Lee
alan.lee@gettingthedealthrough.com

Adam Sargent
adam.sargent@gettingthedealthrough.com

Dan White
dan.white@gettingthedealthrough.com

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Global overview

Arthur Golden, Thomas Reid, Kyoko Takahashi Lin, Laura Turano and Morgan Lee

Davis Polk & Wardwell

During the past several years, it has become relatively commonplace to declare the importance of corporate governance and to predict that the focus on corporate governance, in the C-suite, in the boardroom and by shareholders, is here to stay. We are pleased to write this year's global overview because, at the risk of preaching to the choir, we believe that it is now obvious that corporate governance is accepted as a permanent element of investor valuations of companies and as a permanent consideration for companies and their advisers. We also believe that a global understanding of corporate governance is especially important because this is an area that has only become more global over time, with 'imports' and 'exports' of best practices and considerations across jurisdictions. As in other areas in the past, such as competition laws and anti-corruption laws and practices, we expect to see – over time – a continued evolution toward 'higher' standards and a tendency towards comparability (although not perfect equalisation) of these standards around the world. In this global overview, we endeavour to outline for you the key corporate governance developments of this year, to analyse their significance and to predict their near-term trajectory.

United States

Shareholder activism continues to be in sharp focus despite headwinds

Shareholder activists faced significant headwinds at the beginning of 2016. Last year, we expressed our concern that shareholder activists, like other 'novel' investment classes and strategies before them, were beginning to receive too much credit, and clarified that while we were not claiming that the emperor has no clothes, we did believe that the low-hanging fruit had been gathered and that it was important to remember that the emperor was 'a mere mortal, not an omniscient, omnipotent and omnipresent force'. We are no longer iconoclasts. In the past few months, the limitations that feature prominently in the shareholder activism asset class – low investment diversification, liquidity challenges and personality-dependent strategies – have been on display as shareholder activists have received significant negative press coverage for investment returns, and as scrutiny of Valeant Pharmaceuticals (which as of 1 May 2016 was down 85.04 per cent on 1 May 2015) has spurred scrutiny of the shareholder activists who recently lauded Valeant's management team, strategy and performance.

On 17 March 2016, US Senators Tammy Baldwin and Jeff Merkley introduced the Brokaw Act to 'increase transparency and strengthen oversight of activist hedge funds'. If enacted, the Act would, among other things, direct the Securities and Exchange Commission (SEC) to: shorten the filing window applicable to the acquisition of a 5 per cent stake in an equity security from 10 days to two business days; require disclosure of significant 'short' positions; and amend the definition of beneficial ownership for purposes of section 13(d) to include any person who has a pecuniary or indirect pecuniary interest in the security (an amendment aimed at 'wolf pack' activism). Although some have calculated that the Act has less than a 2 per cent chance of passing (based on, among other factors, the committee to which the Act was referred and the sponsors of the Act), we believe that the Act is a reminder that shareholder activism specifically, and corporate governance generally, do not occur in a vacuum. They are inextricably linked to, among other things, the regulatory regime in which they operate.

We do not believe that the proposal of the Brokaw Act or recent critical reports on shareholder activist performance mark the beginning of the end for the genre – but we do see the development of a consensus that shareholder activists, and their proposals, should not be immune to critical analysis (including analysis of appropriate regulatory parameters for their activities). We believe that this consensus will manifest itself in a number of ways, including increased scrutiny by boards and larger shareholders of companies as to whether they are capitulating too readily to a shareholder activist's demands, and pressure on shareholder activists to develop proposals that include ideas beyond 'divest and distribute'. We will continue to monitor the shareholder activism area, and are pleased to serve as editors for Getting the Deal Through's *Shareholder Activism & Engagement* volumes dedicated to these issues.

14a-8 proposals: proxy access update, other considerations

As we have noted in previous years, it is important to remember that shareholder activism is not limited to costly battles fought on the front page of the *Wall Street Journal* over share buybacks and spin-offs. It also includes proposals submitted under Rule 14a-8, which requires a company 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). Because of its low eligibility thresholds, Rule 14a-8 currently provides a low-cost mechanism for shareholders to provide feedback to management and the board, and, more generally, to promote special interests.

In 2015, the power of Rule 14a-8 proposals was demonstrated when proxy access was largely thrust back on to the agenda by such proposals. Proxy access refers to the right of shareholders, who meet certain eligibility and procedural requirements, to include their nominees for director (subject to limitations) on a company's proxy card. 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 (including certain shareholder groups) who held their shares for at least three years. After 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 2015 proxy season, private ordering ramped up dramatically; at least 91 companies (compared with 18 companies in 2014) received proxy access proposals, and more than 60 per cent of such proposals (compared to 27.7 per cent in 2014) received majority shareholder support.

So far in 2016, we have seen a continuation of these trends. In January 2016, the NYC comptroller, who submitted 75 proxy access proposals in 2015, announced that he had submitted proxy access proposals on behalf of NYC pension funds at 72 companies. As of April 2016, 43 of the 72 companies targeted by the NYC comptroller had already responded by adopting SEC-style proxy access proposals. We believe that this reflects companies objectively evaluating with their advisers whether a proxy access shareholder proposal can be resisted and, if not, choosing to adopt proxy access rather than risking a negative shareholder vote and having to adopt proxy access with a view toward the ISS and Glass Lewis 'board responsiveness policies'. (Under their board responsiveness policies, ISS and Glass Lewis will evaluate whether the major terms of a shareholder proposal were implemented and if any additional terms were implemented that would limit the use of the proxy access right. If they determine that a board has not been responsive to a majority-supported shareholder proposal, they may recommend against the election of the entire board, of nominating or governance committee members, or of individual directors.)

Proxy access has not (at least not yet) proved a significant threat to orderly board governance or administration. It remains to be seen whether the use of a single proxy card coupled with the SEC-style three-year holding period will spur actual use of proxy access to gain board seats, especially by more aggressive or activist investors. It is also not clear whether other proxy access eligibility requirements will make proxy access less of a tool for shareholder activists as opposed to public policy agitators.

We remain sceptical that, in the short term, and absent a proxy access shareholder proposal (or threat of such a proposal), large numbers of companies will choose to proactively adopt proxy access in light of the limited benefits of such an approach and the limited information on 'use' of proxy access. Proactively adopting proxy access does not immunise a company from a proxy access proposal on more 'shareholder-friendly' terms and does not grant significantly greater freedom in choosing proxy access terms given that a relatively strong market consensus has developed on most terms. A 'wait and see' approach allows more time for market practice to develop further and for boards and management to understand the full implications of proxy access.

In contrast to 2015, so far in 2016 there has not been a single Rule 14a-8 proposal that has dominated the proxy season agenda. The proxy season has, however, provided an important reminder to companies as they decide how to respond to Rule 14a-8 proposals. It is essential to remember the potential negative press coverage surrounding no-action requests, especially surrounding requests to exclude environmental, social and corporate governance (ESG) proposals. This year, we saw Amazon's decision to seek no-action relief to exclude a proposal regarding preparing a report on gender pay disparity characterised as an effort to resist gender pay equity. Similarly, Apple's request to exclude a proposal on board diversity was characterised as an anti-diversity move, even though Apple noted in its no-action request that its efforts to increase diversity were much broader than those requested by the proposal. These examples are important reminders that the press is likely to side with the proponent of an ESG proposal, which are often 'headline grabbing' in nature, and discount, if not ignore, the company's arguments.

The proxy season has provided another important reminder of the interplay between politics and corporate governance. Following the adoption of the Paris Agreement in December 2015, in which nearly all countries committed to reduce greenhouse gas emissions, we have seen an increased focus by some shareholders (expressed in Rule 14a-8 proposals and in letters to company management) on whether companies are sufficiently planning for how their business may be affected by climate change and attendant legislative and regulatory changes. This is an important reminder for companies within and outside of the energy space that political and regulatory developments can be expected to impact the focus and tenor of shareholder interactions and shareholder engagement efforts.

Focus on board composition: tenure and diversity

In our 2014 global overview, we noted that board tenure was an important issue to monitor because of the average tenure of directors, because very few US public companies have term limits for directors, and because views are largely split as to whether shareholders are best served by new directors (who may be more independent stewards of the company) or longer-serving directors (who through experience and knowledge are often best positioned to effect change and challenge management). As we expected, board tenure has become an increasingly hot topic, and some investors have even drawn specific lines in the sand on tenure. For example, Legal & General Investment Management, a European institutional asset manager, issued a policy in March 2016 providing that as from 2017, it would vote against the chair of the nominating or governance committee at a company if the average board tenure at that company is 16 years or longer or if no new directors have joined the board in the past five years. In contrast, CalPERS has taken a 'comply or explain' approach (similar to the approach taken under the UK Corporate Governance Code), calling for companies to explain why a director who has served 12 years or more continues to be considered independent.

Although director term limits in the United States remain rare (only 3 per cent of S&P 500 companies have adopted term limits), we also believe this will be an important area to monitor in light of General Electric and Time Warner recently adopting director term limits. We are hopeful that, given the lack of evidence of a direct connection between the length of director tenure and director performance, and given the downsides of limiting board flexibility through term limits, that term limits will not become common practice. It seems much more appropriate to focus on average board tenure and whether there is periodic 'refreshment' of directors, rather than adopting a presumed tenure that would likely be served without regard to actual quality and performance of the individual director (and likely deprive companies of the maximum continued service of their best directors).

Board diversity also continues to be a focal point. In November 2015, SEC Chair Mary Jo White characterised increasing board diversity as a 'business and moral imperative' and in January 2015, SEC Chair White stated that the SEC staff is currently reviewing disclosure requirements regarding board diversity and considering whether additional guidance or rule-making would be appropriate. In December 2015, the US Government Accountability Office released a report on corporate board gender diversity that estimated that it would be more than 40 years before gender parity was achieved (as of 2014, women held approximately 16 per cent of seats on S&P 1500 boards). In March 2016, 10 Democratic lawmakers released a public letter expressing disappointment that the SEC had not taken action on the issue in the past year and proposing enhanced disclosure requirements to spur diversity of director candidates. This comes a year after Germany passed legislation that requires large companies to fill 30 per cent of their non-executive board seats with female members. We expect the focus on board diversity to continue. One important question is the extent to which large institutional investors are willing to draw lines in the sand on diversity. Such policies would not be unprecedented. In Australia, the Australian Council of Superannuation Investors, a collaboration of funds and asset owners, launched an initiative in early 2015 that included targeting companies with all-male boards and, if private meetings proved not to be fruitful, recommending that its members vote against the re-election of directors at such companies.

Board leadership structure; continued examples of institutional investor outreach

For the first time in three years, during the 2015 proxy season, a proposal to separate the roles of chairman and CEO was no longer the most prevalent governance Rule 14a-8 proposal. This does not mean, however, that attention to board leadership has abated. For example, State Street (one of the largest passive investors in the world) sent a letter to board members of its investee companies noting that strong independent leadership will be a key focus of State Street's 2016 corporate governance engagement programme and noted with concern that 23 per cent of S&P 500 companies and 34 per cent of Russell 3000 companies do not have an independent chair or an independent lead director. The State Street letter demonstrates how the trend of large institutional investors sending letters to their investee companies on corporate governance practices has continued. In the past year, BlackRock, State Street, T Rowe Price, Vanguard and others have sent well-publicised letters (and in some cases, multiple letters) on such topics.

In addition, the State Street letter is an example of the increasingly complex web of preferences that directors and management have to wade through. With respect to independent board leadership, for example, State Street specifies that it believes a strong independent board leadership structure should include (i) a clear process for selecting an independent board leader, with a framework for selection that specifies relevant skills and experiences; (ii) at minimum a three-year tenure for the independent chair or lead independent director, with additional terms based on performance; and (iii) regular evaluation by other independent board members of the performance of the board leader.

Cybersecurity

In December 2015, the Cybersecurity Act of 2015 was signed into law. The Act, among other things, establishes a mechanism for cybersecurity information-sharing among private and public sector entities; provides safe harbours from liability for private entities that share cybersecurity information in accordance with certain procedures; and authorises certain entities to monitor specified information systems and operate defensive measures for cybersecurity purposes. In addition, in late 2015, the Cybersecurity Disclosure Act of 2015 was introduced in the Senate. The Act, if passed, would require the SEC to issue rules requiring companies to disclose whether any director has expertise or experience in cybersecurity, and, if not, what the nominating or governance committee took into account in terms of cybersecurity expertise. It is unclear whether the Act will pass, and even if it does, it will likely take years (and not months) to know how key provisions in the Act would be implemented (eg, the definition of 'cybersecurity expert').

As a result of these developments and the announcement of significant data breaches at well-known companies and professional services firms, the question of how to effectively 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, remains on the agenda. Although we will have to see how things evolve, one route that we believe at least some companies will take if the Cybersecurity Disclosure Act of 2015 is passed, or if there continues to be an increased focus on cybersecurity, is to have and disclose that there is a direct reporting relationship between an executive in charge of cybersecurity and the board or a committee of the board, similar to the chief compliance officer's direct reporting relationship to the board or the audit committee. We also expect that in any event, cybersecurity will make it onto more board agendas as a topic. In a recent study, it was reported that although nearly 90 per cent of CEOs worry that cyber threats could adversely impact their company's growth prospects, nearly 80 per cent of the more than 1,000 information technology leaders surveyed had not briefed their board of directors on cybersecurity within the past 12 months. We expect that there will be pressure to resolve this disconnect.

Pay ratio disclosure

Nearly six years after the US Congress enacted the Dodd-Frank Act and more than two years after the SEC released a proposed 'pay ratio' disclosure rule, in August 2015, by a 3-2 vote, the SEC adopted the final rule implementing the 'pay ratio' disclosure requirements under section 953(c) of the Dodd-Frank Act. SEC Chair Mary Jo White noted that the proposed rule had received more than 287,000 comments. 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. Starting in 2018, calendar-year companies will be required to disclose the pay ratio in their proxy statements or annual reports.

The final rule includes changes to the median employee calculation contained in the proposed rule, including, among other things, by providing an exemption for non-US employees located in jurisdictions with data privacy laws that would prohibit the company from collecting the required information; and only requiring the company to identify the median employee once every three years (instead of every year, as required by the proposed rule), unless there has been a change in the company's employee population or employee compensation arrangements that it reasonably believes would result in a significant change to its pay ratio disclosure. Not surprisingly, the announcement of the final rule set off a firestorm of commentary. It will be interesting to see whether the disclosures required under the final rule will spark as much debate, especially once the disclosures are no longer a novel component of company proxy statements.

Pay versus performance; hedging disclosures; clawback

It is widely expected that in 2016, the SEC will issue final rules implementing the 'pay versus performance', 'hedging disclosures' and 'clawback' rules of the Dodd-Frank Act. The SEC issued proposed rules on these topics in 2015. In brief:

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

In particular, we think that it will be interesting to see whether the final 'clawback' rule will be as prescriptive as the proposed rule, which went beyond the requirements of the Dodd-Frank Act; among other things, the proposed rule would require recovery on a 'no-fault' basis and bar companies from indemnifying or repaying executive officers subject to a clawback action.

Clawbacks under Sarbanes-Oxley

In February 2016, two cases provided insight into how the SEC views section 304 of the Sarbanes-Oxley Act. Section 304 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. In addition, section 304 gives the SEC discretion to exempt an executive from the reimbursement requirement. In these two cases, the SEC forwent clawback actions against executives who preemptively reimbursed their companies for certain incentive compensation received after the disclosure of misstated financial statements. It will be interesting to see whether this pragmatic approach to corporate reimbursement informs the process of finalising the 'clawback' rule under Dodd-Frank, which has been criticised for not providing companies with sufficient discretion to decide whether to pursue a clawback action. We also believe these cases are an important reminder of how SEC standards and focus can evolve over time. For example, since the passage of the Sarbanes-Oxley Act in 2002, the clawback standard under section 304 appears to have evolved from a fault-based standard to a strict liability approach. We have also seen the SEC go from bringing no clawback cases in the first seven years following the enactment of the Act, to bringing cases with relative regularity.

Incentive-based compensation and financial institutions

Nearly five years after releasing its initial proposal, the consortium of regulators mandated by the Dodd-Frank Act to prescribe guidelines to curb excessive incentive-based compensation at covered institutions submitted a joint reproposed rule for publication in the Federal Register in May 2016. The delay has been attributed to the difficulties inherent in getting multiple disparate regulators to agree to one set of regulations that need to cover a broad range of highly diverse financial institutions.

Under the reproposed rule, all covered institutions would be subject to a general prohibition on incentive compensation arrangements that would encourage inappropriate risks by providing excessive compensation or that could lead to material financial loss. The reproposed rule also takes a tiered approach with some of the requirements being enhanced for institutions with consolidated assets above certain thresholds. For institutions with consolidated assets above US$250 billion, the rule would require that 60 per cent of a senior executive officer's (SEO) – and 50 per cent of a significant risk-taker's (SRT) – incentive-based compensation be deferred for four years from the last day of the performance period, which is reported to be a year longer than current industry practice. Once the deferral periods ends, an SEO's and an SRT's incentive-based compensation would be subject to a seven-year clawback period, with the clawback triggered upon the SEO or SRT engaging in misconduct that resulted in significant financial or reputational harm to the financial institution, fraud or intentional misrepresentation of information used to determine the SEO or SRT's incentive compensation.

The reproposed rule would require all covered institutions to create records for all new incentive compensation plans (including plan participants) and retain those records for seven years. For covered institutions with consolidated assets in excess of US$50 billion, the reproposed rule would prohibit the use of performance measures that are based solely on industry peer performance comparisons. With respect to internal governance, the compensation committee of covered institutions must be composed solely of directors who are not SEOs. In addition, management must submit an annual (or more frequent) assessment of the effectiveness of the institution's incentive compensation programme and related compliance and control processes.

The reproposed rule will not apply until at least 18 months after the final rule is published and will not apply to any incentive compensation plan with a performance period beginning before the effective date of the rule. We believe that it will be important to watch reactions to the reproposal, and expect that given the US presidential election this year, and the large impact the rule could have on incentivising and retaining top talent on Wall Street, that this will be a hot topic of conversation.

Compensating directors and executives: process matters

Two recent cases emphasise the importance of process in granting compensation packages to directors and executives.

Facebook: challenges to director pay

The first case involves the 2013 decision by the Facebook board to grant non-employee directors an average of US$461,000 in stock. In June 2014, a Facebook stockholder brought suit arguing that Facebook's board had breached its fiduciary duties by awarding itself excessive compensation. After the suit was filed, Mark Zuckerberg, who controlled 61 per cent of Facebook's voting power, ratified the directors' compensation in a deposition and an affidavit. Defending against the suit, Facebook argued that Zuckerberg's ratification was sufficient to shift the standard of review from entire fairness to the business judgement presumption. In an October 2015 decision, the Delaware Court of Chancery disagreed with Facebook and ruled that stockholder ratification must be accomplished through the process provided by the Delaware General Corporation Law (ie, either voting at a stockholder meeting or acting by written consent). In light of the Chancery decision, Facebook decided to settle.

The *Facebook* decision should not be viewed as an anomaly but instead is consistent with a recent line of cases that reaffirm the application of entire fairness review for matters involving director compensation. In 2012, nearly 20 years after a Delaware Chancery decision unexpectedly applied the business judgement rule to a director compensation case, the Court in *Seinfeld v Slager*, upended the then-prevailing presumption of many practitioners by applying entire fairness review to director compensation matters.

The settlement reached by Facebook and the plaintiff is particularly interesting, however, with some suggesting that it might shape the way companies grant and review board compensation, particularly cash compensation. Under the terms of the settlement, Facebook agreed to amend the charter of its compensation committee to include the following responsibilities: conducting an annual review of all director compensation (cash and equity-based); engaging an independent compensation consultant to advise the board in its review of director compensation, including with respect to the amount and type of compensation and peer company data; and recommending to the Facebook board whether to make any prospective changes to director pay. In addition, the Facebook board agreed to review director compensation and the compensation committee's recommendations on an annual basis. Finally, for the 2016 stockholder meeting, Facebook agreed to include separate stockholder approval proposals for: the 2013 director grants (which were the target of the stockholder suit) and the director annual compensation programme (covering both equity and cash).

The focus on cash is particularly interesting because, while many companies have adopted limits on director equity grants, it has not been the norm to impose similar limits on cash grants.

Yahoo: negotiating executive compensation packages

In March 2015, a Yahoo! stockholder filed suit requesting the release of additional books and records related to the hiring and firing of Henrique de Castro, Yahoo!'s former chief operating officer. Marissa Mayer, the CEO of Yahoo!, led the recruitment of de Castro from Google, where the two had previously worked together. At a meeting of the Yahoo! compensation and leadership development committee, Mayer, on a no-names basis, disclosed that she was in discussions to fill the COO position and described the general terms of the compensation package. While the committee's compensation consultant found the package to exceed comparable packages provided by peer companies, the consultant indicated that the package could be justified. The committee authorised Mayer to continue negotiations, subject to the committee's review of the offer letter. Following a 30-minute meeting where the name of the candidate was revealed, the committee approved an offer letter that tracked a term sheet previously reviewed by the committee, while retaining control over any material changes to the offer. Despite this caveat, the Chancery Court found that Mayer made at least three changes to the offer letter that materially increased the compensation package without informing the committee. Fourteen months later, the committee approved Mayer's termination of de Castro, without a meeting and without asking any questions, through an email exchange of written consents.

In light of the above findings, the Court granted the stockholder plaintiff's request for access to Yahoo!'s books and records, concluding that there was a credible basis for concern about wrongdoing at Yahoo!, based on either breach of fiduciary duty or waste. While the eventual resolution of the dispute is still unclear (Yahoo! has appealed the Chancery Court decision) the opinion contains what many have described as a best practices guide for board evaluation and approval of executive compensation packages. These tips, which emphasise the importance of process, include: exploring potential conflicts of interest between the negotiator and recruited executive, providing the board with materials that adequately explain how the compensation package would function and how proposed changes would impact the value of the package, giving directors enough time to review and discuss the compensation package and documenting the decision-making process of the board.

We believe that the above cases suggest that compensation-related litigation is alive and well. Given the numerous SEC-mandated disclosures on executive and director compensation, companies would be well-advised to ensure that adequate procedures are established and followed when awarding executive and director compensation. These cases demonstrate that the plaintiffs' bar is becoming even more adept at carefully mining public disclosures to gather the baseline information necessary to launch a case.

Whistle-blowers and internal reporting

A recent court decision has muddied the scope of whistle-blower protections under the Dodd-Frank Act. In September 2015, the Second Circuit determined that the Dodd-Frank anti-retaliation protections cover employees who report securities-related wrongdoing internally and not just whistle-blowers who report such wrongdoing to the SEC. This conclusion, at odds with a 2013 Fifth Circuit decision, potentially expands the scope of employer liability and reinforces the need for clear internal reporting procedures. While the company subject to the Second Circuit case has declined to pursue a writ of certiorari with the Supreme Court, we believe that this is an issue that may find its way to the Supreme Court, given the current circuit split and the ambiguity it creates for company liability. This, in turn, may depend on the shape of the new court when a ninth justice is eventually confirmed.

Europe

Continued focus on remuneration

In December 2015, the European Banking Authority (EBA) published its final guidelines on 'sound' remuneration policies and its opinion on applying the 'proportionality' principle. The guidelines will take effect on 1 January 2017, and will replace the guidelines published in 2010 by the EBA's predecessor body, the Committee on European Banking Supervisors. EU member states will be required either to adhere to the new guidelines or provide the EBA with a reason for non-compliance within two months of publication and translation of the guidelines.

The new guidelines will apply to all credit institutions and investment firms in the EU, including their non-EU subsidiaries and branches. Under the guidelines, the bonuses of certain employees are capped at 100 per cent of the employee's total fixed pay or 200 per cent with shareholder approval. The guidelines set out general criteria for what constitutes fixed pay and provide guidance on the proper treatment of certain types of compensation (eg, allowances, retention bonuses and discretionary pension benefits).

The proportionality principle requires national regulators to consider the size, complexity, nature and internal organisation of an institution when applying remuneration policies to covered institutions. A number of regulators have used the proportionality principle as the basis for exempting smaller institutions from the bonus cap requirements. However, in December 2015, the EBA announced that the proportionality principle cannot be used to justify the exclusion of smaller institutions from the bonus cap requirements. We think it is likely that the EBA will re-evaluate its position on proportionality in light of the European Securities and Markets Authority declining to endorse the EBA position and two UK regulators announcing that they will continue to use the proportionality principle to exempt some covered institutions from the bonus cap.

Audit market reforms

The audit market reforms are set to take effect in 2016, nearly two years after adoption and approval by the EU Parliament and Council of the EU. Member states of the EU had until June 2016 to implement the measures needed to ensure compliance with the EU Directive. Most notably, the new rules require public interest entities (which include EU-listed companies, banks and insurance companies) to rotate their auditor at least once every 10 years; prohibit audit firms from providing certain non-audit services to their audit clients and cap the fees associated with permitted non-audit services to 70 per cent of the audit fees tendered by the client based on a three-year average; and prohibit the use of 'Big Four only' clauses as a means of expanding the market for audit services to smaller firms. While in the United States, Sarbanes-Oxley prohibits auditors from providing certain non-audit services and requires permitted non-audit services to be pre-approved by a registrant's audit committee, there is no comparable cap on fees earned from non-audit services. We are interested to see what impact these audit reforms will have and whether, in the long term, other jurisdictions will develop comparable caps and auditor rotation requirements.

UK: stewardship code and the culture coalition

It appears that the UK Stewardship Code is poised to receive an update. Under the 'comply or explain' system, signatories must either comply with the Code or explain the reason for their non-compliance. In December 2015, the UK Financial Reporting Council (FRC) announced that it will provide individualised feedback to signatories after reviewing their statements of non-compliance. Later in 2016, the FRC plans to publish an assessment of Code signatories in which signatories will be labelled as either meeting reporting expectations or needing improvement. We think it will be interesting to see if any companies reconsider their commitment to the Code, in light of the FRC adding more teeth to the Code's 'comply or explain' mechanism.

In September 2015, the FRC launched an initiative to gather insight into corporate culture and the role that boards can play in shaping and promoting good corporate practices. The final observations of the culture coalition will not be released until July 2016. Defining corporate culture is a difficult endeavour, and we think it will be interesting to see the results of the FRC's initiative.

Asia

Hong Kong: no to dual-class structures

After more than two years of what appeared to be incremental steps toward permitting dual-class structures, the process came to an abrupt halt when the board of the Hong Kong Securities and Futures Commission unanimously came out against a draft proposal for primary listings with dual-class structures. As we have chronicled, the drive for dual-class structures on the Hong Kong Stock Exchange (HKSE) came after Alibaba's decision to launch its IPO, the largest in history, on the New York Stock Exchange instead of on the HKSE, after the HKSE refused to permit the use of weighted voting rights in the company's control structure. The HKSE's decision was much debated at the time and, in the aftermath of the Alibaba IPO, it issued a concept paper as a first step toward exploring the theme with public engagement. The response to this paper from the market suggested to the HKSE that there was sufficient support for a second-stage consultation on the acceptability of dual-class structures. While the concept paper described the forthcoming process as 'evolutionary rather than revolutionary', it seemed poised to consider the introduction of dual-class structures under limited circumstances. This debate came to a halt when the Commission, in an unusual move, announced, before the HKSE could proceed with the second consultation, that it did not support primary listing with dual-class structures. Among the reasons offered to support this conclusion were the belief that limiting such structures to highly capitalised market participants does not ensure that shareholders will be protected, and misconduct by such participants would have a greater impact on the market; and a concern that it would be difficult to determine effectively which issuers should be able to use dual-class structures, and to ensure that the structures are limited to new issuers.

Perhaps more noteworthy, however, was the acknowledgment by the Commission that the discussion on dual-class structures was to some extent spurred on by the competition from US exchanges for the listing of mainland China businesses and that the Commission should consider both long- and short-term objectives, and the principles of fairness and transparency, when it acts as a regulator. The apparent rejection of dual-class structures in Hong Kong is in stark contrast to the increasing insistence of US technology and media companies on dual-class structures and the increasing tolerance of IPO investors for such structures and, in fact, recognition by leading investors that they can foster a focus on long-term value creation.

Hong Kong: SFC Stewardship Code

As we previewed last year, after public consultation, in March 2016, the Hong Kong Securities and Futures Commission published guidelines on principles of responsible ownership, joining the growing ranks of countries to adopt a stewardship code. Similar to the UK Stewardship Code, the principles are voluntary and centered around a 'comply or explain' mechanism. Like the UK code, the Hong Kong principles provide guidance on how institutional investors should fulfil their ownership responsibilities by actively engaging with and monitoring their investee companies. The principles also focus on the relationship between institutional investors and their stakeholders by encouraging the disclosure of engagement policies, such as voting and handling conflicts of interest.

The principles come amid the implementation of other reforms and expanding regulator discourse with market participants on topics such as listing rule amendments regarding risk management, internal controls and disclosure requirements; the Commission drawing attention to incomplete and misleading disclosures by listed companies in its compliance newsletter; the Commission commencing its first Market Misconduct Tribunal proceedings against an issuer for failing to disclose that certain litigation had been commenced against it; and the enactment of the Hong Kong Competition Ordinance, the first competition law of general applicability in Hong Kong, and the creation of an investigatory commission, the Hong Kong Competition Commission. It will be interesting to witness the interplay of these various developments and whether they adequately address market concerns over concentrated shareholding and the disclosure of conflicts of interest among Hong Kong–listed companies.

Japan: implementing reform amid corporate scandal

In June 2015, the Corporate Governance Code came into effect, joining the previously implemented Stewardship Code as the second prong of reform aimed at implementing effective corporate governance in Japan. Unlike the Stewardship Code, the Corporate Governance Code is mandatory and 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. An analysis by the Tokyo Stock Exchange of more than 1,800 governance reports found that 11 per cent of companies were in full compliance with the principles of the Code, while 88 per cent explained non-compliance with some of the principles of the Code. Of the companies that were not in full compliance, approximately 66 per cent were reported to be in compliance with at least 90 per cent of the principles.

As we noted last year, Japan has a long way to go as it seeks to move its corporate governance practices closer to those of the EU and the United States. The disclosure of the Toshiba accounting scandal highlighted this point. As readers may recall, in July 2015, an independent investigation revealed that Toshiba, the second-largest Japanese electronics conglomerate, had engaged in accounting irregularities that overstated earnings by more than US$1.25 billion. While much has been written about the implications and causes of this scandal, we found it particularly interesting that in advance of current reforms, Toshiba had proactively implemented a Western-style governance structure, with a one-tier board of directors, four independent directors and a majority-independent audit committee. Coming less than five years after the Olympus scandal, which prompted the recent spate of governance reform, we believe the Toshiba scandal reinforces the need for reform that goes beyond simple 'check-the-box' compliance. At the same time, we believe that the Toshiba scandal should not overshadow the potential for current reforms to more than incrementally improve Japanese corporate governance. As the Volkswagen emissions scandal proves, the existence of an established corporate governance code, in Germany's case dating back to 2002, does not eliminate the risk of corporate malfeasance. (One can, of course, point to comparable examples in the United States.)

Japan: shareholder activism

Two years ago, we predicted that shareholder activism in Japan would continue to increase because of the combination of increased foreign ownership and the growing legitimacy of shareholder activist funds as an asset class. As of early 2016, this trend is still in place, most notably with Daniel Loeb's recent engagement with 7-Eleven, where he first proposed restructuring the underperforming businesses and then challenged the succession planning of the CEO and chairman of 7-Eleven's parent company, Seven & i Holdings Co, resulting in a board dispute and the sudden and unexpected resignation of the CEO. As many have noted, the rise of shareholder activism in Japan is no accident. It can be linked to the corporate governance reforms pushed by Shinzo Abe, the prime minister of Japan. *The Economist* has even declared Prime Minister Abe a 'shareholder activist' for his eagerness to meet with foreign shareholder activists and his belief that these investors can push Japanese companies to put cash to more efficient use. (Japanese companies are reported to be sitting on approximately US$1.9 trillion in cash, an amount nearly half the size of Japan's economy.) Yet as we noted last year, for activist shareholders to be successful in Japan, their approach must consider the cultural and structural differences between Japanese companies and companies in markets that have been the traditional hunting grounds of activists. It appears that some activists have begun to acknowledge the ineffectiveness of one-size-fits-all tactics. Mr Loeb recently announced that he would deviate from his traditional brash approach when dealing with Japanese companies; perhaps a lesson learned from his high-profile rebuke by Sony. While we continue to be interested in the role foreign shareholder activists will play in Japan, the growing class of domestic Japanese hedge funds seeking to push Japanese companies to take measures aimed at increasing shareholder returns should not be overlooked.

Latin America

Brazil: at a turning point?

The past few years have been a challenging time for Brazil. The country is in the midst of its worst recession in more than a century owing to a global decline in commodities prices that hit Brazil especially hard (reportedly resulting in over 1.5 million jobs lost in 2015 alone); in February 2016, it lost its investment-grade credit rating (its credit rating is now on par with countries such as Bolivia, Guatemala and Paraguay); and its largest company, state-owned Petroleo Brasileiro (Petrobras), has been embroiled in a bribery and corruption scandal involving, according to some accounts, nearly US$3 billion in bribes paid to politicians.

Yet amid this turmoil, and in some cases because of it, several corporate governance reform measures appear to be on the horizon. The Brazilian Securities and Exchange Commission is leading representatives from 11 capital markets entities in developing a unified governance code for listed companies, which the commission expects to release by the end of 2016. While still in the preliminary stages, it appears that the code will use the now familiar ‘comply or explain’ mechanism, to be applied to all listed companies, although the enforcement mechanisms are still unclear. Reforms are also planned to address concerns over the regulation of state-owned entities in light of the Petrobras scandal. The proposals include, among other things, requiring more independent directors; requiring enhanced shareholder disclosures; improving the system for selecting administrators; and requiring permanent audit committees. Finally, new rules are being drafted to facilitate the use of proxy voting for all listed companies, with a particular focus on easing the process for international shareholders. Many Brazilian companies currently require in-person voting or permit proxy voting only if the shareholder has executed a power of attorney specifically authorising another person to vote in-person. While it is too early to forecast the impact of the proposed reforms (or whether the reforms will be passed in substantially the same form as currently proposed), we will be interested to see whether these reforms persuade some foreign investors to give Brazilian companies a second look.

Davis Polk

Arthur Golden	**arthur.golden@davispolk.com**
Thomas Reid	**tom.reid@davispolk.com**
Kyoko Takahashi Lin	**kyoko.lin@davispolk.com**
Laura Turano	**laura.turano@davispolk.com**
Morgan Lee	**morgan.lee@davispolk.com**

450 Lexington Avenue
New York
NY 10017
United States

Tel: +1 212 450 4000
Fax: +1 212 701 5800
www.davispolk.com

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