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# An Analysis of Nasdaq's "Golden Leash" Disclosure Rule

**July 2016**

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On July 1, 2016, the Securities and Exchange Commission (SEC) approved, on an accelerated basis, Nasdaq's new Rule 5250(b)(3), which requires Nasdaq-listed U.S. companies to publicly disclose any arrangements or agreements relating to compensation provided by a third party to the company's directors or director nominees in connection with their candidacy or board service. Because some of these so-called "golden leash" arrangements involve the compensation of a director by a shareholder or shareholder group based on the achievement of certain corporate metrics or stock performance criteria, Nasdaq's new rule is intended to alleviate concerns that such arrangements could lead to conflicts of interest, call into question a director's ability to satisfy his or her fiduciary duties, and promote a focus on short-term results at the expense of long-term value creation.

The new rule will become effective on July 31, 2016, and initial disclosure pursuant to the new rule must be made either on the company's website (or through a hyperlink to another, "continuously-accessible", website) or in its proxy or information statement no later than the date on which the company files or furnishes a proxy or information statement in connection with its next shareholders' meeting at which directors are elected (or, if it does not file proxy or information statements, no later than when the company files its next annual report on Form 10-K or Form 20-F). Thereafter, a listed company must make the required disclosure at least annually, until the earlier of the resignation of the director or one year following the termination of the compensation agreement or arrangement. Listed companies are not required to disclose new agreements or arrangements at the time they are entered into, so long as disclosure is made pursuant to the rule for the next shareholders' meeting at which directors are elected.

In approving the new rule, the SEC explicitly acknowledged that it overlaps significantly with existing disclosure requirements applicable to U.S. domestic issuers. Accordingly, except with respect to foreign private issuers (FPI), there are only limited circumstances where the rule applies and where there would otherwise be no already-existing disclosure obligation. One context likely to trigger additional disclosure obligations is payments to a director or director nominee by a third party during the year of a shareholder meeting (rather than during the previous year) in an uncontested election. There is also the possibility that certain golden leash arrangements that are intentionally structured to fall outside the purview of existing disclosure rules will now be captured under the new rule. For example, if a golden leash arrangement provides that the majority of the relevant compensation will be paid to a director upon the achievement of certain company stock benchmarks, rather than specifically for his or her service as a director, Item 402(k) of Regulation S-K would not necessarily capture such payment as compensation paid for "services rendered… to the registrant." In contrast, the new rule requires the disclosure of all material terms of such an incentive payment. In addition, the new rule requires annual disclosure of these arrangements, so even if an arrangement is structured such that compensation is not paid in any given year, the existence of the arrangement and its material terms would still be required to be disclosed under the new rule, whereas Item 402(k), which only addresses compensation paid during the last completed fiscal year, would not require such disclosure. The broader scope and the annual disclosure requirement of the new rule could lead to increased shareholder awareness of, and focus on, golden leash arrangements. In addition, the specificity of the rule will likely focus companies' attention on disclosure of such compensation to directors and nominees pursuant to existing rules.

## Issuers Subject to the New Rule

The new disclosure requirement applies to each Nasdaq-listed company, except that FPIs are permitted to follow home country practice in lieu of the requirements of the rule, as long as such FPI:[1]

(i) submits a written statement from an independent counsel in its home country certifying that the company's practices are not prohibited by the home country's laws, and

(ii) discloses in its annual filings with the SEC (e.g., on Form 20-F or Form 40-F) (or, in certain circumstances, on its website) that it does not follow the rule's requirements and briefly describes the home country practice it follows in lieu of these requirements.

Since FPIs do not file proxy or information statements, as a practical matter, compliance would be required on or before the date that the FPI files its next Form 20-F or Form 40-F.

## Scope of Required Disclosure and Certain Situations for Which Disclosure is Not Required

The new rule requires each listed company to disclose the parties to and "the <u>material terms</u> of all agreements and arrangements between any director or nominee and any person or entity other than the company . . . relating to compensation or other payment in connection with that person's candidacy or service as a director." The rule is intended to be construed broadly and the disclosure requirement encompasses non-cash compensation and other forms of payment obligations, such as health insurance premiums or indemnification arrangements.

However, disclosure is <u>not</u> required for any of the following arrangements or agreements:

- *Reimbursement of expenses* – Arrangements that relate only to the reimbursement of expenses incurred in connection with candidacy as a director (regardless of whether such reimbursement arrangement has been publicly disclosed);
- *Pre-existing relationships* – Arrangements that existed prior to the nominee's candidacy (including as a result of an employment relationship) where the nominee's relationship with the third party has been publicly disclosed in a proxy or information statement or annual report (such as in the director or nominee's biography), provided that, if the nominee's compensation is materially increased in connection with their candidacy or service, the amount of such increase would be required to be disclosed under the rule; or
- *Previously disclosed arrangements* – Arrangements that have otherwise been disclosed under Item 5(b) of Schedule 14A of the Securities and Exchange Act of 1934, as amended, or Item 5.02(d)(2) of Form 8-K, in the current fiscal year. However, the company still has an obligation under Nasdaq's rule to provide disclosure on an annual basis in future years.

## Implications in the Proxy Access Context

Given the growth in proxy access activism with respect to U.S. domestic companies, possible golden leash arrangements between shareholders and nominees or directors may be of particular importance to

[1] Rule 5615(a)(3) requires that an FPI that elects to follow home country practice must comply with the Notification of Noncompliance requirement (Rule 5625), the Voting Rights requirement (Rule 5640), have an audit committee that satisfies Rule 5605(c)(3), and ensure that such audit committee's members meet the independence requirement in Rule 5605(c)(2)(A)(ii).

companies. Proxy access is the right of shareholders to include one or more director nominees in the company's proxy materials rather than having to solicit proxies pursuant to a separate proxy statement. A company that has adopted a "proxy access" bylaw allowing eligible shareholders to place their own director nominees on the company's proxy card should note that information provided by the nominating shareholder (or shareholder group) on Schedule 14N is not specifically exempted from the rule's requirements in the same manner as disclosures on Schedule 14A. Even if this information is made public through the Schedule 14N filing, the company is still obligated to disclose any relevant third-party compensation arrangements or agreements. In practice, however, this should not present a significant reporting burden for companies, as most proxy access bylaws require a proxy access nominee to provide comprehensive information (such as through an appropriate inquiry in a director and officer (D&O) questionnaire) that would capture any relevant compensation agreements with a third party required to be disclosed.

## Safe Harbor Provisions for Arrangements that "Should Have Been" Disclosed and Remediating a Deficiency

The new rule contains a "safe harbor" which provides that a company which fails to disclose an agreement or arrangement under the rule will not be considered deficient in its disclosure obligations if it has:

(i) undertaken reasonable efforts to identify all covered compensation agreements and arrangements in a timely manner (such as through an appropriate inquiry in a D&O questionnaire), and

(ii) promptly disclosed any newly-uncovered agreements or arrangements by filing a Form 8-K or Form 6-K, where required, or by issuing a press release.

Remedial disclosures through the company's website do not appear to be permitted. Further, any remedial disclosures, regardless of their timing, do not satisfy ongoing annual disclosure requirements under the rule.

If a company is determined to be deficient under the new rule, it must submit a plan to the Nasdaq staff within 45 calendar days that demonstrates that it has adopted processes and procedures designed to identify and disclose relevant agreements and arrangements in the future. If a company does not submit a plan to regain compliance, it will be issued a Staff Delisting Determination, which the company could appeal to a Hearings Panel.

## Interaction with Existing Rules

Critics of the new rule noted that its requirements overlap considerably with existing SEC requirements. These include the following:

| Provision | Requirement | Difference |
|---|---|---|
| Item 402(k) of Regulation S-K | A company is required to disclose "all plan and non-plan compensation awarded to, earned by, or paid to …. directors… by any person for all services rendered in all capacities to the registrant and its subsidiaries...". | Does not cover director nominees.<br><br>Only covers payments in, or in respect of, the previous completed fiscal year.<br><br>Arrangements could be structured to avoid disclosure of certain payments under 402(k) if the compensation is not paid for "services rendered…to the registrant" but is tied to other criteria, such as company stock performance. |

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| Item 404(a) of Regulation S-K | A company is required to disclose transactions between any director or director nominee, on the one hand, and a greater than 5% shareholder, on the other hand, if the dollar amount exceeds $120,000. | Only applies to payments from greater than 5% shareholders.<br><br>Only applies to payments above $120,000. |
| Item 401(a) of Regulation S-K | A company (or soliciting shareholder in a proxy contest) is required to disclose and "briefly describe" any "arrangement or understanding" between a director or nominee and any person "pursuant to which he was or is to be selected as a director or nominee." | Instruction to 401(a) specifically excludes "arrangements or understandings with directors or officers of the registrant acting solely in their capacities as such" (i.e., director fees) from these disclosure requirements.<br><br>The new rule's scope goes beyond a "brief description" and requires disclosure of all material terms of the relevant arrangement. |
| Item 5.02 of Form 8-K | A company is required to disclose, within four business days of the triggering event, any arrangement or understanding between the new director and any other persons pursuant to which the director was selected as a director, as well as any material arrangements, grants or awards in connection with the election. | The filing obligation arises only in the case of a director who is appointed and not one who is elected by shareholders. |
| Item 5(a) of Schedule 14A | In the event of a proxy contest, a company is required to disclose any interest that directors and director nominees have in the matter to be acted on. | The broad wording of this provision makes it unclear whether disclosure regarding compensation would be required and, if so, what level of detail is necessary. |
| Item 5(b) of Schedule 14A | In the event of a proxy contest, a person soliciting in opposition to a company is required to disclose any direct or indirect substantial interest that a director or director nominee has in the matter to be acted on. | The requirement is limited to proxy contests. |
| Item 5(g) of Schedule 14N | If a shareholder or shareholder group is nominating a director under a company's proxy access bylaw, the shareholder/ shareholder group is required to disclose information regarding the nature and extent of the relationships between the nominating shareholder(s) and the nominee, including any "direct or indirect material interest in any contract or agreement" between the nominating shareholder(s) and the nominee and any other "material relationship." | The requirement is limited to shareholder nominations of director candidates under a company's proxy access bylaws.<br><br>This is a shareholder disclosure that is distinct from the company's proxy statement. |

## Practical Implications

In light of the new rule, and with respect to corporate governance best practices generally, companies should consider the following:

- *Location of disclosures* – To the extent new disclosure is required, we expect most companies will augment existing disclosures in their proxy statements, rather than including such additional information, if any, on their websites. FPIs subject to the new rules are expected to see a more significant impact on their existing disclosures, as FPIs are not subject to the nuanced director compensation disclosure regime applicable to domestic issuers. The extent of the required revisions will vary depending on the disclosure approach currently followed by the FPI (since those approaches vary depending on the home country disclosure requirements).

- *Review and Update of D&O Questionnaires* – Most public companies seek information from their directors and nominees relating to third-party compensation arrangements through their annual D&O questionnaires (and some explicitly prohibit such arrangements in their bylaws). To ensure compliance with the rule (and to enable a company to avail itself of the safe harbor provisions), all companies should review their D&O questionnaires to ensure they adequately capture any golden leash arrangements disclosable under the new rules. As a matter of best practice, NYSE-listed companies should consider a similar review to ensure that the board of directors has complete information with respect to directors and director nominees.

- *Disclosure by Non-Nasdaq Companies* – The NYSE has not indicated a current intention to adopt a similar rule, despite its 2013 commentary to the compensation committee member independence rules indicating that boards of listed companies should consider compensation from any person or entity that would impair such director's ability to make independent judgments about the listed company's executive compensation. Therefore, some concern has been expressed regarding the fact that investors in NYSE-listed companies may now receive different disclosure than investors in Nasdaq-listed companies. However, given the seemingly minimal impact the rule will have on most domestic issuers' disclosures, the disparity is unlikely to be significant. In addition, we expect that some NYSE-listed companies may choose to begin voluntarily including additional disclosures regarding compensation provided by third parties to the company's directors or nominees, to the extent such arrangements are not already disclosed under existing rules.

- *Review of Bylaws* – Companies may need to assess the adequacy of their advance notice bylaw provisions. At a minimum, such bylaws advance the date by which a shareholder proponent is required to submit to the board any proposals for consideration at the meeting and specify the required content for the notice, including basic information about the shareholder and, if applicable, its nominees (including with respect to any special compensation arrangements). At the extreme, such provisions can seek to disqualify any nominee who received any third-party compensation in connection with such nominee's candidacy or service (other than indemnification or reimbursement of expenses). Both Institutional Shareholder Services Inc. (ISS) and Glass Lewis view an outright prohibition on board service resulting from the existence of a third-party compensation arrangement to be an infringement of shareholders' fundamental right to vote for an otherwise qualified director. Similarly, the Council of Institutional Investors, while strongly in favor of disclosure (in 2014 it urged the SEC to consider issuing interpretive guidance or amendments to the U.S. proxy rules to require detailed disclosure of golden leash arrangements in the context of a proxy contest), opposes proxy access restrictions based on compensation arrangements with third parties. In fact, as of January 15, 2016, only three issuers retained outright disqualification provisions in their bylaws.[2] Nevertheless, according to one study, as of October 2015, among more than 4,000 companies tracked by FactSet, approximately 380 had adopted some form of restriction, most often in the form of an advance notice bylaw provision mandating disclosure of any third party compensation arrangement, and 44 of the S&P 500 companies were identified as having a bylaw provision prohibiting a director from receiving undisclosed compensation from a third party in connection with the director's

[2] Cain, Matthew D.; Fisch, Jill E.; Griffith, Sean J.; and Davidoff Solomon, Steven, "How Corporate Governance Is Made: The Case of the Golden Leash" (2016). *Faculty Scholarship.* Paper 1571. http://scholarship.law.upenn.edu/faculty_scholarship/1571

candidacy or board service.[3] These provisions are highly controversial because they can have a chilling effect on the nomination of directors who are affiliated with the proposing shareholder, as they may require the disclosure of private financial information (e.g., full salary information, etc.) that an independent nominee would not have to disclose (e.g., only disclosure of a specific relevant payment would be required). Therefore, in light of continued shareholder activism, it is important for companies to revisit existing bylaw provisions to ensure that advance notice provisions elicit the required information and reflect an appropriate approach to third party compensation for directors.

The proxy access movement continues to have momentum. According to ISS, approximately 36% of companies in the S&P 500 have adopted proxy access, and the trend is growing. As a result, questions regarding director qualifications and eligibility will likely continue to be an area of focus for regulators and institutional investor groups. Nasdaq is currently considering whether to propose additional requirements relating to directors and nominees that receive third-party payments, including whether such directors should be prohibited from being considered independent under Nasdaq rules or serving on the board altogether. It remains to be seen whether the SEC, NYSE or Nasdaq will engage in further rulemaking in this area.

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[3] Schloetzer, Jason D., “Activist Hedge Funds, Golden Leash Special Compensation Arrangements, and Advance Notice Bylaws” (2015). *The Conference Board. Available at* https://corpgov.law.harvard.edu/2016/01/07/activist-hedge-funds-golden-leashes-and-advance-notice-bylaws/