CLEARY GOTTLIEB

Alert Memorandum

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Selected Issues for Boards of Directors in 2016

After several years that seemed defined by turmoil and uncertainty, 2015 delivered some unexpected and much-needed clarity for corporate directors. Over the past year, many corporations were able to put the once disquieting topic of proxy access into perspective and access proposals and board-adopted bylaws converged around the "3/3/25" standard; the SEC proposed (and in one case adopted) the long-threatened Dodd-Frank mandated rules on compensation disclosure; institutional investors and the proxy advisory firms provided some guidance on what they expect in terms of board composition; the Delaware courts opined on how to address certain director and financial advisor conflicts of interest; the SEC gave some indication of potential additional requirements regarding audit committee processes and related disclosure; and despite the alarmism that continued to prevail among many third-party advisors, 2015 saw corporations adopting a more measured and strategic approach toward potential shareholder activism.

Of course, the task of the director will remain a challenging one in 2016. Much of the welcome guidance received during 2015 remains to be implemented this year. Certainly, as in past years, shareholders and regulators will continue to actively and closely monitor boards, and new issues and complexities will undoubtedly arise. Directors in 2016 must stay actively engaged with management, maintain a clear strategic vision, have a distinct path for effecting that vision, and be prepared to effectively communicate with a myriad of constituencies.

In light of the clarity provided by 2015, and the expected challenges in 2016, this memorandum addresses the following issues for boards of directors:

I. Potential shareholder activism

II. Considering and implementing proxy access

III. Board composition

IV. Integrating activist-designated directors into the board room

V. Navigating director conflicts of interest

VI. Potential new requirements for audit committees

VII. SEC compensation disclosure requirements

VIII. Addressing financial advisor conflicts of interest

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I. Shareholder Activism

There has been a great deal of alarm in the last few years among advisors to corporate officers and directors about the threat of hedge fund activism. As a result, we regularly receive calls from general counsel and lead directors asking whether they are sufficiently prepared, even though, like many public companies, theirs is performing well, has a solid long-term plan supported by the board, communicates effectively with shareholders and the market, has received support from shareholders at recent annual meetings, and has no activist shareholders holding more than 0.5 percent.

In response, we have noted that the following developments indicate we have entered a new era of equilibrium:

- Many index funds and proxy advisory firms are trying to distinguish themselves from short-termists, and activists and their sometime allies (including large investment managers and non-activist funds) are recognizing that they need to change their tone and temper their demands to win support.

- Governance activists, led by pension funds, are declaring victory on proxy access (adding to their prior victories on board declassification, majority vote in director elections, and the removal of supermajority vote requirements). As a result, their willingness to pursue additional, somewhat marginal governance reforms (e.g., lowering special meeting thresholds, bringing back action by consent, and separating the chair and CEO roles) is, at best, mixed, and governance activism will be less likely to be a source for volatility that hedge fund activists can leverage.

- Boards and management are sensitive to issues that are likely to provoke governance ire (including on the compensation front), and from a corporate strategy perspective are getting out front on hot-button issues for hedge fund activists like capital allocation, divestitures and spin-offs, strategic alternatives, and board and management composition and succession.

Against this background, our advice for 2016 is to step back a bit from the alarmism of recent years and view potential activism in its proper perspective. We believe the following observations and modest tips will serve boards well in 2016.

Focus on the Institutional Investors

On a number of occasions in 2015, we saw brand-name activists show up several weeks after a series of complaints were made privately by an institutional investor. The subjects ranged from capital allocation to operational direction to compensation. In each case, the activist appeared well aware of the talking points previously used by the institutional investor.

We therefore urge companies to pay attention to their institutional investors, particularly given the open lines of communication between many investment managers and activist funds. Management should keep the board informed of issues raised by institutional investors and its plan for responding. Among the most effective response plans are those that include enhanced explanations to the market of the company’s views on an issue and, if warranted, the remedial

measures being taken. Prompt action along these lines may firm up support from the existing shareholder base and can preempt follow-on hedge fund activism.

Management's Informational Advantage: Not All Hedge Fund Activists Think (or Act) Alike

Advisors in 2015 frequently referred to the increasing number of "wolfpack" scenarios in which a company goes from a "friendly" shareholder profile to one populated by multiple hedge fund activists. Boards, however, should remain aware that hedge funds will not necessarily *all* go on the attack. While there is definitely pressure within the hedge fund community to support "fellow activists," there are continuing signs that this code of brotherhood can be trumped by economic rationality.

Moreover, the board and management will always know more about their business than the activists. With the proper navigation of Regulation FD, including through the use of short-term non-disclosure agreements and enhanced public disclosure, companies may be able to use their informational advantage to win over at least some activists and leverage them to garner support from other shareholders.

Don't Get Caught up in Ideological Wars

During the early 2000s, there was significant concern regarding the potential impact of proxy access. The more practical view on proxy access today is that its use as a tool by activists likely will be far less widespread than anticipated. Indeed, there is even the potential for pension funds and other long-term investors to use proxy access as a tool against short-term oriented activism.

A similar practical evolution is occurring in connection with board attitudes toward hedge fund activism. When it comes to concerns raised by hedge fund activists, the duties of the directors and officers are to determine what is in the best interest of the shareholders based on the specific facts at the time, not based on what an academic study or talking head says about whether those who file Schedule 13Ds are promoting indecent consequences for the macroeconomy. The Delaware Court of Chancery's denial of a motion to dismiss in one case last year—where directors were sued for breaching their duties after they had flip-flopped from criticizing an activist to adopting measures similar to what the activist had proposed—should lead companies to temper their immediate responses to activism. In that case, the court relied on the company's initial public statements condemning the activist as evidence that the directors believed the new strategic direction was not in the best interests of the company and had flip-flopped solely to insulate themselves from threats to their personal reputations and directorships. A balanced, more nuanced approach at the time of the initial activist proposal would have served both the directors and the shareholders far better.

Rationalize Your Engagement Plan

An increasing number of advisors are advocating shareholder engagement plans that require CEOs and independent directors to be present at multiple one-on-one meetings with institutional shareholders two or three times per year. This playbook may make sense in certain high-profile, contested situations. But for many companies, especially those that are neither mega-

caps nor at risk of an imminent activist threat, this approach can lead to tension with shareholders that have limited bandwidth and will be a suboptimal use of the time of executives and directors.

Index funds and investment managers may say they are looking for increased engagement with the most senior executives and with independent directors, but such shareholders often qualify such statements by noting they will raise a flag when time with directors or the CEO is actually necessary. Let institutional investors know that directors and senior managers are available if an investor believes a meeting is necessary, but do not overreact by overscheduling meetings with investors that haven't specifically requested them.

II. Proxy Access

Should there be a mechanism for substantial long-term shareholders to include a director nominee in the company's proxy statement? The question has been with us for decades, but in 2015 the dynamics changed completely. A coordinated campaign led by the New York City Comptroller resulted in more than 100 public companies receiving identical shareholder proposals seeking proxy access bylaw amendments. There will be at least as many shareholder proposals in 2016.

One result has been a wave of companies (particularly large-cap companies) adopting proxy access bylaws—sometimes following a majority shareholder vote, sometimes following the negotiated withdrawal of a shareholder proposal, and often in the absence of a vote or even a proposal. More than 100 companies, including more than 20% of the S&P 500, have proxy access bylaws, and it is easy to imagine this total tripling by the conclusion of the 2016 proxy season, even though shareholder support for proxy access is not universal. When shareholder proposals actually came to a vote in 2015, support was solid but not overwhelming—of 92 companies where shareholders voted (on proposals put forth by shareholders, or by management, or both), the aggregate result was 54% of votes cast in favor, and 62 of those companies ended up with a proxy access bylaw pursuant to either majority shareholder support or preemptive board action.

The principal terms of the 2015 shareholder proposals were all "3/3/25." That is, a shareholder or group of shareholders that has beneficially owned at least 3% of the company's stock continuously for a period of at least 3 years may include director candidates in the company's annual proxy statement for up to 25% of the current board seats. Board-adopted bylaws have largely converged around 3/3/25 as well, though with some variations.

Recently, commentary has increasingly focused on a number of secondary issues, which typical shareholder proposals in 2015 did not specifically address. These include how many investors can form a group for a proxy access nomination; whether loaned shares count toward a shareholder's ownership position; whether proxy access is available if there is a proxy contest at the same meeting; what commitments or disclosures nominating shareholders must provide; restrictions on third-party compensation of nominees; post-meeting shareholding requirements for nominating shareholders; and a half-dozen or so other points. Some advocates of proxy access have expressed concern that these secondary provisions may be obstacles to effective use of proxy access.

The focus on secondary terms presents complications for companies where shareholders have already voted to approve a proposal for proxy access. ISS indicated in December that it will review proxy access bylaws implemented in response to a majority-supported proposal to determine whether the bylaw "unnecessarily restricts" the use of a proxy access right. If ISS determines that proxy access rights have been so restricted, it may issue adverse vote recommendations on individual directors, members of the nominating/governance committee, or the entire board. On the other hand, companies that have adopted 3/3/25 proxy access bylaws without a shareholder vote do not, so far, seem to run a risk of adverse recommendations from ISS on the basis of their proxy access bylaw. It will be important to watch whether—in 2016 or future years—these companies start to receive shareholder proposals to change the secondary terms of their proxy access bylaws.

In light of these developments, in 2016, boards should focus on proxy access for two reasons.

1. **Directors should be ready for the possibility of a shareholder proposal**. Advance preparation will increase a company's ability to react quickly and effectively. In particular, for several of the tactical options—negotiated withdrawal of the proposal, adoption of a bylaw before the proxy is mailed, or submission of a competing management proposal—the board will have a head start if it has considered what it would be prepared to adopt and perhaps even reflected that in a draft. A board that is inclined to oppose proxy access should also consider evaluating the likely positions of its major shareholders on the subject.

2. **Many boards are considering adopting a proxy access bylaw without having received a shareholder proposal**. They see this as proactively accommodating a view that is strongly held among at least some important investors, and they see little risk that proxy access will prove problematic over the long term. Such action also eliminates the distraction that will inevitably result if there is a shareholder proposal and avoids the risk that can later arise if a proposal receives majority shareholder support but its implementation is then viewed as unsatisfactory by ISS or other watchdogs. Boards need to be mindful, however, that a bylaw that is too aggressive could attract negative attention, as proponents begin to identify companies with bylaw terms that they consider off-market.

III. Board Composition

In 2015, institutional investors, proxy advisory firms, and corporate governance advocates increased their focus on board composition, director qualifications, board dynamics, and independence.

During the 2015 proxy season, we saw shareholder proposals regarding tenure and diversity, and we saw tougher stances on board composition taken in proxy voting guidelines of institutional investors such as BlackRock and Vanguard. The Council of Institutional Investors has advocated for diversity and the avoidance of "overboarded" directors, and ISS and Glass Lewis both announced that for the 2017 proxy season they will lower their commitment threshold for determining that a director is "too busy" to be effective from six to five public company boards. Recently, the financial press and regulators also have raised the question of whether directors that technically satisfy NYSE or Nasdaq independence rules are truly

independent in light of informal ties to the company, shareholders, management or other directors.

Board composition is not a new issue. Companies have long been cognizant of the importance of a carefully composed board in optimizing the quality of director deliberations and decision-making. Directors understand that there should be a good mix of experienced and new directors on the board and that as a whole the board should include a complementary diversity of experience, skills, and viewpoints. Given the current climate, however, in 2016, companies should not only continue to focus on board composition but also should aim to document and disclose their efforts on this front more clearly and carefully and to communicate the successful results of those efforts. In light of the recent focus on the impact on independence of factors outside those delineated in the applicable NYSE and Nasdaq rules, we also recommend companies carefully consider a director's other contacts with the company, major shareholders, management, and other directors to determine whether independence may be compromised even if technical requirements are satisfied.

Regarding disclosure, SEC rules have for years required proxy statements to "briefly discuss the specific experience, qualifications, attributes, or skills" that led to each director's nomination. Over the years, however, the disclosure in most cases has been reduced to little more than boilerplate. The traditional "skills matrix" found in company disclosure about board composition and the strengths of individual directors may not be the most useful construct.

As a result, we think companies in 2016 should consider crafting a more holistic discussion of the board's composition. This could include not just citing the facts of director tenure and job history but also exploring how each board member's experience complements that of the others and explaining how the board shaped itself deliberately by identifying and filling talent or other gaps and how the board considered issues of independence. Such a discussion could, for example, examine how shifts in the company's business plan or industry caused the board to reevaluate the suitability of its current members with the result that the board either determined to add new members or decided that the current members were well-placed to handle the challenge. A fresh look at (and take on) this disclosure would clearly benefit shareholders while at the same time aid in warding off potential criticism from outsiders. For example, the Glass Lewis voting guidelines for 2016 clarify that it may recommend a "No" vote for the nominating committee chair if it determines that a company's poor performance was caused in part by the board's failure to ensure it has directors with relevant experience "either through periodic director assessment or board refreshment." While board refreshment is self-evident, thoughtful director reassessment requires thoughtful disclosure.

At the same time, the board also should ensure that meeting minutes fully reflect its processes in nomination (and renomination) decisions, taking into account the results of rigorous board and committee self-evaluations, an examination of the strengths and weaknesses of the board's composition given the current needs of the company, evaluations of independence, and the qualities the board may be looking for in future directors. Such internal documentation will inform external disclosure and may be especially useful in the event of a proxy contest or other issues down the road.

IV. Activists Designated Directors in the Board Room

As more companies reach settlement agreements with activists, companies in 2016 will need to be well-versed in how to deal with the unique challenges presented by directors selected by hedge funds.

In selecting and onboarding these directors, the board will need to consider:

- vetting the potential new board member;
- how to handle information requests from the new director;
- how to identify and deal with any conflicts of interest (discussed in item V below); and
- the impact of the new member on the board's culture and processes.

Candidates should be vetted with appropriate background and reference checks, and should meet with the CEO and members of the nominating/governance committee (and possibly other board members). The board should satisfy itself that any new member has the necessary background, skills, and commitment to advance the interests of the company and its shareholders and will comply with his or her fiduciary duties. The board also should consider the new director in light of the issues regarding overall composition, independence, and related disclosures discussed in item III above.

An activist hedge fund may require that its designated director be permitted to share confidential company information with employees of the fund. This type of information sharing has given rise to concerns that having an activist designee on the board may create a "shadow management." While companies should expect that an activist-affiliated board member may ask for more information than a traditional company-appointed director, there are practical ways to accommodate such a dynamic:

- Boards should require appropriate confidentiality protections and adopt procedures requiring that information requests come only from the director (not another employee of the activist) and be directed to a single point of contact at the company.
- Companies should agree to give the director existing data, analyses, and documents and be cognizant of the director's right, as a matter of corporate law, to receive this information. But, when it comes to the creation of new data, analyses, and documents specifically for the director, the board should impress upon the activist director the practical limitations and need for management to dedicate its time appropriately.
- Information given to a director in response to a request should be made available to all directors.
- The activist and its principals and employees should be subject to the same confidentiality and trading window requirements as the director.

Finally, there is some risk that an activist-affiliated director may change the dynamics in the board room with the result that board deliberations are less candid. All board members should work to maintain the environment of trust, effective challenge, and candor among the directors and with management. In some circumstances, activist directors have remained on boards even after the settlement agreement would have allowed the company not to renominate them. A board culture that encourages different points of view and actively debates the best way to deliver shareholder value is what all directors and shareholders should seek, and an activist director, with a fresh perspective, can become a valuable part of that culture.

V. Director Conflicts of Interest

Boards must be mindful of issues that may arise when directors owe duties to other entities. For instance, a director may have been selected by an activist or by a private equity fund that is a shareholder, or the director may serve on the board of another corporation. A director who owes a duty of loyalty—which under Delaware law includes a duty of confidentiality—to another entity may find herself in an untenable position if potential conflicts are not proactively managed.

Confidentiality issues often present the most challenging of these situations and can arise without warning. For instance, it may be difficult to identify a potential confidentiality conflict until the information is shared with the director, but once the director has the information, he or she immediately could be faced with competing duties of loyalty. In such case, the director could be required to keep the information about one entity confidential while also being required to disclose it to the other entity. In the worst case, even resignation from both entities may not entirely cleanse the conflict.

To mitigate and hopefully avoid such confidentiality conflict situations, a company with a director who has such competing responsibilities should do the following:

- Consider whether it is willing to authorize disclosure to the other entity, assuming the other entity agrees to keep the information confidential, refrain from using it to the detriment of the first company, and comply with trading and other similar policies in the same manner as the director. If appropriate, this type of arrangement should be reflected in a board resolution and documented in a shareholder or other agreement. In the case of a competitor, however, these measures will likely not be appropriate.

- Consider how the business interests of the two entities overlap, and identify topics where conflicts and competing loyalties may arise. It may be possible to ring-fence these issues by having the director agree not to receive any board information about these topics and to have the director recused from relevant board discussions. This may involve some logistical challenges, such as separate board packets and a carefully structured agenda.

- Regularly reassess the situation—at some point, the areas of potential conflict may become too great to allow the director to function effectively.

In addition to confidentiality concerns, the corporate opportunity doctrine may create issues for directors with conflicting fiduciary duties. Under Delaware law, the corporate opportunity doctrine, unless it is renounced in constituent documents, prohibits directors and officers of a

corporation from diverting an opportunity that belongs to the corporation. The doctrine applies to any opportunity in the company's line of business that the company is financially able to undertake and in which the company has a legitimate interest or expectancy. In such cases, both entities should consider adopting resolutions renouncing, to the extent appropriate, an interest in corporate opportunities presented to the director by the other entity.

Other conflicts may arise in the activist context or when a director is selected by a significant shareholder. For instance, a conflict may result from a director's "golden leash" compensation arrangement or from the need of an investor to liquidate its investment at a profit within a certain period of time. Delaware courts have recognized this "timing" conflict and recently criticized a board for allowing a potentially conflicted director to dominate the company's sale process. We often encourage boards to establish at the beginning of a director's tenure that the company will from time to time and in connection with certain events make determinations about the director's potential conflicts of interest and take appropriate remedial measures.

These potential conflict issues, which stem from the duty of loyalty, are of particular concern as the laws of many states, including Delaware, do not permit indemnification of directors for breaches of the duty of loyalty. In addition, acts in contravention of the duty of loyalty often are not covered by D&O insurance or the exculpatory provisions in organizational documents. Some courts also have held that under certain circumstances, disclosing a conflict of interest does not necessarily protect a director from a breach of loyalty claim.

In addition to dual-loyalty issues, antitrust issues between potential competitors also should be considered, as well as specific considerations that may arise under specialized regulatory regimes.

A related concern for companies is disclosure of related-party transactions involving directors, and 2016 promises some changes in this regard. In June 2014, the PCAOB adopted Auditing Standard No. 18, *Related Parties* (AS 18), which was effective for fiscal years beginning on or after December 15, 2014. This standard requires auditors to assess the accuracy and completeness of management's identification of related parties, and specifies heightened audit procedures for certain related party transactions. The underlying accounting standard that requires disclosure of related party transactions (ASC 850, *Related Party Transactions*) has not changed. But the heightened auditor requirements under AS 18 have resulted in an increased focus on a company's processes around identifying and disclosing these transactions. Accordingly, many companies have revised their D&O questionnaires for 2016 (or in some cases, used a separate additional questionnaire) to satisfy auditor inquiries on this topic.

VI. Audit Committees

It appears that 2016 will be another interesting year for audit committees, with developments and potential changes implicating many aspects of the audit function and its oversight.

An emerging area of focus for 2016 is the audit committee report. In recent years, shareholders and other constituents have paid increasing attention to audit committee and auditor disclosures, and some commentators have expressed the view that the SEC's disclosure rules do not provide investors with sufficiently useful information regarding the role and responsibilities of the audit committee. The SEC staff also has noted a growing desire by some

investors for additional information regarding *how* the audit committee performs its gatekeeper role. SEC Chair Mary Jo White recently described the audit committee report as "a place for engaging with shareholders on important subjects" and noted that the report "must continue to meet the needs of investors as their interests and expectations evolve with the marketplace."

The SEC may eventually propose rule changes in this area, as indicated by its July 2015 concept release seeking public comment on audit committee reporting requirements. The concept release highlighted three potential areas of enhanced disclosure:

1. The audit committee's oversight of the auditor.

2. The audit committee's process for appointing or retaining the auditor.

3. The audit committee's consideration of the qualifications of the audit firm and certain members of the engagement team.

Many of the SEC's requests for comment in the release involve potential disclosure about the nature or substance of audit committee deliberations and communications, including with the auditor. New disclosure requirements of this nature would differ significantly from current audit committee disclosure requirements, which are generally process-focused. In summarizing the comments received on the release, SEC staff stated that there is significant investor interest in additional audit committee disclosure, particularly in the areas of the selection and appointment of the auditor, evaluation of the qualifications and work of the audit team, and determination of the auditor's compensation, and highlighted suggestions for principles-based requirements that would allow a company flexibility to create tailored disclosures and avoid use of boilerplate.

The SEC's concept release appeared against a backdrop of ongoing attempts by the PCAOB to revise its regulations regarding the form and content of the audit report. In August 2013, the PCAOB proposed two new auditing standards:

1. The first would require the auditor to include in the audit report information about "critical audit matters" and its evaluation of information in a company's annual report other than the financial statements ("other information").

2. The second would focus on the auditor's responsibilities with respect to a review and evaluation of other information.

Both standards were designed to provide more information about the audit, the auditor and the auditor's responsibilities for other information contained in documents that include (or incorporate by reference) audited financial statements, and the related auditor's report. The proposals have been the subject of significant criticism and debate. In particular, the first proposal has been criticized as going too far in requiring disclosure of matters that involved the most difficult, subjective, or complex auditor judgments, or that posed the greatest difficulty to the auditor in obtaining sufficient appropriate evidence or in forming its opinion on the financial statements. The proposal also included several changes to the format of the report, including expanding the discussion of independence, requiring disclosure of the auditor's tenure, and enhancing certain standardized language. Following a comment period, public hearings, and much deliberation, the PCAOB is currently expected to issue a re-proposal of this audit report

standard in the first half of 2016. The PCAOB continues to evaluate the proposed standard on other information, and no upcoming action on that standard has been announced at this time.

Although it may be some time before new rules on either of these topics are finalized, or before the SEC takes any action as a result of its concept release, audit committees, boards and their advisors should monitor the rulemaking processes and shareholder expectations in this area. Some companies have enhanced their audit committee disclosures in the proxy statement voluntarily, generally with a focus on processes around auditor selection, compensation, and independence. Audit committees, boards and their advisors also should begin to consider how the audit committee's relationship with the auditor may change in the event of a different disclosure model.

Other topics for audit committees in 2016 include a continued focus on oversight of controls, particularly in light of the upcoming adoption of major new accounting standards. Implementation of the new "global" revenue recognition standard continues (with implementation under U.S. GAAP postponed to annual reporting periods beginning after December 15, 2017 for US public companies and under International Financial Reporting Standards (IFRS) to annual reporting periods beginning after January 1, 2018), and a new standard for lease accounting is expected from the Financial Accounting Standards Board (FASB) in early 2016. In addition, recent comments from staff of the SEC's Office of the Chief Accountant emphasized the need for companies to consider the need to implement or redesign controls as part of the application of new accounting standards.

The broader investor focus on "overboarding" (discussed above in item III) is echoed in concerns recently articulated by SEC Chair Mary Jo White about directors who serve on multiple audit committees. She also noted a concern with audit committee workload generally—a consequence of audit committees often being charged with tasks beyond their core responsibilities. Finally, Chair White and other SEC staff signaled the possibility that the SEC might reconsider its rules on audit committee qualifications, including the definitions of "financial literacy" and "audit committee financial expert."

VII. New Compensation Disclosure Rules

Executive compensation has for many years been a hot topic, and the SEC's new pay ratio rule and the three other rules it proposed in 2015 will require board attention in 2016 and future years.

Final CEO Pay Ratio Rule

The CEO pay ratio rule implements the requirement, added at the eleventh hour before its passage to the Dodd-Frank Act, that public companies disclose the ratio of CEO pay to median employee pay. The disclosure will be required in annual proxy statements beginning in 2018 (for 2017 compensation). While some commentators expected significant legal challenges to this rule, to date those have not materialized.

In addition to the potential embarrassment factor associated with this disclosure, there are four issues for directors to consider:

1. Companies with ratios above a certain threshold could be punished through existing or future federal or state legislation limiting their opportunities to bid on certain business opportunities or subjecting them to adverse tax consequences. Legislation along these lines has been introduced in a few jurisdictions in the past, and it is reasonable to expect it could be introduced again, with its chances for success dependent on the then-prevailing political environment.

2. We expect that producing the ratio will be costly and require significant effort, particularly for companies with global workforces or that use different human resource IT systems in different jurisdictions, because of the need to aggregate data for determining the median (not average) employee pay level.

3. The pay of independent contractors and other non-employee service providers (e.g., so-called leased employees employed through outsourced functions and professional employer organizations) is excluded from the calculation. It seems unlikely that companies will attempt to proactively "manage" their ratios by changing the character of their workforce, but there nonetheless has been a global trend in the last few years away from traditional employer/employee relationships and toward these types of alternative arrangements. The impact on the ratio of greater reliance on non-traditional service provider relationships is a factor that may be taken into account by companies, however, if it tips the balance in favor of a lower ratio. That impact, if it materializes, may have other consequences for businesses as the percentage of their workforce comprising nontraditional employees grows.

4. While disclosure of CEO pay is already required and has drawn a fair amount of negative press, boards historically have paid little attention to the impact of determining the median employee pay level. Disclosing this information may present new challenges, particularly stemming from employees' reactions to learning how their pay compares to the median and to that of competitor companies. Dissatisfaction could put pressure on wages and pose a challenge for HR executives. Accordingly, it will be important for boards to consider why their median is what it is and how and why it may be different from that of competitors. Boards should be prepared to be transparent in communicating that information (perhaps even in the proxy statement).

Proposed Pay Versus Performance Disclosure Rule

Companies have, of course, been focused for many years on aligning pay with performance. Nevertheless, the proposed pay versus performance rule was held up at the SEC for quite some time—presumably because of the difficulty of determining how to measure "pay" to compare to performance.

The proposal refers to "pay actually received," which is not an obvious concept to determine and will likely result in anomalous results across companies. For example, in the context of a stock option, its value will be different when the option is awarded, vests, or is exercised, or when the underlying stock is sold. The SEC's proposed rules would require a table with prescribed data and an explanation, in whatever form the company determines to use.

The key for directors will be to assist management in framing and explaining exactly what performance they are trying to incentivize and why and how the pay outcomes are in fact correlated with that performance. Communicating those points can be particularly challenging. For example, the correlation may not be obvious because of timing issues or unanticipated movements in stock attributable to commercial or external factors. A final pay-for-performance rule could be adopted soon and become effective as early as 2017, making it particularly important for directors and management to proactively consider potential approaches to the required disclosure.

Proposed Compensation Clawback Requirement

The SEC has proposed rules that would require the exchanges to adopt clawback requirements applicable if a company restates its financial reports. Many companies already have voluntarily implemented clawback requirements in this context, and the new requirements are, for the most part, not a material departure from existing practices.

The most notable aspects of the proposed rules are that they:

- have a no-fault approach—i.e., they require clawback from executives who engaged in no misconduct and were not involved in any way in the issues giving rise to the accounting restatement; and
- generally do not apply to time-vesting stock options, restricted stock or RSU awards.

The proposed rules raise an important issue for directors in that they leave it to the exchanges to determine how and when recovery of clawback amounts should happen, taking director judgment out of the equation. Under the proposal, directors could, for example, be required by the exchanges (on penalty of delisting) to chase after current or former executives for repayment of compensation even if the directors believe that doing so at a certain time would be detrimental to the interests of shareholders. Such a scenario could easily arise, for example, in connection with a shareholder derivative lawsuit relating to a restatement in which a former executive's willingness to cooperate could be essential to the lawsuit, and harassment for repayment of compensation could be a disincentive to such cooperation.

Proposed Hedging and Pledging Disclosure Requirement

The SEC also proposed rules directing the exchanges to require listed companies to adopt and disclose policies concerning the ability of executives and directors to hedge their holdings of company stock or to pledge company stock to secure indebtedness.

Unlike the clawback rules, these rules do not mandate particular policies and only require that the company adopt some policy. Many companies have already adopted and disclosed policies prohibiting hedging and pledging (in part as a result of ISS and Glass Lewis criticism of both). Directors of companies that have not yet adopted such policies should consider implementation in 2016, as a final rule could go into effect at any time.

VIII. Conflicts of Interest When Selecting a Financial Advisor

In 2015, Delaware courts maintained their close focus on financial advisor conflicts in M&A transactions. The courts have examined both the conflicts themselves and the sufficiency and timing of related disclosures made—or not made—to the board (or to the special committee in transactions with controlling shareholders or management) and to shareholders. We discuss below what steps directors should consider when the company is considering a sale, merger, or other major M&A transaction that will involve retaining an external financial advisor.

The board, typically through counsel, should obtain and consider information from a proposed financial advisor regarding the extent and nature of the financial advisor's relationships with likely counterparties (to the extent that likely counterparties are identifiable at the time of engagement) and even with the company itself—particularly if the financial advisor is a counterparty on complex derivative transactions with the company. Other relationships that counsel and the board should carefully scrutinize include equity investments, whether by the advisory firm or senior members of the banking team; other investment banking and financing assignments; and any recent pitches or other discussions in which the financial advisor may have reviewed a possible acquisition of the company with a prospective bidder. Unearthing and considering these conflicts is often not a straightforward process due to the existence of "walled off" information within investment banks, confidentiality obligations that banks owe their clients, the number of touch points that many large banks have with clients, and the potentially unwieldy number of potential counterparties for the contemplated range of transactions under consideration at the outset of an engagement. Nonetheless, counsel and boards, with cooperation from the prospective financial advisor, should be able to make an informed and intelligent decision regarding the financial advisor's conflicts, even with imperfect information.

If counsel concludes there are conflicts that make retention of the financial advisor inadvisable, they will normally so advise the company's management, and it is not likely that the firm will even be proposed to the board. In other situations, counsel should advise the board that it has made inquiries and should make a full report to the board (or arrange for the prospective financial advisor to report directly to the board) if there are potential material conflicts, even if counsel believes that those conflicts are not disabling. This will allow the board to factor this information into its decision whether to engage that financial advisor.

In addition, whether or not there was any potential conflict identified prior to engagement, counsel should follow up with the financial advisor at key points in the process (for example, after leading bidders emerge during an auction, or if it becomes public that a competitor has commenced a review of strategic alternatives or a sale process) for an update regarding conflicts and potential conflicts that exist or may become likely as a result of ongoing developments. After this review, counsel should again consider whether any of this information warrants a report to the board for further evaluation.

In performing these inquiries and evaluating any existing or potential conflicts:

- The board should expect to receive specific disclosures regarding any existing or potential conflicts of the financial advisor and, in particular, should be told about the nature and magnitude of any equity investment the financial advisor, its affiliates or any senior member of the banking team has in the counterparty; the fees the financial

advisor (or its affiliates) has generated and expects to receive from investment banking assignments for the counterparty; and the benefit it may derive in connection with the possible unwinding of any call spreads or other hedging arrangements in the company's or the counterparty's stock as a result of the proposed transaction. In some circumstances, the amounts implicated by such an unwinding of a hedge can dwarf the potential M&A advisory fee and may be impacted by the timing of the proposed transaction or by the form of consideration (cash or stock) to be utilized by particular bidders, thereby creating questions as to the financial advisor's incentives. In the context of call spreads and other hedging arrangements, it may sometimes be advisable to retain an expert to evaluate (or comment on the financial advisor's evaluation of) the financial impact of various hypothetical transactions on those arrangements.

- The board and counsel should keep in mind that courts recognize that excellent advisors with relevant industry experience are likely to be in demand and may have a number of conflicts and potential conflicts. Courts also recognize that it can be counterproductive for directors (or counsel) to be so "gun-shy" as to avoid advisors with manageable conflicts or potential conflicts, particularly if doing so would require retaining advisors with materially less relevant expertise or industry experience or who would be outmatched by the counterparty's advisors. In balancing the need to retain excellent and experienced advisors against the conflicts and potential conflicts of that advisor, the board, with input from senior management and advice from counsel, must understand and evaluate the specifics of the financial advisor's incentives.

These competing financial incentives and existing or potential conflicts do not *per se* make it inadvisable to retain the proposed financial advisor. Indeed, many actual and potential conflicts are not disabling, and they can be cured simply by disclosing their existence to the board and shareholders at the appropriate times so the board and shareholders can factor that information into their decisions. Accordingly, this inquiry and evaluation may lead the board, with advice from counsel, to conclude that there is no material conflict requiring remedial steps, or that the financial advisor should be retained but steps should be taken to eliminate or minimize the risks created by such conflicts, such as the creation of effective firewalls or the retention of a properly incentivized second financial advisor.

The process and results of the inquiry, including any material or potential conflicts, should be documented in the board's minutes. If any conflicts or potential conflicts are identified, the minutes also should reflect the board's rationale for determining that such conflicts were immaterial or were manageable and should describe any remedial measures implemented. Any updated conflict analysis or confirmation to the board that develops during the process and the resulting board decisions also should be reflected in the minutes. In addition, similar disclosures should be made to shareholders in the proxy statement or tender offer documents relating to the proposed transaction.

In this regard, an October 2015 Delaware Supreme Court decision (*Corwin v. KKR Fin. Holdings LLC*) has made clear that after a fully informed shareholder vote on a merger transaction, in a suit for damages the board's actions will be reviewed under the deferential business judgment rule—even if in an injunction action prior to such a shareholder vote the board's actions would have been or were subject to review under stricter standards.

Accordingly, it is important for care to be taken to ensure that all material facts regarding a financial advisor's conflicts are included in the proxy statement.

In short, directors, with advice from counsel taking into account the bankers' capability and experience, should be vigilant in seeking to understand their financial advisor's relationships with both the company and other parties and how those relationships could incentivize the advisor to act—intentionally or unintentionally—in a manner that might be inconsistent with the board's fiduciary duties.

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

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