The State of Corporate Governance for 2015

The balance of power between shareholders and boards of directors is central to the U.S. public corporation’s success as an engine of economic growth, job creation and innovation. Yet that balance is under significant and increasing strain. In 2015, we expect to see continued growth in shareholder activism and engagement, as well as in the influence of shareholder initiatives, including advisory proposals and votes. Time will tell whether, over the long term, tipping the balance to greater shareholder influence will prove beneficial for corporations, their shareholders and our economy at large. In the near term, there is reason to question whether increased shareholder influence on matters that the law has traditionally apportioned to the board is at the expense of other values that are key to the sustainability of healthy corporations. These concerns underlie the issues that will define the state of governance in 2015 and likely beyond:

- Impact of federal regulation on governance roles that have traditionally been defined by state law
- Tensions between achieving short-term returns versus making long-term investment
- The impact of shareholder activism on board decisions and on wealth creation
- Litigation and reactive protectionism by boards through bylaw provisions
- Proxy adviser power and influence
- Drawing the line between oversight and management
- Regulation and enforcement activity
- Rebuilding society’s trust in the corporation

I. Governance Roles and Responsibilities

Over the past 15 years, two distinct theories have been advanced to explain corporate governance failures: too little active and objective board involvement and too little accountability to shareholders. The former finds expression in the Sarbanes-Oxley Act’s emphasis on improving board attention to financial reporting and compliance, and related Securities and Exchange Commission (“SEC”) and listing rules on independent audit committees and director and committee independence and function generally. The latter is expressed by the Dodd-Frank Act’s focus on providing greater influence to shareholders through advisory say on pay votes and access to the company’s proxy machinery for nomination by shareholders of director candidates.

The emerging question is whether federal law and regulation (and related influences) are altering the balance that state law provides between the role of shareholders and the role of the board, and if so, whether that alteration is beneficial or harmful. State law places the management and direction of the corporation firmly in the hands of the board of directors. This legal empowerment of the board—and implicit rejection of governance by shareholder referendum—goes hand in hand with the limited liability that shareholders enjoy. Under state law, directors may not delegate or defer to shareholders as to matters reserved by law for the board, even where a majority of shareholders express a clear preference for a specific outcome. Concern about appropriate balance...
in shareholder and board roles is implicated by the increasingly coercive nature—given the influence and policies of proxy advisory firms—of federally-mandated advisory say on pay proposals and advisory shareholder proposals submitted under Securities Exchange Act Rule 14a-8 on other matters that do not fall within shareholder decision rights. The extent of proxy advisory firm influence is linked, at least in part, to the manner in which the SEC regulates registered investment advisors.

II. Short-Term Returns vs. Long-Term Investment

Management has long reported significant pressures to focus on short-term results at the expense of the long-term investment needed to position the corporation for the long term. Observers point to short-term financial market pressures which have increased with the rise of institutional investors whose investment managers have incentives to focus on quarterly performance in relation to benchmark and competing funds.

Short-term pressures may also be accentuated by the increasing reliance on stock-based executive compensation. It is estimated that the percentage of stock-based compensation has tripled since the early nineties: in 1993, approximately 20 percent of executive compensation was stock-based. Today, it is about 60 percent.

Boards that should be positioned to help management take the long-term view and balance competing interests are also under pressure from financial and governance focused shareholder activism. Both forms of activism are supported by proxy advisors that favor some degree of change in board composition and tend to have fairly defined—some would say rigid—views of governance practices.

III. Shareholder Activism and Its Value

As fiduciaries acting in the best interests of the company and its shareholders, directors must make independent and objective judgments. While it is prudent for boards to understand and consider the range of shareholder concerns and views represented in the shareholder constituency, shareholder engagement has its limits: The board must make its own independent judgment and may not simply defer to the wishes of shareholders. While activist shareholders often bring a valuable perspective, they may press for changes to suit particular special interests or short-term goals that may not be in the company’s long-term interests.

A. Governance Activism

Shareholder pressure for greater rights and influence through advisory shareholder proposals are expected to continue in the 2015 proxy season. A study of trends from the 2014 proxy season in Fortune 250 companies by James R. Copland and Margaret M. O’Keefe, Proxy Monitor 2014: A Report on Corporate Governance and Shareholder Activism (available at www.proxymonitor.org), suggests that the focus of most shareholder proposal activity does not relate to concerns that are broadly held by the majority of shareholders:

- Shareholder support for shareholder proposals is down, with only four percent garnering majority support, down from seven percent in 2013.
- A small group of shareholders dominates the shareholder-proposal process. One-third of all shareholder proposals are sponsored by three persons and members of their families and another 28 percent of proposals are sponsored by investors with an avowed social, religious or public-policy focus.
- Forty-eight percent of 2014 proposals at Fortune 250 companies related to social or political concerns. However, only one out of these 136 proposals received majority support, and that solitary passing proposal was one that the board had supported.
Institutional Shareholders Services Inc. (“ISS”) is far more likely to recommend in favor of shareholder proposals than the average investor is to support them. Nonetheless, the universe of shareholder proposals included in corporate proxy statements pursuant to Rule 14a-8 has grown significantly over the years. In addition, the coercive power of advisory shareholder proposals has expanded as a result of the policy of proxy advisors to recommend that their clients vote against the re-election of directors who fail to implement advisory shareholder proposals that receive a majority of votes cast. Directors should carefully assess the reasons underlying shareholder efforts to use advisory proposals to influence the company’s strategic direction or otherwise change the board’s approach to matters such as CEO compensation and succession, risk management, governance structures and environmental and social issues. Shareholder viewpoints provide an important data set, but must be understood in the context of the corporation’s best interest rather than the single lens of one particular constituency.

**Hot Topics for 2015 Shareholder Proposals**

Early indications are that in 2015, the most frequent shareholder proposals will relate to:

- Shareholders’ ability to impact board composition, through proxy access and—at mid-tier companies—replacement of plurality voting in uncontested director elections with majority voting;
- Board leadership in the form of an independent board chair; and
- Enhanced disclosure regarding corporate efforts on social and environmental issues or “sustainability reporting.”

Expect proxy access proposals to be particularly prominent in the 2015 proxy season. New York City Comptroller, Scott Stringer, has announced a “Boardroom Accountability Project” targeting 75 companies with non-binding proxy access shareholder proposals to bring pressure to bear with respect to other issues. The targeted companies were selected because of concerns about climate change, board diversity or executive compensation. The proposal seeks access to the proxy machinery for up to a quarter of board seats for shareholders who have held three percent of company shares for three years.

Proxy access proposals framed to track the SEC’s now-vacated proxy access rule—allowing access for shareholdings of three percent for three years—have a fair likelihood of receiving a majority of votes cast. That has significant implications for proxy adviser recommendations regarding the election of directors the following year if the company does not adopt proxy access. Of the proxy access proposals that went to a vote in 2014, fewer than half received a majority of the votes cast in favor, with average support of approximately 37 percent. Support was highest for proposals like the Comptroller’s, which relied on a three percent for three year holding requirement: all proposals that received a majority of votes cast were based on this requirement.

Note that in early December 2014, the SEC Division of Corporation Finance agreed that Whole Foods could exclude under Rule 14a-8(i)(9), a three percent for three-year proxy access proposal from James McRitchie, given the company’s stated intent to put its own nine percent for five-year proxy access proposal up for a shareholder vote. McRitchie has appealed the grant of no-action relief to the full Commission. Whole Foods has since filed with the SEC its preliminary proxy statement with a five percent, five-year proxy access proposal rather than the nine percent, five-year proposal it originally indicated it would file. A number of other companies have also sought no-action relief based on company plans to include a proposal at the five percent for five year threshold. Boards should carefully assess whether to recommend a binding management proposal on proxy access. Where a binding management proposal passes, shareholders may seek to bring a proposal to lower the thresholds the following year and such a proposal is unlikely to be excludable under the “substantial implementation” grounds of Rule 14a-8(i)(10). In the meantime, the company may lose good will with
institutional investors and there is a risk that directors up for re-election could be targeted with a negative vote campaign in the current year due to their support of the counter proposal tactic.


B. Financial Activism

Over the past three years, the number and intensity of financial activism initiatives has increased. The ongoing debate on the wealth effects of hedge fund activism is worth following and is well-covered on Harvard’s corporate governance blog (blogs.law.harvard.edu). Although financial activism may return immediate wealth to some shareholders through the sale of assets, payment of special dividends or share buybacks, evidence is mounting that this may be at the expense of the longer term corporate and societal interests. For example, a July 2014 paper by Yuan Allaire and Francois Dauphin, “Activist” Hedge Funds: Creators of Lasting Wealth? (available at www.igopp.org), concludes that “the most generous conclusion one may reach” is that activist funds “create some short-term wealth for some shareholders” because investors tend to jump into the stock of targeted companies upon the announcement of activist activity. “In a minority of cases, activist hedge funds may bring some lasting value for shareholders but largely at the expense of workers and bond holders; thus the impact of activist hedge funds appears to take the form of wealth transfer rather than wealth creation.” The research further notes that hedge funds tend to be focused on the short term, with half of interventions not lasting nine months. In addition, a growing number of commentators, including senior representatives of some institutional investors, have expressed concern about the impact of hedge fund activism, and associated increased debt and cuts in capital spending, on long-term corporate health, innovation, job creation and GDP growth.

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<th>Preparation for Shareholder Activism</th>
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<td>The ability of the board and management to address activism pressures depends largely on the ability to communicate effectively regarding long-term strategy, risk oversight, management succession and company performance. Avenues of communication include the company’s investor relations efforts and shareholder outreach, as well as periodic filings and proxy statements.</td>
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To prepare for shareholder activism, the board and management should assess company vulnerabilities that relate to performance, strategy and governance as viewed by activists. Specifically, the board and management should:

- Identify areas in which the company may be subject to activism;
- Consider the company’s positions on those topics and prepare responses;
- Consider the company’s defense profile;
- Monitor governance and activist updates to keep abreast of “hot topic” issues;
- Assure that a protocol (including a script) is in place that details how members of management and directors should respond if they receive a call from an activist;
- Invest in building relations with the company’s large long-term shareholders; and
- Identify the team of advisors that the board would retain in an activist situation and discuss these issues with them.
IV. Litigation and Protectionism

Corporations today are routinely subject to shareholder litigation for which corporations—and, by extension, their shareholders—foot the bill. An oft-cited January 2014 article by Matthew Cain and Steven Davidoff, Takeover Litigation in 2013 (available at http://papers.ssrn.com), reported that 97.5 percent of 2013 takeover transactions valued at over $100 million resulted in shareholder litigation—up from 39 percent in 2005. Board decisions and proxy disclosures related to executive compensation are also leading to an increase in shareholder litigation, albeit on a smaller scale.

Since even weak shareholder claims pose uncertainty, significant costs and settlement pressures, corporate interest in how to reduce nuisance suits has grown. Recent Delaware state court decisions underscore the potential for corporate bylaws, including those adopted by boards, to reduce incentives for the plaintiffs’ bar to file such lawsuits. For example, the Delaware courts have upheld, at least as a general matter, the statutory and contractual validity of board-adopted bylaws that seek to limit the forum for intra-corporate litigation. In addition, the Delaware Supreme Court has upheld—in the context of a non-stock corporation—the statutory and contractual validity of bylaws that allocate all or a portion of the cost of intra-corporate litigation to the losing party. Although these court decisions have spurred significant interest in board-adopted bylaws aimed at reducing incentives for the plaintiffs’ bar to file claims, caution is advised. Despite strong arguments that support deterring nuisance suits that are costly to companies and their shareholders, some shareholders, shareholder rights advocates and proxy advisory firms have expressed concern about unilateral board-adopted bylaws that they view as improperly restricting shareholder litigation rights. For more detailed discussion, please see, “The Elusive Promise of Reducing Shareholder Litigation Incentives Through Corporate Bylaws” published on June 4, 2014 at http://www.sidley.com/06-03-2014-Update/.

A. Exclusive Forum Bylaws

Delaware forum selection provisions designate a Delaware court as the exclusive forum for certain intra-corporate disputes, including derivative suits, breach of fiduciary duty suits, suits brought under the Delaware General Corporation Law (“DGCL”) and other suits involving the company’s internal affairs. During the past few years, an increasing number of Delaware corporations have adopted forum selection provisions in their organizational documents, in an effort to minimize the risk of duplicative multiforum stockholder litigation. A forum selection provision is not designed to prevent stockholders from bringing claims; it only addresses where the claims may be litigated. Delaware courts, particularly the Court of Chancery, are thought to afford several benefits to corporations, including a well-established body of corporate case law, a judiciary knowledgeable in business disputes and relatively expedited litigation schedules.

In June 2013, the Delaware Court of Chancery ruled that forum selection bylaws unilaterally adopted by the boards of directors were valid on a statutory and contractual basis under Delaware law, eliminating prior uncertainty regarding their enforceability. The Delaware Supreme Court affirmed that decision.

Thereafter, courts in several other jurisdictions (including Alabama, Illinois, New York and Louisiana) have upheld such provisions, although an Oregon court recently declined to enforce an exclusive forum provision. Critical to the Oregon court decision, however, was that the company had adopted the exclusive forum provision on the same day that it had approved a merger agreement that was at issue in the litigation sought to be moved to Delaware. The Oregon court decision, however, is at odds with a recent decision of the Delaware Court of Chancery, City of Providence v. First Citizens Bancshares, where the court enforced a forum selection bylaw adopted on the same day as the announcement of the merger challenged in the litigation.

The policy of Glass Lewis & Co LLC (“Glass Lewis”) has been to recommend against the re-election of the chair of a governance committee if, in the past year, the board adopted a forum selection bylaw without stockholder
approval. Over 300 company boards unilaterally adopted forum selection clauses in 2013 and 2014, and Glass Lewis recommended against re-electing the governance committee chairs of the companies within this group. The unilateral adoption of a forum selection clause will not generally result in a negative vote recommendation against a director by Institutional Shareholder Services Inc. (“ISS”). Although ISS’ new policy for unilateral adoption of bylaw provisions that impair shareholder rights may result in a recommendation against director re-election, ISS has confirmed that this policy will not apply to exclusive forum provisions.

B. Fee-Shifting Bylaws
In the United States, unless otherwise agreed by contract or required by statute, each litigant is responsible for paying its own attorney fees and court costs. Some jurisdictions outside the United States have a “loser pays” system to discourage lawsuits of questionable merit and avoid pressures on corporations to settle non-meritorious suits early to save time and money and avoid uncertainty.

On May 8, 2014, the Delaware Supreme Court ruled, in answering a question certified by the U.S. District Court for Delaware, that a bylaw adopted by the Board of a non-stock corporation that provided for a losing plaintiff to pay defendants’ attorney fees and costs associated with its intra-corporate suit would not violate the provisions of the DGCL. The Court did not opine on the validity of the bylaw under equitable principles.

This ruling has created interest in the use of fee-shifting bylaws in traditional stock corporations. For several reasons, however, very few public companies have yet adopted these provisions. One reason is the reaction of ISS and Glass Lewis, both of which will likely recommend against directors at companies that adopt fee-shifting bylaws without a shareholder vote. A second concern is uncertainty regarding how long and under what limitations fee-shifting provisions will continue to be an option for Delaware corporations. The Corporation Law Council of the Delaware State Bar Association has proposed amending the DGCL to prohibit Delaware stock corporations from adopting fee-shifting bylaws. Action on this is currently in process.

V. Concerns About Proxy Advisors
Over the past decade, the growing influence of proxy advisory firms on shareholder voting, executive compensation and corporate governance practices has caused no small degree of consternation and concern among public companies, given the perceived power of the highly-concentrated proxy advisory industry to effectively coordinate shareholder voting. Criticisms have also been voiced about: (i) the opacity and lack of nuanced analysis underlying vote recommendations, (ii) potential conflicts that arise when proxy advisers also provide consulting services to public companies, and (iii) inherent pressures in the proxy advisors business model that motivate these firms to continually “push the envelope” on corporate governance and disclosure reform. Federal legislation and the SEC Rules and guidance are also thought to have played a role in the growth of proxy advisor influence. Not surprisingly, the corporate community—through organizations such as The Business Roundtable, the U.S. Chamber of Commerce and the Society of Corporate Secretaries and Governance Professionals—as well as members of Congress and even some SEC Commissioners—have urged the SEC to consider whether additional regulation of the proxy advisor industry is warranted.

On June 30, 2014, the staffs of the SEC’s Division of Corporation Finance and Division of Investment Management (the “Staff”) issued long-awaited guidance related to both proxy advisory firms and their investment adviser clients. The guidance, published in Staff Legal Bulletin No. 20 (the “Bulletin”) (available at http://www.sec.gov/interps/legal/cfslb20.htm), addressed investment adviser responsibilities for the voting of proxies and diligence considerations regarding the retention and oversight of proxy advisory firms. The Bulletin also addressed two exemptions to the proxy solicitation rules on which proxy advisory firms often rely. Although the SEC Staff’s guidance could cause investment advisers to more carefully scrutinize the quality of proxy
advisers’ services—and even to reduce reliance on these services—the guidance does not directly address many concerns that have been raised to date. For additional information please see, “SEC Staff Guidance May Lessen Investment Adviser Demand for – While Also Raising the Costs of Providing – Proxy Advisory Services” published on July 10, 2014 at [http://www.sidley.com/7-10-2014_Update/](http://www.sidley.com/7-10-2014_Update/).

On November 6, 2014, ISS issued its final 2015 proxy voting guideline updates, effective for annual shareholder meetings held on or after February 1, 2015. Notably, the policy changes suggest a negative bias towards director elections where boards have unilaterally adopted bylaws (or, in certain circumstances, charter amendments) that ISS views as limiting stockholder rights. Although not signaled in the draft policy changes that ISS released for comment, ISS will now recommend against the election of directors when the board unilaterally adopts bylaws or charter amendments that, in ISS’s view, “materially diminish shareholders’ rights or ... could adversely impact shareholders.” Board actions that could trigger this amended policy include adopting, without a shareholder vote, fee-shifting and “arbitration only” requirements. Notably, however, as discussed above, ISS has indicated in remarks outside its policy document that it will not recommend against directors of companies that have adopted exclusive forum bylaw provisions.

### ISS Policy Changes for 2014

On November 6, 2014, ISS released updates to the internal voting guidelines it uses to make voting recommendations to its investor clients. ISS updates for 2014 focus on four key policy areas:

- **A new “balanced scorecard” for evaluation of equity compensation plan proposals:**
  ISS adopted a new “Equity Plan Scorecard” model that takes into account multiple factors, both positive and negative, in evaluating equity incentive plan proposals. These factors fall under three pillars: Plan Cost (45 percent weighting), Plan Features (20 percent weighting) and Grant Practices (35 percent weighting).

- **A more nuanced analysis of shareholder proposals that call for an independent board chair:** ISS indicated that it will take a more holistic approach in its evaluation of proposals calling for an independent board chair. It will also consider additional factors, including the presence of a non-independent chair in addition to the CEO, recent leadership transitions, tenure and a longer total shareholder return comparison.

- **A bias against director re-election where boards adopted bylaws (or, in certain circumstances, charter amendments) that ISS views as limiting stockholder rights:** ISS has modified its policy related to bylaw amendments adopted without shareholder approval. If such an amendment does or could materially diminish shareholders’ rights, ISS will generally recommend that shareholders vote against or withhold from directors individually, committee members or the entire board, after considering factors identified in the policy update. Separately, ISS has indicated that the adoption of an exclusive forum bylaw will not lead to adverse vote recommendations under the policy. ISS has also modified its approach to proposals relating to bylaw provisions that would impact shareholder litigation rights. ISS has identified in the policy several factors that it will consider in determining its recommendation with regard to such proposals. ISS has stated that it will generally recommend a vote against fee-shifting bylaws.

- **A modified approach to shareholder proposals relating to political contributions and greenhouse gas emissions.** ISS made minor changes to its policies regarding political contributions and greenhouse gas proposals to refine and clarify the factors considered in evaluating such proposals.

### VI. Oversight versus Active Management

The ever increasing pressures on, and expectations of, boards threaten to blur the line between the role of the board and the role of management. Expanding board activity into traditional areas of management has significant implications for the quality and objectivity of board oversight. Undue board involvement in areas of
management is also likely to undermine the effectiveness of corporate management and the ability to attract and retain the most qualified talent. In addition, the greater the involvement of directors in the day-to-day management of the company, the more difficult it will be (should there occur in the course of such management an adverse event that results in a stockholder suit) for those directors to use their reliance on the relevant corporate officers as a basis to avoid personal liability.

A key aspect of the board’s oversight role is to prioritize the board’s own time and attention given the unique circumstances facing the company to assure the board is focused on the most important issues and at the right level of attention. While the details will vary from company to company, the key focal areas remain:

- Oversight of strategy direction (including consideration of opportunities and risks) to drive competitive corporate performance and return on investment over the long term, in an ever changing business and geopolitical environment;
- CEO selection, evaluation, compensation and succession planning, and talent development;
- Risk oversight in relation to strategic direction, as well as the processes management uses to identify and manage risk. In 2015, cyber-security will continue to be a significant risk concern;
- Oversight of internal controls, financial reporting and compliance systems;
- Crisis preparedness;
- Shareholder relations, engagement and preparedness for activism; and
- Board succession, composition, leadership and performance, with particular focus on issues related to board refreshment (tenure and director evaluation) and diversity.

Although the board has much on its agenda, in most circumstances the largest portion of board time should be reserved for discussion of corporate strategy and performance. Financial institution boards will also inevitably be preoccupied with regulatory and compliance oversight issues. A recent Blue Ribbon Commission report of the National Association of Corporate Directors emphasizes the role of the board in providing guidance through the development of a strategic plan based on an iterative discussion with management. The board should also give special attention to supporting appropriate long-term investment and prudent risk-taking in the face of significant short-term pressures for immediate returns.

The overarching issue for audit committees in 2015, as in prior years, is how to prioritize committee resources to ensure that members have the time to read, understand and provide meaningful oversight of financial reporting. The danger is that with so much on the audit committee’s agenda, the committee will rely on checklist compliance at the expense of tailored attention to the issues that bear most importantly on the accuracy and reliability of disclosed information.

Risk oversight is also a top issue for many audit committees. While the audit committee typically has oversight obligations with respect to the processes and controls related to risk management (where there is no dedicated risk committee of the board), the responsibility for risk oversight is closely related to oversight of strategy and should therefore require full board attention. As to specific types of risk, cyber-security is an area to which audit committees and boards are likely to give greater attention in 2015.
VII. Regulation and Enforcement Activity

A. New Regulation Activity

Disclosure Effectiveness
During the past year, members of the Staff of the SEC Division of Corporation Finance have engaged in a “disclosure effectiveness project.” The goal of that project is to review existing disclosure requirements to determine whether modifications should be made to reduce the costs and burdens on public companies while also promoting the disclosure of material information to investors and eliminating duplicative disclosures. The SEC has not made any specific recommendations and has not provided a timetable for when it will do so.

Dodd-Frank Rule-Making Activity
In fall 2013, the SEC issued proposed rules relating to a new disclosure requirement regarding the ratio of CEO pay to median employee pay. Although the Dodd-Frank Act requires the SEC to adopt such rules, the SEC has not yet adopted final rules on this subject. Even if the SEC does so in 2015, it is not expected that any new disclosure will be required until the spring of 2016, at the earliest.

The SEC also has yet to propose rules for the Dodd-Frank-related items listed below. The SEC previously stated that it intended to propose and adopt the following rules before the end of June 2012, but later withdrew its commitment to that timeframe:

- Enhanced disclosures on pay for performance—each company must disclose the relationship of the compensation actually paid to its executive officers versus the company’s financial performance, taking into account changes in the value of its stock and dividends or distributions;
- Mandatory clawback policy that would require companies to recover excess pay to current and former executive officers in the event of financial restatement even in the absence of misconduct; and
- Employee hedging policy disclosure.

Regulation of Risk Governance for Financial Institutions
Boards of financial institutions face special governance challenges complying with rules, regulations, guidelines and expectations of U.S. and international banking supervisors in the wake of the financial crisis and the persistent perception that the crisis exposed widespread governance lapses at financial institutions.

Regulators assert that the importance of banks generally to the financial system as a whole, and individually from a safety and soundness perspective, mandates better alignment of bank corporate governance with regulatory objectives. This has implications for board decision-making with respect to capital allocations and distributions, loss absorbency measures, mergers and acquisitions, for risk management and oversight, and the extent of fiduciary duties of financial institution boards and officers generally. In a seminal speech in 2014, Dan Tarullo of the Board of Governors of the Federal Reserve queried whether the fiduciary duties of directors of financial firms should include a duty (presumably owed to corporation and its shareholders) to ensure the attainment of the firm’s regulatory objectives. Consistent with the concept of heightened regulatory duties for directors and officers, the Treasury Department’s Financial Crimes Enforcement Network recently sued the former chief compliance officer of MoneyGram International for failing to ensure the cash transfer firm’s compliance with anti-money laundering regulations. The lawsuit seeks the imposition of a lifetime ban from employment in the industry and a $1 million personal penalty.

During 2014, U.S. banking regulators issued regulations and guidelines to strengthen the risk governance and
risk management practices of large financial institutions. As part of the “enhanced prudential standards” regime under the Dodd-Frank Act, the agencies have required banks to establish and implement a written risk governance framework that manages and controls risk-taking activities and provides minimum standards for board and risk committee oversight of the risk governance framework. These regulations and guidelines address:

- how risk governance should be structured within the institution;
- the role and reporting responsibilities of its internal control functions, including the independent risk management function, to the CEO, the board and the risk committee of the board;
- the board and risk committee’s responsibility to establish written policies governing the risk appetite of the institution and oversight of its risk culture; and
- the board’s responsibility with respect to ensuring that compensation programs incorporate the risk tolerances and encourage prudent risk-taking behaviors.

Separately, the Basel Committee of international banking supervisors and central banks (which includes senior officials of the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency) have issued for comment revised corporate governance guidelines for risk governance and supervisory oversight of banks in nearly 30 of the world’s largest economies. These guidelines address the role, responsibilities and governance structures of the board of directors of financial institutions within those jurisdictions, including the tone at the top regarding risk culture, the communication to employees of the firm’s risk appetite and appropriate risk-taking behaviors, the governance and reporting of risk management, compliance and internal controls functions, and the importance of properly structured compensation programs.

For additional information, please see Sidley Update “International Banking Regulators Propose Revised Corporate Governance Principles: Reinforce Board Responsibilities for Risk Oversight and Governance Culture” on November 17, 2014 at http://www.sidley.com/11-17-14-Banking-and-Financial-Services-Update/.

B. Enforcement

Section 16 Reporting Enforcement Action

On September 10, 2014, the SEC announced enforcement actions against 34 defendants for claimed violations related to requirements to report transactions in company equity securities under Section 16(a) of the Securities Exchange Act. The defendants included 13 persons who were or had been officers or directors of public companies, five individual investors, 10 investment funds/advisers and six public companies. These enforcement actions were unprecedented: the SEC had never previously targeted that many defendants at once for violations of the Section 16(a).

Although Section 16(a) reporting obligations are personal to the officer, director or 10 percent holder that is subject to Section 16, six of these actions were brought against public companies. Those six enforcement actions were predicated on one or both of two theories: (1) the companies had not included in their proxy statements the disclosure required by Item 405 regarding untimely Section 16(a) filings by a company’s officers, directors and 10 percent holders; and (2) the companies had caused the underlying violations by the officers/directors by assuming the obligation to assist their insiders in their filings but failing to do so properly. All companies paid fines of either $75,000 or $150,000. Several individual officers/directors who were charged raised as a defense that the companies where they worked or served as a director had undertaken to assist them with their filings but had not done so properly. That defense was not recognized as valid. The SEC noted that the filing obligations are personal to the insider. Despite the unprecedented nature of these actions, it seems unlikely that the SEC has
abandoned its traditional practice of not bringing enforcement actions for reporting violations that are inadvertent and isolated. In the six enforcement actions, each defendant had a large number of violations, sometimes numbering in the dozens. For a more detailed discussion please see, “SEC Enforcement Actions Regarding Section 16 Reporting Obligations” published on October 3, 2014 at http://www.sidley.com/10-03-14-Corporate-Governance-Update/.

Whistleblower Activity and Awards

In 2011, the SEC created the whistleblower program under the Dodd-Frank Act. That program rewards high-quality original information that results in an SEC enforcement action with sanctions exceeding $1 million. Awards can range from 10 percent to 30 percent of the money collected in a case.

The SEC’s first payment to a whistleblower was made in August 2012 and totaled approximately $50,000. In August and September 2013, more than $25,000 was awarded to three whistleblowers who helped the SEC and the Department of Justice halt a sham hedge fund. The ultimate total payout in that case is likely to exceed $125,000.

On September 22, 2014 the SEC announced it had awarded over $30 million to a whistleblower, more than twice the size of the largest award previously announced. Only one year earlier, on October 1, 2013, the SEC announced that it awarded more than $14 million to a whistleblower, its largest award at that time under the program.

Few details about the underlying case are known, other than that the whistleblower was located overseas. In the SEC’s press release relating to the case, the Director of the SEC’s Division of Enforcement is quoted as saying that the “whistleblower came to us with information about an ongoing fraud that would have been very difficult to detect.” The press release also indicated that, as of the release date, the SEC had provided awards to nine whistleblowers in its 2014 fiscal year.

In December 2014, a federal district judge approved a whistleblower award of $56 million for a former Bank of America executive who alerted federal prosecutors to mortgage fraud at Countrywide Financial Corp.

VIII. Restoring Trust

Corporations create wealth for shareholders. The ability of a corporation to return long term shareholder value is a key metric for assessing whether the corporation is effective and efficient in its activities. However corporate contributions to our economic and societal well-being extend well beyond shareholder return. By spreading investment risk, corporations facilitate the funding of large-scale entrepreneurial activities that enhance the qualities of our lives. They deploy assets and support innovation to produce needed goods and services; they provide employment and associated insurance and retirement benefits, pay taxes and support various social and charitable programs.

As recognized by The Conference Board’s Task Force on Corporate and Investor Engagement—and many others—over the long-term, creation of sustainable shareholder value requires significant focus on the interests of—employees, creditors, suppliers, customers, communities and the environment in which the company operates (available at http://tcbblogs.org/governance/2014/08/07/wealth-transfer-versus-wealth-creation/#more-3496).

Shareholders, boards and management have a common long-term interest in promoting both shareholder value and the societal trust in corporations that is essential to ensuring that regulation does not stifle innovation and robust entrepreneurial activity. They also have a common interest in maintaining the governance balance that is essential to corporate success.
AN EXAMPLE OF A COMMUNICATION DESIGNED TO ADDRESS CONCERNS AND TO REBUILD TRUST

In December 2014, JP Morgan issued a report titled “How We Do Business” that is well worth reading. The report addresses the steps the firm has taken to strengthen its corporate culture in response to acknowledged operational missteps. It includes discussion of the firm’s ethical values and business principles, and how its leadership and governance structure and its employment policies (including compensation practices) align with these values and principles. It also discusses the firm’s renewed focus on the control environment, its commitment to customers and to transparency and responsive with regulators, and its focus on engagement and communication with shareholders (including through the shareholder-director exchange established earlier in the year). While it does not attempt to provide root cause analysis, and is not the result of an independent survey with recommendations for improvement (like the Goldman Sachs report of 2011), JP Morgan’s “How We Do Business” is an important example of an effort by a leading company to rebuild trust with key constituencies.

If you have any questions regarding this update, please contact the following Sidley lawyers or the lawyer with whom you usually work.

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