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Selected Issues for Boards of Directors in 2018

January 9, 2018

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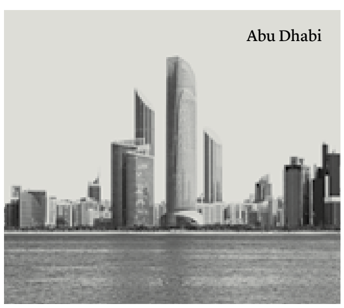

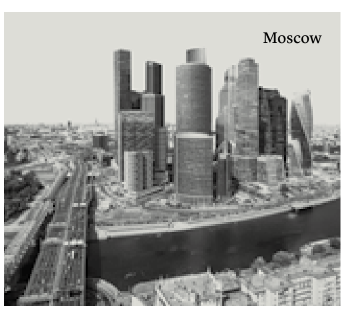

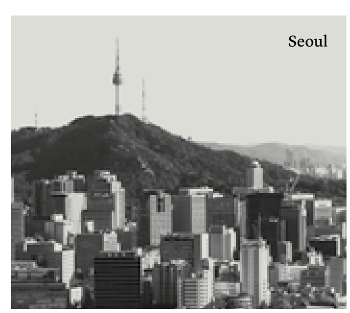

2017 began with a heightened level of uncertainty as the beginning of the year brought significant change in the legal environment, including a change in administration that promised to significantly alter the tenor of regulation.

While certain changes did occur in 2017, in many respects, 2018 is setting itself up as the year to watch for continuing developments in areas that are likely to fundamentally transform how companies operate and interact with an increasingly larger number of vocal stakeholders. For example, while environmental, social and governance topics continue to receive heightened attention from a variety of constituencies, 2017 was the first year in which several significant institutional investors voted in favor of shareholder proposals on climate change, resulting in passing proposals at a handful of companies and increased attention to environmental and social issues that companies must address top-down.

Companies are also facing new challenges from a regulatory perspective. U.S. tax reform virtually monopolized attention at the end of 2017 and promises to be an area of significant focus in 2018, while global concerns about privacy and cybersecurity, after several significant and publicized cybersecurity breaches in 2017 and attendant regulation in a variety of jurisdictions, require more knowledge and complex oversight for companies operating globally. A new federal administration has also altered the focus of regulatory oversight in areas such as enforcement and antitrust, which requires a review of practices with respect to compliance and processes in these areas, and brought about significant developments in policies related to how enforcement of the Foreign Corrupt Practices Act will shape company compliance practices over the next year.

For some areas, 2018 was always set to bring some uncertainty. Companies continued to assess and implement compliance programs ahead of the EU General Data Protection Regulation becoming fully applicable and issues related to Brexit continue to move forward in the United Kingdom, with a slow pace in 2017 primed to accelerate in 2018 following significant December developments.

2018 also promises continued acceleration of topical issues that rose to a level of prominence in 2017. While 2016 was a relatively uneventful year for brand-name shareholder activism, 2017 brought a resurgence of activists in significant campaigns both in the United States and Europe. In addition, in 2017, attention to multi-class share structures, which had been a point of contention with investors for several years, resulted in some of the leading stock indices barring new entrants with multi-class share structures from joining the indices.

If 2017 has proved anything, it is that companies must be ready for an accelerated pace of change on a variety of fronts, including unexpected areas. It will require quick and skillful mastery of complex and challenging issues in near real time and on a global basis. The role that the board and its oversight plays in guiding companies in these times will be critical. As pressure on, and scrutiny of, the board mounts, it will be increasingly important to ensure that communication between management, the board, shareholders and all other stakeholders be executed with thoughtful direction and effective leadership.

This memorandum addresses the following issues for boards of directors:

Developments in Best Practices in the Boardroom

Board composition and environmental, social and governance (ESG) issues have been a focus of good governance for several years. We featured both of these topics in our memo to boards of directors last year. In the past year, the focus has continued to intensify and many companies are becoming increasingly responsive on these issues—both in public and private engagements. There have been significant developments in these areas in 2017 that merit review as companies prepare for 2018. In addition, the Board of Governors of the Federal Reserve System (FRB) released guidance on board effectiveness that may affect how even non-financial institution boards view their oversight role.

Board Refreshment and the New York City Comptroller

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This past September, New York City Comptroller Scott M. Stringer and the New York City Pension Funds launched the "Boardroom Accountability Project 2.0," calling on companies to make their boards more diverse and to enter into a dialogue regarding their board refreshment process with the Comptroller's office.

As part of the campaign, Comptroller Stringer sent letters to the boards of 151 U.S. companies urging them to disclose the race, gender and skills of their board members in a standardized director-qualifications matrix. Of these 151 companies, 92 percent have adopted proxy access, thus their boards face the possibility of a proxy access candidate or other shareholder proposal if they do not demonstrate meaningful progress in expanding diversity on the board. This all comes at a time when BlackRock and State Street have started voting against

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nominating and governance committee members that fail to demonstrate progress in addressing diversity issues, and, in its *2017 Investment Stewardship Annual Report*, Vanguard emphasized its focus on gender diversity in the boardroom.

Proxy advisory firms ISS and Glass Lewis have as part of their annual review of voting guidelines included considerations regarding board diversity, a key driver of refreshment. ISS noted that board composition should be significantly diverse to consider a wide range of perspectives and will highlight a lack of board diversity in its company-specific reviews. Glass Lewis put companies on notice that beginning in 2019, it will recommend that shareholders vote against the chair of the nominating and governance committee at companies with no female directors (although it seemed to make allowances for non-Russell 3000 companies) and hinted that depending on other company factors, including size, industry and overall governance profile, its no-vote recommendations may extend to other nominating and governance committee members.

Many companies have heeded the warning; according to Spencer Stuart, women and minorities accounted for half of the nearly 400 independent directors added at S&P 500 companies as disclosed in 2017 proxy statements, an increase of 15 percent as compared with 2016 proxy statements. However, this news is tempered by the fact that nearly half of S&P 500 boards did not appoint a new director and many boards continue to rely on mandatory retirement ages as the driver for refreshment.

In light of the focus on board diversity and refreshment, below are some practical steps that boards can begin to take as they prepare for the 2018 proxy season:

— *Critically review board composition and skill set*. The nominating and governance committee should critically reflect on the board's progress in diversity recruitment and review the skill set of the board against current and projected needs.

— *Enhance the director search process*. The lack of board diversity at many companies results in part from a nomination process that relies largely on the recommendations of existing directors. Boards should consider how they can enhance the director search process (e.g., soliciting investor recommendations; engaging director search firms; looking outside of existing networks) to identify a more diverse mix of candidates.

— *Review corporate governance documents*. The nominating and governance committee should review its committee charter and the corporate governance principles to ensure that the company's commitment to board diversity is appropriately reflected.

— *Engage with shareholders*. Institutional investors expect companies to actively engage with them on diversity and board refreshment issues. Companies should review and, if necessary, revise their disclosures on board composition and diversity and consider discussing their plans for improving board diversity over time.

In launching the Boardroom Accountability Project 2.0, Comptroller Stringer stated, "Diversity isn't a box to be checked—it's a strategy for economic success. Today, we're doubling down and demanding companies embrace accountability and transparency." As investor attention to board diversity and refreshment continues to grow, it will become increasingly important for companies to demonstrate corporate governance practices that support more diverse, independent and effective boards.

Tone at the Top

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Tone at the top is meant to inform the tone of the entire company—and after the board, senior management is next in line.

Tone at the top has been a focus for boards for several years, brought into sharper focus by corporate crises, such as at Wells Fargo, particularly after the report commissioned by Wells Fargo's independent directors was released. Tone at the top is also an important feature of governance and social trends, as investors and other stakeholders expect that companies will be responsive from the top down and recognize that company standards, culture and compliance are directed and influenced by those in the boardroom.

In the past few years, shareholder proposals and city and state legislation have brought gender pay inequality to the spotlight, while gender imbalance in such industries as tech and finance has been making headlines. The pressure from the top down and the bottom up is likely to result in C-suite diversity becoming a primary focus for public companies. In their role as overseers of management succession, directors should examine closely the candidates and plans presented to them and ensure that the issue of diversity has a sufficient focus. Tone at the top is meant to inform the tone of the entire company—and after the board, senior management is next in line. Many companies focused on improving board diversity at the board level, as discussed above, continue to lag in gender and race diversity at the executive officer levels.

Boards should also pay attention to another topic in the news—sexual harassment. Boards should inquire as to the status of the company's sexual harassment policies and training, as well as complaints, complaint procedures and complaint resolutions. Companies should be revisiting their policies, training and procedures to ensure that they foster environments in which employees feel free to raise issues and, if so, to find such issues dealt with fairly. Boards should ask for confirmation of these efforts.

While day-to-day HR matters may seem unlikely fodder for boardroom presentations, an ongoing and dedicated commitment to respect in the workplace resonates throughout a company. As with company-wide compensation plan design and execution, a board should demand to be informed as to the soundness of company-wide harassment policies and procedures and as to the vigilance of their enforcement.

Environmental, Social and Governance Focus

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The trend of increasing investor focus on ESG issues continued in 2017. Shareholder proposals on the full range of ESG topics—from climate change reports to board diversity to employment discrimination—have continued to gain momentum. In addition, a number of these institutional investors—most notably BlackRock, State Street and Vanguard—have issued statements or guidelines highlighting ESG issues:

— In 2017, BlackRock released its "Investment Stewardship" priorities with climate risk disclosure as one of the five areas of focus, as well as a series of ESG-related white papers. BlackRock has indicated that it expects the whole board to have

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"demonstrable fluency" in how climate risk affects the business and how management mitigates risk.

— In its 2017 annual letter to investors, State Street stated its belief that ESG issues can have a material impact on a company's ability to generate returns in the long term, and it continued to tie corporate scandals to poor management of ESG risks. State Street has also indicated that it expects companies to disclose information on relevant management tools and material environmental and social performance metrics.

— Vanguard, in a significant shift in spring 2017, changed its voting guidelines with respect to ESG shareholder proposals and now considers proposals on a case-by-case basis, supporting those where there is a "logically demonstrable linkage between the specific proposal and the long-term shareholder value of the company."

Although these proposals are generally still not yet receiving majority support, three proposals seeking environmental reports from oil and gas or utility companies did pass with support from some of the leading institutional investors, making this an area to watch in 2018.

A number of institutional investors have urged companies to participate in the Sustainability Accounting Standards Board (SASB) standard-setting process. In October 2017, SASB released for public comment its latest round of draft industry-specific standards, with the hope of developing a more standardized approach to ESG disclosure.

On the other side of the scale, however, is the November 2017 SEC guidance on excluding shareholder proposals from a company's proxy statement (Staff Legal Bulletin No. 14I). This new guidance suggests increased deference to companies on the part of the SEC and may allow companies to exclude more proposals from the proxy statement, particularly in the ESG area, although how liberally it will be applied remains to be seen (particularly because the first company to rely on it did not receive no-action relief).

In particular, the guidance highlights the board's assessment of the significance of the policy issue underlying the shareholder proposal. As a result, boards will likely be asked to assess some of the shareholder proposals companies receive, a change from previous common practice of informing the board or the nominating and governance committee of proposals but not generally seeking direct board action on them.

In light of these developments, some actions we recommend for companies and boards for the coming year in the area of ESG include:

— Review ESG disclosure in SEC filings and outside of SEC filings to consider whether there are areas that could or should be aligned (e.g., what risks are being portrayed as "material" across communications);

— Review how ESG information functions fit within the company's control environment;

— Develop a process for elevating ESG information and management to the board;

— Ensure investor relations teams are soliciting feedback on ESG issues, pay attention to shifts in institutional investor behavior and know what issues are important to which investors in the company's shareholder base;

— Keep an eye out for shareholder proposals that are gaining shareholder support over time;

- Prepare a strategy for responding to shareholder proposals, including a process for the board or relevant committee to assess the significance of underlying issues;

- Monitor industry and peer company developments and plan for how to address criticisms or gaps in the company's approach to ESG compared to others; and

- Ensure ESG programs, initiatives or other evidence of commitment to ESG issues are showcased and emphasized for shareholders.

Guidance on Board Effectiveness for Large Financial Institutions

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In August 2017, the FRB issued proposed supervisory guidance addressing effectiveness for boards of directors. The proposed board effectiveness guidance (BE Guidance) would apply to certain large bank and thrift holding companies supervised by the FRB.

The BE Guidance responds to concerns that boards of directors have been spending disproportionate time and resources on matters outside of their core responsibilities and that distinctions between the roles of the board and senior management have been blurred.

The FRB's proposal generally has been viewed positively by affected institutions. At the same time, the practical implications of the BE Guidance will depend not only on how it is finalized after the public comment process, but also on how it is implemented by Federal Reserve examiners in the field.

The spotlight on the independence and stature of the internal audit and risk management function highlights the importance of those areas in all companies in providing critical information to both management and the board.

The BE Guidance would define and explain the following five key attributes of effective boards of directors:

1. Setting clear, aligned and consistent direction regarding the firm's strategy and risk tolerance.

2. Actively managing information flow and board discussions.

3. Holding senior management accountable for implementing the firm's strategy and risk tolerance and maintaining the firm's risk management and control framework.

4. Supporting the independence of the independent risk management and internal audit functions.

5. Maintaining a capable board composition and governance structure.

The BE Guidance is part of a package of complementary proposals, which also includes:

- Streamlining and clarifying previous FRB guidance to align with the BE Guidance;

- Revising previous guidance to clarify which examinations findings should be directed to the board of directors (vs. management);

- Creating a new large financial institution rating system for large bank and thrift holding companies (which would incorporate the BE Guidance); and

— Clarifying the guidance that would apply to smaller bank and thrift holding companies (below the $50 billion asset threshold for the BE Guidance).

The BE Guidance and related proposals signal a potential shift toward a more streamlined and risk-based supervisory approach to defining expectations of boards of directors. At the same time, FRB Governor Jerome Powell has noted that the FRB does "not intend that these reforms will lower the bar for boards or lighten the loads of directors."

Public comments on the BE Guidance are currently due on February 15, 2018.

While the proposal will only affect regulated financial institutions, the focus on the board's responsibility to guide strategy and oversee compliance and risk management are familiar issues for boards to reflect on periodically. In addition, the spotlight on the independence and stature of the internal audit and risk management function highlights the importance of those areas in all companies in providing critical information to both management and the board.

Finally, at a time when directors may feel that they are suffering from "information overload," it might be appropriate to consider whether the standard information package strikes the right balance between clear communication of risks and opportunities and sufficient detail to allow for effective oversight.

Significant Regulation and Reform Under the Trump Administration

After the results of the November 2016 elections, focus turned to which areas would be most impacted by the Trump Administration and the dynamics in Congress. Two areas that received significant attention in 2017 were taxes and antitrust, although other areas have seen significant other developments and will be important to watch in 2018.

Taxation

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2017 saw a significant amount of change and uncertainty related to the enforcement of existing tax laws as well as major changes to the tax law, most notably the U.S. tax reform bill that ripped through Congress like a major snow storm culminating in its enactment on December 22, 2017. These developments will have significant implications for companies and may create new risks in the coming year, as discussed below.

1. *U.S. tax reform enacted into law.* The new U.S. tax law has made major changes to the U.S. tax rules applicable to all types of businesses and to individuals. The new rules include major benefits for businesses, such as dramatic rate reductions for corporations and many pass-through businesses, immediate expensing for the cost of certain newly-purchased property, and a shift to a territorial system of international taxation in which U.S. companies are not taxed on the repatriation to the United States of business profits earned outside the United

States. These opportunities are balanced by many unfavorable new rules, including new limits on deductions for interest expense and net operating losses, new taxes on certain types of income from international businesses (affectionately labeled the "GILTI" and "BEAT" taxes), and a one-time tax on U.S. companies' offshore profits. These new rules are intended, in part, to prevent businesses from using international structures and transactions to reduce their U.S. tax obligations, although there is significant disagreement as to the actual impact these new rules will have and whether they will spur retaliatory changes by other countries. Even though the exact operation of some of these rules is still unclear, companies are actively assessing the impact on their financial statements, cash tax obligations and business projections. Companies should also be considering possible steps to optimize their position going forward. Meanwhile, Treasury and the IRS are trying to develop and publish regulatory interpretations and guidance and deal with the ambiguities, inconsistencies and conundrums created by the speedily-enacted legislation. You may wish to provide comments or otherwise participate in efforts to assist Treasury and the IRS in this process. Our U.S. Tax Reform website has more information and analysis of the U.S. tax reform legislation and its implications for different types of businesses and structures, and can be accessed here.[1]

2. *New tax laws around the globe*. The United States is not alone in efforts to prevent companies from eroding the local tax base and shifting profits to lower-taxed jurisdictions. The Organisation for Economic Co-operation and Development's (OECD) base erosion and profits shifting (BEPS) project (which began in 2012 and hit a crescendo in 2014 and 2015) and other developments have energized non-U.S. tax authorities to push for changes in laws and in enforcement policies, aimed primarily at multinational businesses and transactions involving intangible property. Structures and transactions that were put in place prior to these developments should be looked at in light of these and other potential future changes. Multinationals should also be on the look-out for additional developments and should realistically assess their exposures in this evolving environment.

3. *The European Commission's Continued Efforts to Find and Reverse "State aid" Given to Multinationals*. The European Commission's investigations into State aid have, so far, resulted in several formal decisions ordering the relevant corporate taxpayer to pay enormous sums to the specific foreign tax authority which had previously issued a favorable tax ruling to that taxpayer. Examples include Fiat (ordered to return €20 to €30 million to Luxembourg), Starbucks (ordered to return €20 to €30 million to the Netherlands), Apple (ordered to return more than €13 billion to Ireland) and Amazon (expected to be ordered to return nearly €250 million to Luxembourg). The taxpayers are contesting these judgments, and there is likely to be years of litigation before we have a conclusive determination of whether the European Commission's expansive interpretation of "State aid" is correct. In the meantime, investigations can be expected to continue (two that have been made public are Engie and McDonald's), especially considering that the Paradise Papers leak has triggered increased scrutiny of European tax rulings, revealing Dutch rulings granted to Nike and Procter & Gamble that have prompted the Dutch authorities to investigate thousands of previously granted tax rulings. Multinationals that have received private rulings from any European tax authority should review those rulings and assess whether they are at risk and what steps they might take to reduce or mitigate their risks.

4. *Increased disclosure and multinational cooperation*. One of the significant changes coming out of the OECD's BEPS project is the new mandatory reporting by multinationals of country-by-country tax information, which is then shared with all the countries in which the multinational has operations. Tax authorities are increasing their cooperation and

[1] https://www.clearygottlieb.com/news-and-insights/publication-listing/tax-cuts-and-jobs-act-our-insights

These developments will have significant implications for companies and may create new risks in the coming year.

information sharing generally and we have seen, and expect to continue to see, an increase in "joint audits" where two or more countries audit transfer pricing or other practices jointly or in tandem. We also anticipate an increase in treaty-based mutual agreement procedures (or "MAP") wherein two or more taxing authorities mutually agree on how much should be reported by a specific multinational in each jurisdiction. MAP is usually initiated by the taxpayer and multinationals should be considering whether MAP would be beneficial in obtaining certainty and preventing conflicting claims resulting in double taxation.

5. *Use of criminal charges and procedures, whistleblowers, data leaks and other types of unwanted publicity.* Another troubling recent phenomenon has been the leaking of massive amounts of confidential information by non-governmental actors (e.g., Paradise Papers, Panama Papers, Luxembourg and Swiss leaks). Whistleblowers seeking bounties under various government programs have brought companies' allegedly questionable tax practices to the attention of regulators, prompting securities, tax and other investigations, including under state "false claims" laws (with potentially substantial penalties). Also, in Europe, tax authorities have resorted to highly publicized "midnight raids" and criminal proceedings. Management needs to be prepared to respond to these challenges and the public relations complications that they present.

6. *Tax-related shareholder litigation.* Shareholder litigation is not a new development, but we have seen a recent increase in tax-related shareholder litigation against multinational companies. Several of these suits have concerned the adequacy of disclosure about pending tax audits and/or the tax consequences of contemplated transactions. Examples include Caterpillar, Eaton, AbbVie and First Marblehead. Companies should be diligent in ensuring that public filings fully and fairly disclose all ongoing audits and other tax issues and be prepared to respond to assertions that the disclosures were inadequate.

7. *Taxpayers on the attack using procedural rules as weapons.* Up until a few years ago, when the IRS asserted that a taxpayer had underpaid its U.S. taxes, the IRS and the taxpayer duked it out over the substantive law and how it applied to the taxpayer's facts. But recently, taxpayers have found significantly more success in defending against IRS requests for additional taxes by arguing that the IRS has failed to comply with the U.S. Administrative Procedures Act or some other procedural rule (for example, a statutory rule that an IRS supervisor has formally approved the assertion of penalties *before* they are asserted). Courts have invalidated significant Treasury Regulations based upon procedural failings and applied the Administrative Procedures Act in other ways that have emboldened taxpayers to raise procedural challenges that would have been unheard of years ago. In light of these developments, companies confronted with unfavorable Treasury Regulations or other IRS determinations should consider whether they have any procedural claims that should be pursued via a court challenge or otherwise.

Antitrust

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Since President Trump took office, companies and boards have been closely watching developments in Washington, D.C. for signals about regulatory and enforcement policies under the new administration. In the antitrust world, after the active era of merger enforcement under President Obama, any shifts in

Overall, we expect a modest, not radical, rightward shift in antitrust enforcement under the Trump administration.

enforcement could have significant consequences for corporations, particularly those with high market shares or those considering M&A transactions. As in other areas, key personnel decisions provide clues about the likely antitrust landscape under President Trump.

Most of President Trump's appointments to lead the two federal antitrust agencies, the U.S. Department of Justice (DOJ) Antitrust Division and Federal Trade Commission (FTC), were delayed until well into 2017, but his antitrust team has now taken shape, though several Senate confirmations remain pending.

Overall, we expect a modest, not radical, rightward shift in antitrust enforcement under the Trump administration. Most of President Trump's appointees—including the heads of each antitrust agency, DOJ Assistant Attorney General for Antitrust Makan Delrahim (who has been confirmed by the Senate) and FTC Chairman nominee Joseph Simons (whose nomination is pending)—are mainstream antitrust enforcers who are unlikely to dramatically change the antitrust enforcement landscape. Both Delrahim and Simons, as well as several other of President Trump's selections, had leadership roles in the antitrust agencies during the George W. Bush administration, when the antitrust agencies remained reasonably active, including in challenging mergers.

Beyond the mainstream nominees, several factors will limit any shift toward more lax antitrust enforcement:

— Career staff at the DOJ and FTC control the flow of investigations and how cases are presented to the agency's political appointees and have become highly skilled at challenging deals.

— Being "pro-business" does not always mean being anti-enforcement—major corporations are often antitrust complainants, as well as merging parties.

— Enforcement by private plaintiffs, state attorneys general and international antitrust authorities will continue and may increase to compensate for any decrease in federal antitrust enforcement.

We expect relatively significant reductions in enforcement in monopolization cases, where enforcement was relatively lax under the Bush administration. On the other hand, criminal enforcement against hardcore antitrust violations (such as price fixing) has been an area of strong bipartisan consensus and is likely to remain aggressive. The change in horizontal merger enforcement will likely fall in between, with a noticeable, but not radical, decrease from the Obama administration.

Vertical mergers are another area where the Bush administration's enforcement was relatively lax, but recent events make clear that vertical merger enforcement is not dead. On November 20, 2017, the DOJ sued to block AT&T's acquisition of Time Warner, a vertical deal the DOJ alleges "would result in fewer innovative offerings and higher bills for American families." In a DOJ press release, Delrahim explained, "AT&T/DirecTV's combination with Time Warner is unlawful, and absent an adequate remedy that would fully prevent the harms this merger would cause, the only appropriate action for the Department of Justice is to seek an injunction from a federal judge blocking the entire transaction."

The decision to challenge AT&T/Time Warner is consistent with a broader policy statement from Delrahim expressing deep skepticism regarding behavioral remedies. In a November 16, 2017 speech, Delrahim explained that, "like any regulatory scheme, behavioral remedies require centralized decisions instead of a free market process" and "set static rules devoid of the dynamic realities of the market."

"Like most regulation," Delrahim said, behavioral remedies "can be overly intrusive and unduly burdensome for both businesses and government."

Delrahim further emphasized that this skepticism of behavioral remedies "cuts both ways—if a merger is illegal, we should only accept a clean and complete solution, but if the merger is legal we should not impose behavioral conditions just because we can do so to expand our power and because the merging parties are willing to agree to get their merger through." In short, we expect somewhat less vertical enforcement, but also expect less willingness to accept consent decrees in the few vertical cases that do pose competitive concerns.

While the future of U.S. antitrust policy in 2018 and beyond remains to be seen, President Trump's mainstream leadership appointments and several institutional factors point in the direction of a modest, but not dramatic, rightward shift in antitrust enforcement under his administration.

Activism in 2018

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Two years ago, we explained to clients that the shareholder activism landscape was undergoing significant change. Returns at many of the "brand name" activist funds were down, companies had become savvier at messaging to their investors about why their positions on areas of activist focus were well-founded and, in numerous cases, companies had preemptively taken steps to adjust their strategic plans to be consistent with the approaches that activists would take.

Many clients remained on high alert, but they were regularly encountering "false alarms" when famous activists would show up in their profiles after the quarterly Form 13F filings and generate media buzz, but the investment would turn out to be for purposes of liquidity rather than influencing management. In addition, a number of clients received requests for meetings or telephone calls with activist investors, only to realize later that the investor was primarily interested in gathering information for purposes of macro-economic analysis, rather than as a first step in launching a campaign.

Meanwhile, the letters and inquiries to clients from actively managed (but not "activist") funds—such as T. Rowe Price and Neuberger Berman—became increasingly pointed and urgent, focusing on the areas that were traditionally the turf of the high-profile activists—allocation of capital, strategic alternatives and separation of parts from the whole. We regularly heard from investor relations personnel about how the actively managed funds were loyal long-term investors who "love us," and then these letters would arrive. We anticipated, at the time, a new era of "activism by traditional long-term holders" and the fading of the celebrity activists.

While activism, including threats of proxy contests, by the traditional, actively managed institutional funds is now becoming increasingly commonplace, the brand name activists are back. Their tools (white papers and threatened and actual proxy contests) remain the same. But they have shifted their time horizons and initial focus. The activists are now regularly holding investments for four to five years and focusing more consistently during the initial years of their investments on advocating for operational turnarounds. A push for a sale of the company remains a favorite solution, but many activists are prepared to maintain their investments for a few years before this alternative becomes an urgent, best next step. In addition, while campaigns to force out management still exist, the focus initially is now more typically on the need to refresh the composition of the board.

The activists had no choice but to adapt to this new, longer-term approach because companies susceptible to quick fixes—such as a spin-off or sale of a division, a leveraged recapitalization or a sale of the company to a cash-rich competitor—had largely disappeared due to preemptive actions by boards that had learned to "think like an activist." Moreover, the market has made it worthwhile for the activist funds to adapt. Not only are assets under management for activist funds at an all-time high, but we are now seeing activist groups able to raise large, special-purpose funds for a specific, multi-year investment on short notice.

Another change in hedge fund activism is traceable to the shift of approximately $5 trillion over the last 10 years in the United States from actively managed funds to index and other passive strategy funds. This shift is causing not only companies, but also the activists themselves, to appeal to the longer-term and often structural and governance-oriented concerns of the passive strategy fund shareholders. Activists are now fluent in issues of "diversity of tenure," "gender, race and age diversity," "board skillset matrices" and provisions in charters, bylaw and governance guidelines that "good governance" advocates find compelling.

The activist hedge funds will shamelessly lace their communications to companies with references to these issues as a way to signal that they intend to round up the passive strategy funds and others in the "good governance" community to support their campaigns. At the same time, we are spending more time working with clients to refine their messaging and strategy in these areas, including through regular by-law and governance guideline upgrades, off-cycle governance roadshows that include meetings with the leading passive strategy funds and improvements to their disclosures in the annual meeting proxy statement, sustainability reports and other shareholder communications.

The significant growth of index funds means that the 10 top institutional holders of the stock of U.S. publicly traded companies will increasingly hold over 40 percent or even 50 percent of the voting power.

The battle for the votes and loyalty of the passive strategy fund shareholders will continue to be hard fought for the next several years. We often see tensions between what actually drives the voting decisions of the ETFs and index funds in contested situations versus the statements made on behalf of these passive strategy funds in well-publicized annual letters, in published guidelines and by their governance-oriented spokespersons at conferences. Moreover, the recommendations of ISS and Glass Lewis are no longer sufficient to lock up the votes of the passive strategy fund shareholders.

We cannot emphasize enough how precarious these relationships with the passive strategy funds may become during an activist campaign and, despite signs that all is well during "clear days," how important it is to nurture these relationships whether or not a company's shareholder profile has signs of activist hedge fund interest.

The settlement vs. fight calculus has become tougher as well against this backdrop. The significant growth of index funds means that the 10 top institutional holders of the stock of U.S. publicly traded companies will increasingly hold over 40 percent or even 50 percent of the voting power—making it relatively easy for shareholders to be led in an efficient revolt against incumbents if the company's relationship with these holders is not solid. In addition, when settling with an activist, companies ought to have an action plan in place to explain to this group of 10 top institutional holders why the terms of the settlement with the activist and its implications for the company's strategic direction are in their best interest.

The fickleness of top institutional holders colored the recent "victories" by ADP and Procter & Gamble (and earlier by DuPont) against the short-slate proxy contests run by Pershing and Trian. These proxy contest "wins" not only cost these companies millions of dollars, but also left the boards having to digest voting data that indicated that very significant percentages of their institutional investors, including several top holders at each company, did not support the management slate (and, by implication, the strategic direction and leadership of the company) and, in the case of Procter & Gamble, resulted in the voluntary appointment of Nelson Peltz to the board. Moreover, and perhaps most importantly, the activists do not just go away after these votes; they continue their pressure and campaigns and often end up "winning the war while losing the first battle" as boards end up pushing back against plans that stick to the status quo.

Additionally, on the settlement front, the activist funds have been increasingly open to backing off in exchange for the appointment of directors with industry experience, as opposed to demanding that one of their funds' own founders or other senior employees join the board. Companies are frequently open to having these well-regarded individuals join their boards (and, in fact, are sometimes grateful for the catalyst to board refreshment provided by the activists). In many instances, these new outside directors energize, contribute to and build new bridges within the boardroom.

In the same vein, we have found that senior executives have largely come around to accepting that their boards will inevitably include strong personalities and leadership experience that will not translate into easy deference to management. Outside directors are more eager than ever to critically analyze strategic decisions and corporate governance and no longer view embracing activist ideas as a taboo.

Against this backdrop, management teams, including the legal department, have an opening—and indeed are under pressure—to assure their outside directors that they have all material information about and analyses of the strategic plan, that messaging to investors about the long-term plan and goals is well-articulated and not neglected due to over-focus on short-term guidance, and that the spectrum of governance "hot buttons" is being addressed by the company in a thoughtful manner. Taking up this challenge is the best preparation for and defense against activism.

Cybersecurity and Data Privacy Updates

As in 2017, we expect that companies will continue to face challenges in 2018 as they grapple with overlapping, and at times conflicting, privacy and cybersecurity regimes, as well as concerns related to cybersecurity incidents.

The issues below highlight the critical need for boards and companies to be aware of the evolving regulatory landscape in the areas of cybersecurity and privacy so that they may best assess and assist in mitigating the risks.

Cybersecurity Risks

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Boards should provide their management with clear guidance regarding the board's risk tolerance in the area of cybersecurity, ensure that management is dedicating sufficient resources to cybersecurity issues and make sure the company's disclosures provide investors with sufficient information about cyber incidents and cybersecurity risks.

Companies and boards will continue to grapple with two key cybersecurity-related risks: the risk of a cybersecurity incident and the risk of noncompliance with cybersecurity laws and regulations.

Cybersecurity incidents. As the recent breach incident with Equifax highlights, companies and boards will need to continue to focus on how they safeguard their and their customers' data and respond to data breaches. The SEC, itself the victim of a cyber breach in late 2016, has also indicated recently that it may give increased scrutiny to company disclosures and responses related to cyber issues and cyberattacks.

Boards should provide their management with clear guidance regarding the board's risk tolerance in the area of cybersecurity, ensure that management is dedicating sufficient resources to cybersecurity issues and make sure the company's disclosures provide investors with sufficient information about cyber incidents and cybersecurity risks.

Boards should also learn from the Yahoo data breaches, in which an independent committee of the Yahoo board found that Yahoo's security team had contemporaneous knowledge of the 2014 data breach, but failures in communication, management, inquiry and internal reporting contributed to a lack of proper understanding and handling of the incident by senior executives. The independent committee also found that Yahoo's board was not adequately informed of the full severity, risks and potential impacts of the incident.

Boards can avoid such issues by making sure there are clear risk assessment and security incident response protocols, including protocols to help ensure escalation of cybersecurity vulnerabilities and incidents to senior executives and the board of directors.

Compliance with cybersecurity regulations. In 2018, we expect that cybersecurity regulations will increase in number and become more complex as many jurisdictions become more concerned with cyber threats, particularly in the financial sector.

— *Varied Regulatory Schemes*. In October 2017, the Financial Stability Board (FSB) released the results of its international survey with respect to cybersecurity in the financial sector. The FSB's survey of 25 jurisdictions found 56 schemes of regulation and guidance targeted to cybersecurity, with some jurisdictions reporting as many as 10 schemes. While there is considerable convergence among the various schemes, there are also important differences of which companies and boards will need to be aware. Furthermore, the FSB survey found that 18 of the 25 jurisdictions surveyed plan to issue new regulations, guidance or supervisory practices within the next year.

— *Federal Cybersecurity Regulations for Financial Institutions*. Still pending in the United States is the October 2016 proposal by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation for enhanced cybersecurity risk management and resilience standards that would apply to large financial institutions and services provided by third parties to such institutions. The comment period for the proposed rules closed in February 2017. Industry opposition to the proposed framework and the Trump administration's stated aversion to federal regulation may reduce the likelihood of the proposed rules surviving in their current form, but boards of financial institutions should be aware that additional federal cybersecurity rules remain under consideration.

— *New York*. New York State's most recent cybersecurity regulations went into effect on August 28, 2017, and all individuals and companies operating under a license or similar authorization under New York banking, insurance or financial services laws (with narrow exceptions) must annually certify their compliance with the regulations commencing on February 15, 2018. New York requires such entities to:

- Develop a cybersecurity program based on a risk assessment;
- Develop a cybersecurity policy;
- Designate a Chief Information Security Officer (CISO);
- Limit who has access to data or systems that provide access to nonpublic information;
- Use qualified cybersecurity personnel;
- Notify the New York State Department of Financial Services of a cybersecurity event within 72 hours; and
- Have a written incident response plan.

A detailed report on New York's regulations can be found here.[2]

[2] https://www.clearygottlieb.com/news-and-insights/publication-listing/nydfs-cybersecurity-regulations-take-effect-8-21-17

— *China*. As we head into 2018, implementation of China's first comprehensive cybersecurity law will continue to progress. The law applies to all "network operators," which likely includes any company that uses networks to provide services in China, and proscribes a tiered system of stringent requirements regarding internal security systems, preventative and monitoring measures and data protection. Under the draft regulations implementing the law, companies subject to the law must self-report with the relevant Chinese agency. Most fines for violations range from ¥5,000 to ¥1,000,000, but some violations could result in revocation of the entity's business license. A report on China's PRC Network Security Law can be found here.[3]

- On October 27, 2017, the Hong Kong Securities and Futures Commission (SFC) issued new cybersecurity requirements (guidelines), which will apply to all securities and futures dealers and asset managers registered with the SFC, as well as all banks (including foreign banks with Hong Kong branches) supervised by the Hong Kong Monetary Authority (HKMA). While the guidelines do not officially have the force of law, they are effectively mandatory for entities regulated by the SFC or HKMA, given the potential impact of a breach on their licensed status in Hong Kong. A report on the new guidelines can be found here.[4]

— *Europe*. The EU General Data Protection Regulation (GDPR), discussed below, will impose strict obligations on firms operating in the European Union with respect to data security and specific breach notification guidelines.

[3] https://www.clearygottlieb.com/~/media/cgsh/files/2017/publications/alert-memos/understanding-the-impact-of-chinas-far-reaching-new-cybersecurity-law-10-5-17.pdf

[4] https://client.clearygottlieb.com/87/512/uploads/2017-11-01-hong-kong-sfc-and-hkma-issue-new-guidelines-for-reducing-and-mitigating-hacking-risks-associated-with-internet-trading.pdf

Privacy and Cybersecurity in M&A Transactions

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As the number of cyberattacks increases and privacy and cybersecurity laws continue to proliferate, companies contemplating M&A transactions must consider how to best mitigate the related cybersecurity risks. Purchasers must identify and address privacy and cybersecurity risks associated with a target's pre-closing operations, as cyberattacks are most often discovered only several months after they occur (and could thus not be known at the time of the transaction). Both purchasers and sellers should consider risks related to the transfer of personal data owned by or related to the target company. Purchasers must also consider risks related to post-closing integration of personal data.

Companies contemplating an M&A transaction should:

— Identify all applicable laws;

— Identify the level of risk in the target's data practices;

— Review the target's privacy and cybersecurity policies and compliance therewith;

— Assess risk related to the target's use of third-party vendors; and

Purchasers must identify and address privacy and cybersecurity risks associated with a target's pre-closing operations, as cyberattacks are most often discovered only several months after they occur.

— Consider including specific contractual protections for privacy and cybersecurity issues.

For a full report on privacy in M&A transactions, see parts one and two of a series on Cleary's M&A and Corporate Governance Watch blog.[5]

GDPR Preparedness Programs

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In undertaking their GDPR preparedness activities, companies should prioritize those areas of their businesses that conduct "high-risk" processing, for example, that utilize sensitive personal data or process personal data on a large scale to systematically monitor individuals.

We are now reaching the final months in which companies must implement compliance programs ahead of the GDPR becoming fully applicable on May 25, 2018. From this date, data protection regulators in the European Union will be able to levy fines of up to 4 percent of a group's annual worldwide turnover for breaches of EU data protection laws. Non-EU companies will be subject to the GDPR to the extent that they process personal data in the context of the activities of an establishment (for example, an entity or branch) located in the European Union, or offer goods or services to, or monitor the behavior of individuals in, the European Union.

The factors that may lead to the applicability of the GDPR to non-EU companies cover a broad range of activities including (i) evidencing an intention to offer goods or services, including for free, to customers in the European Union (e.g., whether a website that is available in a language spoken in the European Union enables the delivery of goods to EU addresses and/or accepts payments in a currency used in the European Union); and (ii) tracking the behaviour of individuals located in the European Union via the internet.

Regardless of whether they are based in the European Union, companies that will be subject to the GDPR's requirements should consider taking the following steps as part of a wider GDPR compliance program:

— *Mapping the personal data the company holds*, including their type, the purpose of their processing, where they come from, where they are stored, to whom and where they are sent and the risk that each processing activity poses to data subjects.

— *Reviewing current practices for GDPR compliance*, including whether current consents to data processing are sufficient under the enhanced requirements of the GDPR, and considering whether to update consumer- and employee-facing privacy policies.

— *Audit existing agreements with vendors* that are processing personal data as part of their services to assess whether they need to be amended to comply with the GDPR.

— *Start documenting GDPR compliance*, including by holding a register of data processing, auditing technical and organizational measures taken to secure personal data, updating internal policies and procedures, assessing whether data protection impact assessments are required and implementing a process for handling requests from data subjects.

[5] https://www.clearymawatch.com/2016/10/privacy-ma-transactions-navigating-traps/ & https://www.clearymawatch.com/2016/10/privacy-ma-transactions-navigating-traps-part-2/

— *Redesigning systems where necessary* in order to enable the company to comply with data retention, data minimization and data breach notification requirements.

— *Assessing the need to appoint a data protection officer* and, for companies located outside the European Union, an EU-based representative.

In undertaking their GDPR preparedness activities, companies should prioritize those areas of their businesses that conduct "high-risk" processing, for example, that utilize sensitive personal data or process personal data on a large scale to systematically monitor individuals.

The New DOJ FCPA Corporate Enforcement Policy Highlights the Continued Importance of Anti-Corruption Compliance


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In a significant development for companies relating to the Foreign Corrupt Practices Act (FCPA), in late November the U.S. Department of Justice (DOJ) announced a new FCPA Corporate Enforcement Policy (the Enforcement Policy).

The Enforcement Policy[6] is designed to encourage companies to voluntarily disclose misconduct by providing greater transparency concerning the amount of credit the DOJ will give to companies that self-report, fully cooperate and appropriately remediate misconduct. Notably, in announcing the Enforcement Policy, the DOJ highlighted the continued critical role that anti-corruption compliance programs play in its evaluation of eligibility under the Enforcement Policy.

Both this Enforcement Policy, as well as new enforcement efforts in other countries, underscore why maintaining an appropriate anti-corruption compliance program has never been more important to companies and their boards.

By way of background, while there were questions early in 2017 whether the Trump administration would continue to prioritize FCPA enforcement, the Enforcement Policy suggests that the Trump administration will maintain the DOJ's focus on the FCPA and will continue its efforts, first announced in the FCPA Pilot Program (described in our memorandum last year, found here)[7], to encourage self-reporting by providing concrete benefits for companies that identify misconduct. The Enforcement Policy makes provisions of the Pilot Program permanent, and, in particular, the Enforcement Policy enhances the credit that companies will receive for "voluntarily self-disclos[ing] misconduct in an FCPA matter, fully cooperat[ing], and timely and appropriately remediat[ing]": there is now a presumption that companies that satisfy these criteria, as now defined in the Enforcement Policy, will receive a declination so long as there are no "aggravating

6 https://www.justice.gov/criminal-fraud/file/838416/download

7 https://www.clearygottlieb.com/news-and-insights/publication-listing/department-of-justice-foreign-corrupt-practices-act-enforcement-initiatives

The Enforcement Policy was announced against the backdrop of increased cooperation between anti-corruption authorities in various countries, which, in turn, has greatly increased the exposure to companies for corruption-related misconduct.

circumstances."[8] The Enforcement Policy also modestly improves the outcome for companies that satisfy the criteria but are ineligible for a declination because of those aggravating circumstances—the Enforcement Policy promises these companies a 50 percent reduction off the low end of the U.S. Sentencing Guidelines fine range, rather than the Pilot Program's offer of a reduction up to 50 percent.

The Enforcement Policy was announced against the backdrop of increased cooperation between anti-corruption authorities in various countries, which, in turn, has greatly increased the exposure to companies for corruption-related misconduct. To highlight three recent examples:

1. Rolls Royce agreed to pay over $800 million to authorities in Brazil, the United States and the United Kingdom for its role in a global bribery scheme.

2. Telia agreed to pay over $965 million in criminal and regulatory penalties to U.S., Swedish and Dutch authorities (notably, the DOJ's press release announcing the settlement thanked over 10 countries for their assistance in the investigation).

3. Most recently, Keppel Offshore & Marine agreed to pay over $422 million to authorities in the United States, Brazil and Singapore.

In addition, the recent wave of corruption cases, particularly in Latin America, has led a number of countries to implement or enhance their own anti-corruption legislation targeting misconduct by companies. The trend started with Chile, Brazil and Colombia and has recently accelerated with:

1. Peru passing the Corporate Corruption Act, which went into effect on January 1, 2018;

2. Mexico's General Law for Administrative Responsibility, which went into effect in July 2017; and

3. Most recently, Argentina passing the Law on Corporate Criminal Liability and Compliance Programs.

These statutes share certain common characteristics, such as allowing local authorities to impose significant penalties on corporations for bribing public officials and include leniency-type programs to encourage self-reporting and provide credit for maintaining an effective anti-corruption compliance program (including as an absolute defense to liability in some instances).

In light of these recent developments, boards should continue to view an effective compliance program as an increasingly important aspect of a firm's risk management. Among other things, a strong compliance program can both deter wrongdoing and help identify misconduct at an early stage. And, if misconduct is identified earlier, companies will be in a much better position to manage the possible financial and reputational damage, including, to the extent appropriate, by potentially taking advantage of the incentives set forth in the Enforcement Policy or other similar programs.

[8] The Enforcement Policy, however, does require companies "to pay all disgorgement, forfeiture and/or restitution resulting from the misconduct at issue" to be eligible for any credit.

Given the DOJ's emphasis on a company's compliance program in evaluating whether to fully credit a company for timely and appropriate remediation, helpfully, in February 2017, the DOJ published its "Evaluation of Corporate Compliance Programs" (the Guidance[9]), which takes the form of 119 specific questions (organized into 11 topics) that the DOJ may ask in making an "individualized determination" of the effectiveness of a company's compliance program. Although the Guidance is not limited to anti-corruption compliance, we believe it can serve as a "best practices" standard against which companies can measure their own anti-corruption compliance programs.

While the Guidance is based on several prior well-known resources, including the FCPA Resource Guide, and many of the topics it covers will be familiar, there is a notable emphasis on process and evidence, which are similarly emphasized in the Enforcement Policy. Specifically, the Guidance focuses on how compliance objectives are identified and met by an organization and explicitly asks companies what data they have collected to evaluate their compliance programs.

The following is a summary of some of the key questions raised by the Guidance:

— Has there been appropriate conduct at the top? What concrete actions have members of senior management taken to demonstrate leadership in the company's compliance efforts? Notably, the Guidance refers to "conduct" and not just tone at the top.

— Is the board exercising oversight over the compliance function? What information have the board and senior management examined in their exercise of oversight? Does the board have direct access to the compliance and control functions? Does the compliance function have a direct reporting line to the board?

— Has the company conducted an appropriate risk assessment to guide the development and execution of the company's compliance program?

— Is the compliance function sufficiently funded in light of that risk assessment, with appropriate resources, and does it have appropriate stature within the company to ensure its effectiveness?

— How has the company responded when compliance has raised concerns about conduct? Is there an effective internal reporting mechanism, and what is the response to internal reports of misconduct?

— What has been the company's process for designing and implementing new policies and procedures? Have policies and procedures been implemented in an effective fashion with appropriate training and guidance?

— Has the company appropriately disciplined wrongdoers? Are compliance and ethical conduct incentivized?

— Has the company assessed and attempted to manage the risk from third parties?

— What policies and procedures does the company have in place to track and remediate risks identified during the due diligence process in M&A transactions?

— How has the company tested, audited and updated its program?

— Where misconduct has been identified, what is the company's analysis of the causes of the underlying conduct and was it remediated? This root cause analysis is highlighted in the Enforcement Policy as a requirement for receiving full remediation credit.

9 https://www.justice.gov/criminal-fraud/page/file/937501/download

There is obviously no "one-size-fits-all" approach to compliance (something the Enforcement Policy itself recognizes), and each company (and its board) will need to conduct its own assessment of its risk and how best to design its anti-corruption program. However, a board can use the questions contained in the Guidance to benchmark its own compliance efforts and, to the extent it ever becomes necessary, provide some assurance that its compliance program will satisfy the heightened expectations of DOJ and other anti-corruption authorities across the globe.

Evolution or Revolution for Companies with Multi-Class Share Structures

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This past year has been marked by significant and, in some cases, opposing attitudes and practices with respect to multi-class share structures. We are likely to see some of this churn continue in 2018 as the various market participants continue to define or refine their positions on this issue.

In 2016, a coalition of investors and pension funds lobbied against multi-class structures and, in 2017, the Council for Institutional Investors (CII) was vocal about its view that one vote per share is central to good governance. This movement is largely in connection with a minority trend of multi-class high-vote/low-vote and, sometimes, no-vote equity structures. In the spring of 2017, the initial public offering (IPO) of Snap Inc. put significant pressure on the issue when Snap offered its no-vote common stock to the public, followed shortly by Blue Apron's IPO, which sold a class of low-vote stock to the public, while its capital structure also has a class of non-voting stock. Both companies suffered significant stock price drops following their IPOs.

In response to growing market pressure, in summer 2017, the S&P Dow Jones banned companies with multiple share class structures from inclusion in several of its indices (while nonetheless allowing for the grandfathering of companies that are already included in the index), the FTSE Russell announced it would begin excluding from its indices those companies without publicly-held voting stock representing at least five percent of a company's voting rights and, in November, MSCI announced its review of unequal voting structures and its decision to temporarily treat any securities of companies with unequal voting structures as ineligible for certain of its indices.

In addition, proxy advisory firms ISS and Glass Lewis piled on with the recent release of policies that result in their recommending voting against board and/or committee members at companies with dual-class structures, depending on other governance factors. Furthermore, Glass Lewis' 2018 voting policies indicate that for companies with disproportionate voting and economic rights, it will carefully examine the voting turnout on proposals and if a majority of low-vote shareholders support a shareholder proposal or oppose a management proposal, Glass Lewis believes the board should demonstrate appropriate responsiveness to this voting outcome.

Many companies seem undeterred in their pursuits of going public with a multi-class structure as a way of preserving founder or early investor control, in part in an attempt to combat the trend in increasing short-term, activist and other shareholder demands.

Despite this pressure, many companies, so far at least, seem undeterred in their pursuits of going public with a multi-class structure as a way of preserving founder or early investor control, in part in an attempt to combat the trend in increasing short-term, activist and other shareholder demands. Significant IPOs with dual-class stock occurred in the latter half of the year—after the indices' ban—including Roku, CarGuus, StitchFix, Sogou and Qudian.

Importantly, NYSE and NASDAQ continue to permit, and even actively court, multi-class companies for listing. And momentum may be increasing internationally as well. After failing to attract the 2014 Alibaba IPO, the Hong Kong Exchange recognized its struggle to capture market-share for new technology companies with untraditional capital structures and issued a proposal to permit companies with multi-class structures to list IPOs on a new listing board. More recently, the Hong Kong government signaled its willingness to amending existing rules to permit multi-class companies to list under the status quo.

So far, the Securities and Exchange Commission (SEC) has largely side-stepped the issue in its regulatory agenda. In the fall U.S. Department of the Treasury report, the Treasury reiterated that corporate governance and shareholder rights are a matter of state law and recommended that the SEC's role continue to be limited to reviewing the adequacy of disclosure and effects on shareholder voting for companies with dual-class stocks.

It may be premature to know the impact that the ban by many of the indices will have on the desire for companies to go public with multi-class structures. After all, many IPO companies are not eligible for immediate inclusion in any index (and each index has its own set of requirements). For instance, the S&P 500 has requirements on the length of public company trading (12 months), market capitalization ($6.1 billion) public float (50 percent of the class of stock) and performance (the sum of the four most recent consecutive quarters' earnings must be positive), that make it impossible for a newly-public company to be listed inside a year and, for some companies, a significant number of years post-IPO.

The strength of the indices' ban will be tested when a recently-public multi-class company achieves significant growth and would otherwise be eligible to be included in an index. Will some of the largest index-based funds, which may conceptually prefer equal voting rights for all shareholders, be satisfied with being left out of a company's shareholder base because the company's multi-class structure otherwise precludes it from being included in the index? According to an analysis conducted by State Street Global Advisors using data from FactSet, companies in the S&P 500 with multi-class stock structures outperformed their single-class counterparts by approximately 26 percent cumulatively over the 10-year period ending in 2016, and exclusion of those companies would have resulted in underperformance of the index by approximately 1.86 percent over the same period.

Already BlackRock, the world's largest asset manager and a signatory on the coalition of investors advocating for equal rights for all shareholders, has publicly bristled at the thought of limiting returns for its clients due to the ban and has publicly disagreed with it, stating that "policymakers, not index providers, should set equity investing and corporate governance standards" and that it would support shareholder review of a company's capital structure periodically through management proposals in the company's proxy statement. Depending on stock performance of the IPO class of 2017, the first potential test case could occur as early as 2018 and this will be a development to monitor throughout the year.

Corporate Governance in the Context of Brexit and Political Uncertainty in the United Kingdom and Europe

The United Kingdom faces significant uncertainty in 2018 as negotiations for its exit from the European Union in 2019 continue to develop.

Domestically, the political situation is unstable following a general election in 2017 in which Prime Minister Theresa May's Conservative Party lost its majority in the UK parliament. In this political context, the UK government has proposed wide-ranging reforms to the corporate governance regime with implications for listed companies' practices in relation to executive remuneration and stakeholder engagement, among other things.

Brexit

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The United Kingdom delivered its "Article 50" notice on March 29, 2017, starting the two-year clock on its negotiated exit from the European Union, which will be automatic unless the remaining 27 member states (the EU 27) unanimously agree to extend negotiations. The United Kingdom has confirmed that it does not seek future membership of the European single market, but will aim to negotiate a comprehensive free trade agreement with a transition period of around two years following Brexit.

After slow progress in exit negotiations over the course of 2017, UK and EU negotiating teams reached a breakthrough in early December, and the European Council has now issued a decision confirming the EU 27's willingness to proceed to the second phase of negotiations, which will include discussions around the United Kingdom's future trading relationship with the European Union. However, the process is expected to continue to be fraught.

Companies' exposure in relation to Brexit will vary widely, and we expect that boards have taken steps during 2017 to identify vulnerabilities.

As Brexit negotiations evolve during 2018, boards should focus on the following:

— *Be alert to early indications of the direction of trade negotiations*. Key indicators of the EU 27's position will be the European Commission's negotiating

After slow progress in exit negotiations over the course of 2017, UK and EU negotiating teams reached a breakthrough in early December, and the European Council has now issued a decision confirming the EU 27's willingness to proceed to the second phase of negotiations, which will include discussions around the United Kingdom's future trading relationship with the European Union.

directives in relation to the discussion of the future UK-EU relationship (expected in early 2018) and the outcome of the European Council meeting scheduled for late March 2018.

— *Continue to review and develop contingency plans with an eye on implementation timelines*. Despite interest in the United Kingdom and the European Union in maintaining a strong relationship, companies with undertakings in the United Kingdom should nevertheless prepare for the possibility of a "no-deal" Brexit. Boards should confer with advisers to clarify the process and timing of potential contingency plans and may wish to begin to implement such measures early in the coming year.

— *Identify opportunities*. Following Brexit, we expect the UK government to make efforts to preserve and enhance the competitiveness of the United Kingdom as a home for international business. Boards should consider how to engage strategically with the government or industry bodies to make the most of these opportunities.

Corporate Governance Reform in the United Kingdom

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In a surprise UK general election held on June 8, 2017, Prime Minister May's government lost its majority, significantly weakening her leadership and forcing her to form a minority government propped up by the support of a small socially conservative party. Against the backdrop of Brexit and this political uncertainty, the UK government has announced a program to significantly reform the UK corporate governance framework. Changes will be introduced at a legislative level (expected by mid-2018), supported by a revised (and significantly condensed) edition of the UK Corporate Governance Code (the Code, applicable to premium-listed companies on a "comply or explain" basis). A consultation on the Code was launched in December 2017.

Boards should prepare for these reforms but should be aware that they are closely associated with Prime Minister May's leadership. Should there be a change in the Conservative Party leadership, or even a change of government, they are unlikely to be implemented in the form in which they have been proposed.

Executive Compensation

U.S. public companies, most of which will make a similar disclosure for the first time for fiscal years starting on or after January 1, 2017 with the result that many of these companies will begin making disclosures in early 2018, may take comfort from the fact that their UK counterparts will soon be required to disclose the ratio between CEO and average (not, as in the United States, median) pay. We expect further details to be released in early 2018 and will be looking at the challenges faced and lessons learned already.

Unlike in the United States, UK companies listed in the United Kingdom or the European Economic Area, or admitted to trading on the New York Stock Exchange or NASDAQ (Quoted Companies), are required to prepare (i) a directors' remuneration policy; and (ii) an annual remuneration report on remuneration paid or awarded to directors during the previous reporting period, which must also include a statement describing how the company intends to implement the current directors' remuneration policy in the year of the report, as well as information on targets that will trigger future bonus payments and benefits for directors under long-term incentive plans (LTIPs).

The remuneration report must be put to an advisory shareholder vote at each annual general meeting and the remuneration policy is subject to a binding shareholder vote at least every three years (or earlier to approve changes or because the advisory vote was not passed).

The UK government now intends to legislate increased public disclosure by Quoted Companies of potential outcomes for directors under LTIPs and has asked the Investment Association, which is the trade body that represents UK investment managers, to maintain a public register of Quoted Companies that experience shareholder opposition of 20 percent or more to the advisory vote. Boards of Quoted Companies should take stock of the scale of any such historical shareholder opposition to identify reputational vulnerabilities that may arise from such disclosures and should also consider increasing their engagement with significant shareholders on proposed pay arrangements.

To complement these reforms, the Financial Reporting Council's consultation on amendments to the Code covers the steps premium-listed companies should take when encountering significant voting opposition from shareholders, increased engagement by remuneration committees with the workforce as a whole and the introduction of a minimum combined vesting and holding period of five years for director share awards.

Stakeholder Engagement

The UK government has made several proposals intended to strengthen the voice of company stakeholders. These include introducing a requirement for public and large private companies to report on how directors have complied with their existing statutory duty regarding stakeholder interests. Additionally, the draft revised Code requires premium-listed companies to adopt a method for engaging with its workforce, suggesting a number of options (including having a director nominated from among the workforce, establishing formal staff advisory panels and designating a non-executive director to represent workers' interests).

The new provisions, while potentially far-reaching, significantly fall short of initial proposals to mandate the appointment of employee representatives to company boards. To assist boards in complying with the new requirements, the government has asked the Investment Association and the Institute of Chartered Secretaries and Administrators (the professional body for corporate governance professionals) and, separately, the GC100 (the professional body for professionals working as general counsel and/or company secretaries in FTSE100 companies), to publish practical guidance.

Most boards will already have mechanisms in place to engage with key stakeholders, but they should consider the following:

— *Identify and prioritize key stakeholder groups.* Employees, customers and suppliers are likely to be key stakeholders for most large companies, but boards should cast the net wider to consider, for example, local communities that may be impacted by their operations. In relation to their workforce, boards should be aware of moves underway in the United Kingdom to improve the position of those in atypical working arrangements who are not strictly classified as employees, which may include, for example, agency workers or workers on "zero hours" contracts. Companies that take the opportunity to engage with these groups now may find themselves ahead of the curve as UK employment law evolves.

Against the backdrop of Brexit and this political uncertainty, the UK government has announced a program to significantly reform the UK corporate governance framework.

— *Review existing stakeholder engagement mechanisms.* Boards of companies subject to the Code should closely follow the Code consultation and developing guidance, including the Investment Association/ ICSA's guidance on *The Stakeholder Voice in Board Decision Making* (published in September 2017).

Large Private Companies and Smaller Premium-Listed Companies

Recognizing that large businesses are increasingly choosing to operate as private companies in the United Kingdom, as is the case elsewhere, the UK government intends to increase the transparency of large private companies.

The proposed new legislation would require all companies over a certain size that are not already subject to a separate reporting requirement to disclose details of their corporate governance arrangements in their directors' report, which forms part of their annual report and accounts. This obligation would be complemented by a new set of voluntary corporate governance principles for large private companies.

Boards of premium-listed companies below the FTSE 350 that have previously benefitted from a number of exemptions in the current Code should be aware that these exemptions have been removed in the consultation draft. Once implemented, this would bring them within the scope of all Code provisions, including the requirement for half of the board to be independent and for an independent board evaluation to be carried out every three years.

Please call any of your regular contacts at the firm or any of the partners and counsel listed under Capital Markets, Corporate Governance, Cybersecurity, Executive Compensation, Taxation, Litigation, or Mergers and Acquisitions in the Practices section of our website (https://www.clearygottlieb.com/) if you have any questions.

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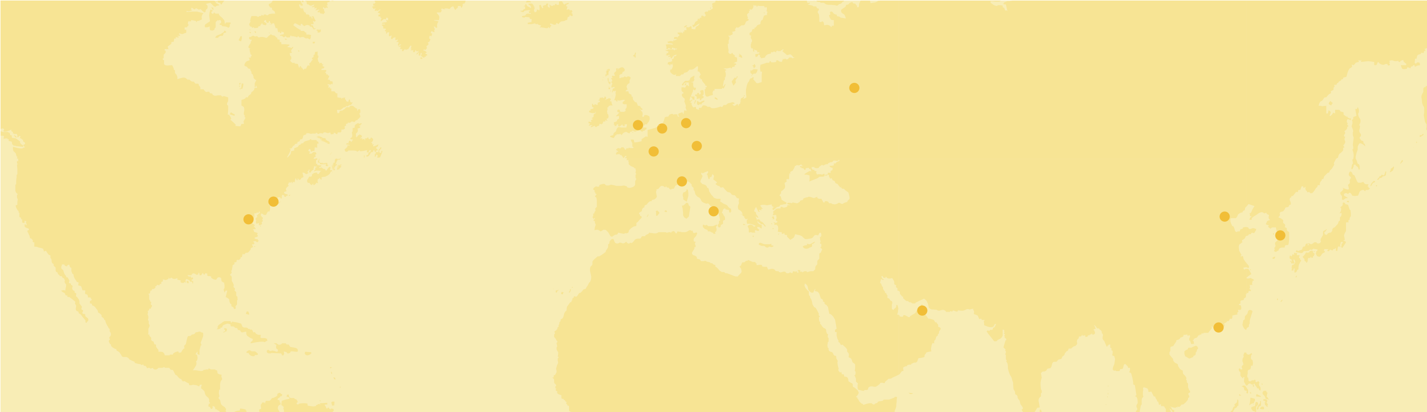

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Founded in 1946 by lawyers committed to legal excellence, internationalism, and diversity, Cleary Gottlieb Steen & Hamilton LLP is a leading international law firm with approximately 1,200 lawyers around the world. The firm has 16 closely integrated offices in New York, Washington, D.C., Paris, Brussels, London, Moscow, Frankfurt, Cologne, Rome, Milan, Hong Kong, Beijing, Buenos Aires, São Paulo, Abu Dhabi, and Seoul.

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