The Advocate
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FOR INSTITUTIONAL INVESTORS

Labor’s Capital
How Institutional Investors are the Last Line of Defense Against Fraud
A Conversation with Boston University Professor David Webber

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Going Green
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This edition of The Advocate for Institutional Investors marks the 20th anniversary of our publication. The Advocate has provided continuous, timely, and educational updates on issues of concern to the institutional investor community and to our investor and fiduciary clients. While the specific issues affecting investors have evolved, our mission has remained the same: to shed light on the perpetual struggle between the business lobby and shareholder advocates to obtain transparency, accountability, and profitability.

Our interview in this issue with Professor David Webber of Boston University School of Law captures one of The Advocate’s dominant themes — the essential role of institutional investor activism in policing misconduct and increasing transparency in the capital markets — while noting ever-increasing efforts to stifle investors’ voices.

The reporting in this issue similarly addresses this continuing struggle. For example, we discuss the nuances of corporate America’s attempts to force investors out of court and into arbitration; we probe the dramatic disconnect between CEO pay and performance; and we consider the future of environmental, social, and governance investing as regulators and legislators seek to limit it. Additionally, we address recent legislation in the Netherlands that allows litigants to band together in a class action to seek monetary damages. As always, we have highlighted additional recent legal, market, and regulatory developments affecting the institutional investor community.

We are also excited to announce the opening of BLB&G’s office in Wilmington, Delaware. Greg Varallo, a renowned litigator and nationally recognized corporate governance expert, will lead the office. Details are available on page 34.

We hope you enjoy this edition of The Advocate. Current and past issues of The Advocate are available on our website at www.blbglaw.com. We have been honored to serve you for the past 20 years, and here’s to 20 more!

The Editors – Julia Tebor and Kate Aufses
Standing Together

“Labor’s Capital” at Work: How Pension Funds are the Last Line of Defense Against Fraud

By Julia Tebor and Kate Aufses

David H. Webber is a Professor of Law and the Associate Dean for Intellectual Life at Boston University School of Law. The winner of Boston University School of Law’s 2017 Michael Melton Award for Teaching Excellence, Professor Webber also co-teaches the Pensions and Capital Stewardship course for the Harvard Trade Union program at Harvard Law School. He is a graduate of Columbia University and NYU Law School.

A singular voice for the critical role that pension funds have played as stewards of the financial markets over the last two decades, Professor Webber has published op-eds in several major news sources, including The New York Times, the Washington Post, the Chicago Tribune, and The Los Angeles Times on the topic of shareholder activism and litigation. He also co-edited the “Research Handbook on Representative Shareholder Litigation” (Elgar), and has published scholarly articles, including “The Use and Abuse of Labor’s Capital” in the New York University Law Review and “The Plight of the Individual Investor in Securities Class Actions” in the Northwestern University Law Review.

Professor Webber’s most recent book, “The Rise of the Working-Class Shareholder: Labor’s Last Best Weapon,” was published in 2018 by Harvard University Press and has been reviewed or otherwise covered in The New York Review of Books, the Financial Times, Publisher’s Weekly, Bloomberg Radio, CSPAN’s BookTV, Forbes, the Harvard Law School Forum on Corporate Governance and Financial Regulation, and numerous other outlets.

Professor Webber sat down with our editors, Julia Tebor and Kate Aufses, to discuss institutional investors’ impact on shareholder activism.
The main thing I worry about is “pension reform.”

There is a concerted, nationwide, extremely well-funded effort to take big public pension plans, which is where most of the assets are, and “smash and scatter” them into millions of individually managed 401(k)s which then get farmed out to the usual mutual funds. If that happens, I think a lot of the activism goes away and that void will not be filled by the mutual funds.

Welcome Professor, we are very excited to have this discussion — thank you so much for making the time to join us. You have written extensively about the value of shareholder activism and, in particular, how public pension funds can use the Delaware corporate law and the federal securities laws to push back against abuses by corporate managers and insiders. Your book argues that these institutional shareholders are now effectively the last free market answer to combating corporate fraud. Can you explain for our readers some of the key themes in your writing?

I’d be happy to. These ideas first started crystallizing for me when I was in private practice and I saw how public pension funds and labor union funds were playing this key role in shareholder litigation. They were taking lead plaintiff positions in securities fraud class actions and M&A class actions, and these actions were becoming more effective, and having positive impacts on the marketplace. Subsequently, in my academic career, I started to attend meetings of pension trustees and learning about all the other forms of shareholder activism that they were engaged in, including shareholder voting and proposal initiatives, and directly lobbying on significant issues in Washington. I saw that these pension funds were doing a terrific job as market monitors — that they were active stewards of the assets that they had under management. For example, when you look at the remarkable transformation in shareholder voting that has occurred in the last 7-8 years, the lobbying that’s gone on in Washington to get favorable outcomes for investors, much of it has been due to this institutional shareholder activism. Dodd-Frank getting private equity funds to register for the first time, shedding light on the CEO-to-worker pay ratio, pushing back on excessive CEO pay and executive compensation — so much of what has occurred in the corporate governance movement — this push for more accountability comes from these same pension funds, from public pension funds and from labor union funds. I really was just so interested in the role that these entities were playing — in this kind of fascinating idea of “labor’s capital.” Labor’s capital behaves like ordinary capital generally, but it’s actually looking out for the interests of workers in a way that much of the rest of financial markets or corporations are not. And furthermore, I’ve become thoroughly convinced that this activism by public pension funds and labor funds is not just good for the participants and beneficiaries in these plans, it’s actually good for the rest of us.

You have written about the backlash against pension funds. Could you talk about what that backlash has been and what you propose as a response?

Well, there are various forms of a backlash. Some of it is just an attack on investor rights such as mandatory arbitration provisions potentially being approved by the SEC, and other efforts, which to date have been unsuccessful, making it harder to file shareholder proposals. There is some more conservative shareholder activism that is being designed to thwart this type of activism, but the main thing that I am really worried about most is “pension reform.” Pension reform is not something that ordinarily gets thought of in
this sort of “corporate investor rights” space, but those of us who focus in this space need to pay very close attention to what is going on with this seemingly unrelated but, in fact, quite closely related issue. As I document at length in my book “The Rise of the Working-Class Shareholder,” there is a concerted, nationwide, extremely well-funded effort to take these big public pension plans — which is where most of the assets are — and convert them from collective traditional defined benefit pension plans into individually managed 401(k)s. And if that happens, I fear that much of the activism, the capacity for activism that I describe in the book, will simply go away. The necessary precondition for this activism — the proxy access fight or to push for majority voting or to push for de-staggering of corporate boards or even to bring, in some senses, credible shareholder litigation — is to have large pools of separately managed capital. For example, you have New York City Pension Funds, California Public Employees Retirement System, or the California State Teachers’ Retirement System or even smaller pension funds. They need not be quite as big as those, but the key is they are sizable separately managed pools of capital. And so they can bring shareholder proposals and they can exercise some real muscle — they can truly provide some shareholder voice. The problem with these pension reform proposals is that they aim to take these pensions and “smash and scatter” them into millions of individually managed 401(k)s which then get farmed out to the usual mutual funds. If that happens, I think a lot of the activism goes away and that void will not be filled by the mutual funds.

Is it fair to say that pension fund activism has encouraged or influenced other types of funds into demonstrating some more pro-investor behavior?

I think so. One of the big developments of the last couple of years is that two years ago Vanguard and BlackRock actually voted in favor of environmental shareholder proposals that were put out by New York City and others, at some of the energy companies. So that’s a nice position for BlackRock to
When I think of key achievements, I would start with shareholder voting, which has been almost entirely transformed by these pension funds. The three key aspects that have seen great change fostered by the efforts of these activist funds are proxy access, majority voting, and de-staggering of corporate boards.

Could you talk about some of the signature activist achievements of public pension funds and other institutions? What do you see as the biggest achievements and why do some want this activism to go away?

Shareholder voting has been almost entirely transformed by these pension funds. The three key aspects of shareholder voting that have seen great change fostered by the efforts of these activist funds are: proxy access, majority voting, and de-staggering of corporate boards. Shareholders have been fighting for proxy access since the 1940s at least. Basically, you are allowed to nominate candidates to run for the board. But the problem historically has been that while you can nominate the candidates, you can’t get the companies to list those candidates on the proxy. You have to circulate your own proxy and your own proxy cards and send those out to investors with the names of your nominees. This is enormously expensive and time consuming to do. And that is why historically the only people that ever did that were hedge funds. Hedge funds would run a proxy fight and spend millions of dollars to put up their own proxies and circulate them to investors to challenge a corporate board. But for all the big diversified investors, such as a big public pension fund, historically it made no sense to do that because as a diversified investor, you own a small percentage of a broad range of different companies. For you to spend millions of dollars to have a proxy fight with one company is economically irrational. As a fiduciary, it makes no sense to spend millions of dollars to do something like that. So the bottom line is, because there was no proxy access, nobody would exercise those rights — which is exactly how corporate management has always liked it. And so, in the Dodd-Frank Act, the Council of Institutional Investors and other entities that serve as lobbying arms for public pensions and labor funds pushed and got proxy access into Dodd-Frank. To make a very long story short, proxy access found its way in to Dodd-Frank through the efforts of activist institutions, the SEC made the rule, and the rule was struck down by the D.C. Circuit Court of Appeals. I tell that whole story in the book, too, for readers who might be interested. The bottom line is that it looked like proxy access was dead. But the story doesn’t end there. What followed is New York City, under the leadership of Scott Stringer, the
New York City Comptroller, picked up the baton and filed shareholder proposals with 75 companies just in the first year to get them to adopt proxy access which basically would say, if you own 3 percent of the company for three years, your nominee gets listed on the company’s proxy. It saves millions of dollars because the companies have to circulate those proxies anyway. And so, the bottom line is, in the first year only approximately five of the S&P 500 companies had proxy access, but because New York City and a couple of the pensions pushed for it, now hundreds of the S&P 500 companies have it. That transformation never would have happened without public pension funds picking up and running with proxy access.

Same thing with majority voting. It used to be just plurality voting. Apple famously had a policy that said that if an incumbent director or a board nominee got one share voted in his or her favor, he or she would be seated at the board. And you could vote for yourself. That’s not real action; that’s a joke. The United Brotherhood of Carpenters Union filed 700 plus shareholder proposals with different companies to get them to adopt a majority voting rule, and those companies have, and now it’s spread like wildfire. So that empowers shareholders to run a withhold vote campaign, even when there is a competing candidate. If you can stop a director you don’t like from hitting the 50 percent threshold, you can unseat them.

The third prong here is the de-staggering of corporate boards which was pushed by a bunch of public pension funds through the shareholder rights project. So now instead of one-third of the board being up every election cycle, the whole board is up every election cycle at many of these companies. The point is that you add these reforms together — proxy access, majority voting and de-staggering of corporate boards — and what you have are boards that are now much less insulated from, and much more accountable to, shareholders. That never would have happened without these pension funds.

The last thing is just the lobbying piece — getting “say on pay” in Dodd-Frank, getting the SEC to issue the CEO-worker pay ratio guidance, which finally happened last year. Those are some additional achievements by these funds.

JT What are your concerns about the state of the federal securities laws and the trends you are seeing specifically under the Trump administration? What setbacks are you seeing and what are your hopes in terms of coming back from those setbacks? What key issues should the institutional investor community be focused on?

DW Before the Democrats took the House, there was some very dangerous legislation afoot in the form of the Financial Choice Act, which would have raised the shareholder proposal threshold to 1 percent. Today, in order to make a shareholder proposal at a public company, you have to own $2,000 in stock. If they had raised the threshold to 1 percent, then for Amazon, a trillion-dollar company, you’d have to have a $10 billion investment in the company to make a shareholder proposal. This would have killed off as a practical matter a lot of shareholder proposals. Fortunately, that did not get adopted. The SEC is looking

Continued on page 29.
Recent research suggests that the explosion in executive pay over the last few decades has had little to do with improved shareholder outcomes.

The job of corporate executives is to deliver value for shareholders. Well-designed, transparent compensation schemes — implemented by strong company boards that truly represent shareholders’ interests — should incentivize a company’s leadership to do just that. If executive compensation worked as it should, one might think that skyrocketing executive compensation in recent years indicates that management is delivering on its obligations to shareholders to an unprecedented degree. But recent research, news, and legislative developments underscore that executives and directors often create compensation arrangements that not only fail to promote shareholder value, but in fact undermine it — enriching management while adding little to no value, and even permitting or encouraging fraud.

High-level executive pay has increased dramatically in recent years. Indeed, an analysis by the corporate research firm Equilar shows that, in 2018, median pay among the 200 highest-paid executives in the US grew to $18.6 million, a 6.3 percent increase from the year prior — nearly double the growth of average workers’ wages. Looking back further, a recent analysis by the Economic Policy Institute found that the average CEO’s pay grew by over 1,000 percent from 1978 to 2017 — almost twice the growth of the stock market over that period. Concerns about extraordinary CEO pay, particularly relative to workers’ pay, have grown apace. In a recent, high-profile example, Abigail Disney — great-niece of Walt Disney — made headlines when she strongly criticized the compensation received by Bob Iger, the CEO of Walt Disney. Iger received
A recent analysis by the Economic Policy Institute found that the average CEO’s pay grew by over 1,000 percent from 1978 to 2017—almost twice the growth of the stock market over that period. Concerns about extraordinary CEO pay, particularly relative to workers’ pay, have grown apace. Almost $66 million in 2018 alone, more than 1,000 times the median Walt Disney employee. The company defended Iger’s pay, claiming that he “delivered exceptional value for shareholders.”

But several pieces of recent research suggest that the explosion in executive pay over the last few decades has scarcely improved shareholder outcomes. An analysis by The Wall Street Journal revealed a severe disconnect between CEO pay and performance: in 2018, median CEO compensation for leaders of S&P 500 companies grew 6.6 percent from the prior year, even as the median S&P 500 company returned negative 5.8 percent for investors. That analysis further showed that the median CEO compensation for the best-performing 20 percent of S&P 500 companies was $14 million — barely more than the $12.6 million median CEO pay at the worst-performing 10 percent of companies. Similarly, investment research firm MSCI Inc. divided more than 400 large companies into quintiles based on CEO pay, and found that, over a ten-year period, the ones that paid their CEOs the least generated over 60 percent larger returns for shareholders than the ones that paid their CEOs the most. Consistent with these findings, the Economic Policy Institute anecdotally observed that CEO pay often increased for reasons clearly unrelated to performance, such as when increases in world oil prices caused oil company CEOs’ compensation to spike. The Economic Policy Institute also reviewed research showing that nearly half of unanticipated CEO deaths are associated with a stock price increase. This result is inconsistent with the idea that CEOs are extraordinarily talented individuals who are essential to the success of their companies, a common justification for executives’ exorbitant pay.

One cause for the disconnect between CEO pay and performance may be a lack of transparency in performance metrics. Recent research from Robert Pozen and S.P. Kothari of MIT and Nicholas Guest of Cornell University analyzed S&P 500 firms that report high non-GAAP (Generally Accepted Accounting Principles) earnings relative to GAAP earnings (in other words, companies whose financial reporting includes bespoke, non-standardized measures that generally make the company look much better than standardized metrics do). They found that companies using non-GAAP metrics also tend to pay CEOs excessively—to the tune of approximately 16 percent extra—even though their present and future performance and stock returns tend to be relatively poor. Reacting in part to this research, Pozen and SEC Commissioner Robert Jackson wrote in an op-ed in The Wall Street Journal that “[t]he SEC’s disclosure rules have not kept pace with changes in compensation practices, so investors cannot easily distinguish between high pay based on good performance and bloated pay justified by accounting gimmicks,” and they called on the SEC “to require companies to explain why non-GAAP measures are driving compensation decisions—and quantify any differences between adjusted criteria and GAAP,” noting: “A few public companies already provide investors with this kind of transparency. Others can too.”
Of course, rules mandating transparency are also an important safeguard against overt fraud, as the recent scandal concerning former Nissan chairman Carlos Ghosn underscores. Ghosn allegedly hid tens of millions of dollars in compensation from the public, in part due to vagueness in Japanese disclosure rules. Even in the US, which has stricter rules than Japan and many other countries, important transparency loopholes exist that need to be closed with thoughtful regulation.

The rules around insider trading serve as a useful example. The securities laws make trading on non-public information illegal, but corporate executives — who naturally possess inside information — sometimes need to trade stock for legitimate reasons, such as to pay taxes or diversify investments. To help executives avoid accusations of inappropriate insider trading, SEC Rule 10b5-1 allows them to schedule stock sales in advance pursuant to a “10b5-1 plan.”

In theory, because such sales would be automatic and nondiscretionary, they should not reflect inside information that the executive has learned after the date the plan was made, and therefore should provide some assurance that the sales are above board. In reality, however, numerous holes in the rules governing 10b5-1 plans likely render them far less effective at preventing fraud. For example, because no rules either specify how far in advance a 10b5-1 plan must be established before trading under that plan can begin, or prevent cancellation of plans, executives can legally enter into such plans mere days before starting to trade, or cancel planned sales on short notice. Similarly, executives are not required to disclose many relevant details about their 10b5-1 plans, including their existence or termination, their specific provisions, or the changes made to them.

These weaknesses undermine the spirit of the 10b5-1 planning process, and may explain how executives have been able to adhere to the letter of the rules while still appearing to trade opportunistically. For example, research from the University of Colorado at Boulder found that 46 percent of the early terminations of 10b5-1 plans calling for stock sales happened Investment research firm MSCI Inc. divided over 400 large companies into quintiles based on CEO pay, and found that, over a ten-year period, the ones that paid CEOs the least generated over 60 percent larger returns for shareholders than the ones that paid their CEOs the most.
The Shifting Meaning of “Fair Value”: The Delaware Supreme Court’s Reversal of Aruba Clarifies Dell and DFC Global

By Christopher J. Orrico

On April 16, 2019, the Delaware Supreme Court issued a highly-anticipated decision in Verition Partners v. Aruba Networks, Inc. (“Aruba”). In Aruba, the Court held that, in connection with an appraisal action brought by certain Aruba Networks stockholders, the Delaware Court of Chancery erred by determining the company’s fair value using the 30-day average of Aruba Networks’ trading price prior to the announcement of a merger.

In February 2018, the Court of Chancery valued Aruba at $17.13 per share — approximately $7 below the deal price of $24.67. This case followed the Delaware Supreme Court’s decisions in DFC Global Corp. v. Muirfield Value Partners, LP and Dell v. Magnetar Global Event Driven Master Fund, which both strongly suggested that, absent a controlling stockholder transaction or fundamental shift in the market post-signing, investors pursuing appraisal rights must show that the sales process was tainted in order for the court to find that the “fair value” was above the deal price. The Court of Chancery in Aruba found that, because Aruba’s stock appeared to trade on an efficient market, Aruba’s unaffected market price prior to the merger ($17.13) was a sufficient proxy for fair value.

In April 2019, the Supreme Court rejected the Chancery Court’s reliance on Aruba’s 30-day average unaffected price because neither party argued for that valuation, which was not grounded in the trial record before the Court. The Supreme Court clarified that a trial court may not rely on presumptions or check-the-box approaches but must take a flexible approach to valuing a company, considering all relevant factors in the trial record, the principles of economic reality, and tenets of corporate finance.

The Supreme Court remanded Aruba back to the Court of Chancery to enter a final judgment of fair value of $19.10 — still lower than the deal price — reflecting the deal price minus the portion of synergies attributable to the merger. The Supreme Court explained that, for several reasons, the trial record — and economic reality and theory — supported its new valuation: Aruba’s buyer was uniquely positioned and incentivized to value the company properly; Aruba’s buyer possessed material nonpublic information about the seller; and because no deficiencies existed in the deal process, the negotiations were at arm’s length.

The Aruba decision will have lingering effects in appraisal litigation. Notably, this development could entice increasingly aggressive breaches of duty as selling companies argue that any arm’s length sales process with no obvious deficiencies supports a deal price-minus-synergies valuation. Institutional investors must, therefore, remain vigilant and exercise their appraisal rights where an uneven playing field, conflicts of interests, and/or signs of misconduct appear to exist.

Through thoughtful and strategic appraisal litigation, investors provide a critical check on corporate actors and deficient sales processes, ensuring the payment of fair value.

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KPMG-PCAOB “Steal the Exam” Scheme Results in Convictions and a $50 Million Settlement

By Brenna Nelinson

Previously, we reported on the increasingly common conflicts of interest between auditors and their clients. We also emphasized the important role of the Public Company Accounting Oversight Board (“PCAOB”) in overseeing auditors, noting that the recent KPMG “steal the exam” scandal cast doubt on the PCAOB’s reliability. Specifically, DOJ and SEC actions were ongoing in connection with claims that a former KPMG partner conspired with a former PCAOB employee to obtain advance information about the PCAOB’s audit of KPMG in order to game the inspection process. Once KPMG obtained advance information regarding which KPMG audits the PCAOB planned to inspect, it was able to correct or hide any problems with these audits so as to deceive the PCAOB and avoid penalties for poor quality audits.

On March 11, 2019, the US Attorney for the Southern District of New York announced convictions of both defendants on charges carrying a maximum sentence of 20 years in prison. Then, on June 17, 2019, the SEC announced a settlement with KPMG consisting of a $50 million fine — the largest ever imposed against an auditor in an SEC action — and the retention of an independent consultant to review and assess KPMG’s ethics and integrity controls. In a press release, Steven Peikin, co-director of the SEC’s Enforcement Division, commented that “[t]he breadth and seriousness of [KPMG’s] misconduct at issue here is, frankly, astonishing.” Stephanie Avakian, also co-director of the SEC’s Enforcement Division reiterated that “[t]his conduct was particularly troubling because of the unique position of trust that audit professionals hold. Investors and other market professionals rely on these gatekeepers to fulfill a critical role in our capital markets.” Indeed, KPMG’s role in the capital markets cannot be understated — it is one of four “Big Four” accounting firms that audit 98 percent of the companies in the S&P 500.

Sadly, investors must be wary when reviewing and considering audited financial statements as part of their decision to invest in publicly traded companies, as the quality of the audits may be lacking.

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US Courts Remain Open For Securities Fraud Suits Against Foreign Issuers of ADRs

By James Fee

On June 24, 2019, the Supreme Court declined the defendants’ request for the Court to hear an appeal in Stoyas v. Toshiba Corp. regarding the rights of investors to sue foreign issuers of American Depositary Receipts (“ADRs”) in the United States — i.e., certificates issued by a US depositary bank that represent shares of a foreign company’s stock (that itself trades on a foreign exchange). In Toshiba, defendants appealed from the Ninth Circuit Court of Appeals’s decision holding that plaintiff investors may sue a foreign issuer of ADRs under the Securities Exchange Act of 1934 (“Exchange Act”) even where the foreign issuer was uninvolved in the ADR transaction — also called an “unsponsored” ADR.

Toshiba follows the Supreme Court’s 2010 decision in Morrison v. National Australia Bank Ltd., which held that issuers may face liability under the Exchange Act only for “transactions in securities listed on domestic exchanges, and domestic transactions in other securities.” In Toshiba, the Ninth Circuit held that the foreign issuer’s involvement (or lack thereof) in the ADR transaction is irrelevant to the Morrison analysis. In other words, as the Ninth Circuit explained, the Exchange Act applies to “claims of manipulation of share value from afar.” Toshiba thus not only creates positive precedent for investors in unsponsored ADRs who wish to pursue securities fraud claims, but also for investors in sponsored ADRs — in which the foreign issuer has far more involvement.

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Protecting the Protectors: Attacks on the Constitutionality of the CFPB

By Ryan Dykhouse

Established in 2010, the Consumer Financial Protection Bureau (“CFPB”) has recovered billions of dollars for consumers. Yet, it has faced significant legal and political challenges, including President Trump appointing Mick Mulvaney as CFPB chief after Mulvaney openly stated that the agency should not exist. The CFPB was granted a reprieve in January 2019 when the US Supreme Court declined to hear State National Bank, et al. v. Mnuchin, a case challenging the constitutionality of the CFPB’s structure. Plaintiffs in the case, a group of financial institutions, argued that the provisions of Title X of the Dodd-Frank Act — the legal mechanism under which the CFPB was created — improperly insulates the CFPB from checks on its authority by providing funding outside the congressional appropriations process and prohibiting the removal of the CFPB director except for cause.

In January 2018, the D.C. Circuit Court of Appeals upheld the constitutionality of Title X’s for-cause removal provision, rejecting the financial group plaintiffs’ argument and the DOJ’s amicus brief in support of plaintiffs. Then-Judge Brett Kavanaugh dissented, arguing that the CFPB “is unconstitutionally structured because it is an independent agency that exercises substantial executive power and is headed by a single director.”

The Ninth Circuit also recently upheld the constitutionality of the CFPB and decisions on the same issue are pending in the Fifth and Second Circuits. Should the Supreme Court consider anew the constitutionality of the CFPB and swing in the direction of now-Justice Kavanaugh, the agency will lose independence and efficacy in its fight for consumers and accountability.

Ignorance is Bliss: Courts are Ruling Against Sophisticated Investors

By Ryan Dykhouse

Certain recent attempts to prosecute fraud against securities traders have failed, with several courts holding, effectively, that sophisticated parties engaging in arm’s length bargaining should expect some deceit from the other side. Most recently, in March 2019, in US v. Bogucki, the District Court for the Northern District of California threw out a wire fraud case against a Barclays trader before a jury verdict. This case involved Hewlett-Packard’s acquisition of Autonomy, a British software company. Barclays had been retained by Hewlett-Packard to carry out a large and complex options and currency trade. Prosecutors accused Barclays’ traders of manipulating the options market to the detriment of Hewlett-Packard, using as evidence chat messages that the traders would “hammer the market lower.” Despite this behavior, Judge Breyer ruled that Barclays’ conduct was not “material,” as both parties had knowledge about the foreign exchange markets, and both had engaged in deliberately deceptive tactics to protect their positions in the deal. Further, Judge Breyer held that when sophisticated parties bargain and negotiate, they anticipate the others’ misstatements. While a dismissal before a jury verdict is rare, Judge Breyer’s reasoning is not unique. In 2016, the Seventh Circuit in US v. Weimart overturned the conviction of a bank official who misled both the buyer and the seller in a real estate deal about his involvement as an investor. The Court explained that Weimart’s deception concerned only his negotiating position, and that buyers and sellers “will often try to mislead the other party about the prices and terms they are willing to accept. Such deceptions are not criminal.” A common thread — sophisticated parties negotiating at arm’s length — unites these outcomes. But another common thread is at work in these cases. Crucial to decisions by Judge Breyer and the Seventh Circuit was the fact that the individuals involved were not agents or fiduciaries of the sophisticated parties they misled. The core issue in each case was whether sophisticated parties could commit fraud by making misleading statements to the other side of an arm’s length negotiation.

Can sophisticated investors be defrauded? The answer is still yes — indeed, the former CFO of Autonomy was recently sentenced to prison for fraudulently overstating Autonomy’s value in connection with the above-discussed Hewlett-Packard deal. However, as recent decisions have shown, sophisticated parties should proceed with caution during arm’s length negotiations.

Eye on the Issues

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Insiders Grab Too Big a Share: Pushback Leads to Dwindling Popularity of Dual-Class Voting

By Tamara Gavrilova

As we discussed in the article “One Share, No Vote: Multi-Class Shares Sideline Investors as Corporate Insiders Run the Show” (summer 2017 edition), dual-class voting structures allow company insiders (often a company’s founders) to reap the benefits of taking their company public, while retaining control over their companies without input from outside investors. In the earliest stages of a company’s public life, the “founder knows best” rationale often justifies the existence of a dual-class voting system, but this system often also allows a select group of shareholders to dictate the direction of the corporation to the detriment of the other shareholders. For this reason, investors, stock exchanges, and regulatory bodies have been increasingly pushing back against such structures. While some pushback has been unsuccessful in preventing or eliminating a dual-class share system, ultimately, it seems to have contributed to a decreasing popularity of such share structures.

For example, in March of 2019, a group of investors demanded that the board of Lyft Inc., a transportation network company based in California, eliminate its proposed dual-class voting structure ahead of its IPO. Even so, on March 28, 2019, Lyft became a public company with a dual-class share system that granted its founders, Logan Green and John Zimmer, ten votes for every share. As a result, Green and Zimmer, who own approximately 5 percent of Lyft’s total shares, control 49 percent of its voting power.

Then, in April 2019, institutional stockholders in Facebook unsuccessfully attempted to wrest control of the company from Facebook’s Founder, CEO, and Chairman, Mark Zuckerberg. With Facebook plagued by months of scandal, including over its handling of data privacy issues, the stockholders argued that Zuckerberg’s disproportionate control over Facebook was gravely harming the company. However, given Zuckerberg’s control of approximately 60 percent of Facebook’s voting power, this proposal ultimately failed.

In addition, investors, regulators and stock exchanges have also recently pushed back against dual-class voting structures. For example, in 2017, S&P Dow Jones announced that the S&P Composite 1500 and its component indices would no longer add companies with multiple class share structures. Similarly, in 2017, FTSE Russell announced that it would exclude companies that offered shares with low, or no, voting rights from its indices and would require companies seeking to be listed on its indices to offer at least 5 percent voting rights to public stockholders. And in February 2018, SEC Commissioner Robert Jackson Jr. argued that companies should be forced to eliminate special classes of stock after a certain number of years. Asking if “public investors [should] have to place eternal trust in corporate insiders,” Mr. Jackson recommended instituting sunset provisions on dual-class shares.

Given this pushback, unsurprisingly, dual-class share provisions have experienced a rapid decrease in popularity. Indeed, in 2017, nearly 20 percent of the companies listed on US stock exchanges had dual-class voting structures, compared to just 1 percent in 2005. In 2018, however, only 11 percent of initial public offerings issued in the US included dual-class shares. Similarly, whereas in 2017, dual-class voting structures comprised nearly 50 percent of the market capitalization of American IPOs, by 2018, that number had dwindled to 17 percent.

The decreasing popularity of dual-class structures shows that, while attempts by Facebook’s and Lyft’s shareholders to limit those companies’ dual-class voting structures were not fruitful, investor, stock exchange, and regulator opposition to these unbalanced and undemocratic systems has triggered a creeping turn in the tide. As stockholders grow wearier of dual-class voting structures, and more vocal against their implementation, company founders and other insiders will need to rethink their funding strategies.

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Recently, throwing up yet another roadblock to investors seeking relief from the courts, corporations have begun including mandatory arbitration bylaws in their corporate charters.

For the last several years, attempts to deprive shareholders of their day in court have become increasingly common. These attempts took center stage after the Delaware Supreme Court, in its 2014 opinion ATP Tour, Inc. v. Deutscher Tennis Bund, endorsed a fee-shifting bylaw provision for nonstock corporations, which shifted the expense of litigation to stockholders whose claims against the corporation were ultimately unsuccessful, regardless of merit. ATP sparked a trend: after its release, thirty Delaware corporations adopted fee-shifting bylaws. In response, the Delaware bar noted that such bylaws would chill potentially meritorious securities and corporate governance litigation, as the risk of paying defense fees would discourage even meritorious claims.

Fortunately, to preserve the availability of stockholder litigation, the Delaware legislature amended the Delaware General Corporation Law in summer 2015 to prohibit fee-shifting bylaws. In the same amendment, the legislature took further steps to invalidate any bylaw that mandates arbitration “if it would preclude litigating [internal corporate] claims in the Delaware courts.” As the significant portion of US companies are incorporated in Delaware, the law of this state regulates the behavior of the majority of US companies. The question following this 2015 amendment became: what does it mean to be an “internal corporate” claim for which mandatory arbitration provisions are precluded?

Given the Delaware legislature’s 2015 amendment, the validity of a mandatory arbitration bylaw will likely turn on whether a corporation’s governing documents — its charter and bylaws — can regulate anything other than the internal affairs of a corporation. Generally, a corporation’s “internal affairs” pertain to the
relationships among the corporation and its officers, directors, and shareholders. If the governing documents can only regulate the corporation’s internal affairs, the question still remains whether the relevant internal affairs include shareholders’ ability to bring federal securities claims against the corporation, and whether internal governance documents could be used to prevent shareholders from accessing federal courts.

Recently, corporations have more frequently added mandatory arbitration bylaws to their corporate charters — throwing up yet another roadblock to investors seeking judicial relief. As discussed in the winter 2018 edition of The Advocate, mandatory arbitration provisions create many pitfalls for investors. For example, if individual investors are required to arbitrate their claims arising under the federal securities laws — and can no longer access the class action mechanism — most wronged investors will not be able to afford to pursue relief. Additionally, if a securities claim is pursued on an individual basis, the wrongdoer is liable only to the investor who brought the claim — not to the entire class of investors harmed by the wrongdoer’s conduct. Moreover, arbitration procedures can impair investors’ access to procedural and substantive transparency due to constraints such as reduced discovery, lack of jury trial, and lack of meaningful appellate review. Finally, because arbitration is generally conducted privately, corporations that require claimants to arbitrate can avoid the public pressure to reform their conduct that often accompanies public litigation.

The validity of mandatory arbitration bylaws in connection with the securities laws is currently being litigated in the New Jersey courts. In a curious twist, the corporate behemoth Johnson & Johnson (“J&J”) is arguing against the legality of mandatory arbitration bylaws for securities claims. In other words, the party defending shareholders’ rights to bring a class action against the company is the company itself. The choice is an unusual one for a corporation, which usually prefers the more private and individualized mandatory arbitration proceedings.

The J&J action arose when Hal S. Scott, a longtime advocate against securities litigation and proponent of arbitration, submitted a proposal on behalf of a J&J shareholder, the Doris Behr 2012 Irrevocable Trust (the “Trust”), that stockholders be allowed to vote on whether the company should adopt a mandatory arbitration bylaw. J&J disagreed with the proposal and asked the SEC to confirm that it would not take action if J&J rejected the proposal. J&J took the position that the mandatory arbitration bylaw, if implemented, would cause the company to violate both the federal Securities Exchange Act of 1934 (the “Exchange Act”), which voids any contractual condition that waives the protections of the Exchange Act, and New Jersey state law, which states that federal securities claims are not internal corporate claims. The New Jersey Attorney General agreed with J&J’s position.

On February 11, 2019, the SEC opined in favor of J&J and announced that the company could legally exclude this shareholder proposal from its proxy materials.
The SEC refused to determine, however, whether the proposal would cause the company to violate federal law. The company then issued its proxy without the mandatory arbitration provision.

The Trust filed suit in New Jersey federal court, alleging that the company violated federal securities laws by excluding the proposal from its proxy materials. The Trust asked the judge to declare that J&J would violate neither federal nor state law if it amended its bylaws to require arbitration of securities law claims. Specifically, the Trust argued that no law or court precedent clearly prohibits mandatory arbitration clauses, and that, in any event, the Federal Arbitration Act’s requirement that mandatory arbitration provisions be enforced, would trump state law.

On May 23, 2019, cognizant of the curious posture of this case, the California Public Employees’ Retirement System and Colorado Public Employees’ Retirement Association — represented by BLB&G — moved to intervene. These two funds and J&J asked the Court to dismiss the Trust’s lawsuit on the grounds that the proposed amendment would cause J&J to violate New Jersey law, that the Federal Arbitration Act does not apply to corporate bylaws, and even if it did, it would not preempt New Jersey’s corporate law. The court has not yet issued a decision.

A bellwether case in the Delaware Court of Chancery which will likely have implications on the J&J action, Sciabacucchi v. Salzberg, recently addressed an attempt to keep shareholders out of Delaware courts by forcing them instead into federal courts. Specifically, Salzberg considered whether a corporation may include in their corporate charters federal forum-selection clauses mandating that shareholders litigate fraud claims relating to the corporation’s initial public offering in federal court. In December 2018, Vice Chancellor J. Travis Laster invalidated the forum-selection clauses, reasoning that, because fraud claims stemming from an IPO do not concern a company’s internal affairs, a corporation’s governance documents cannot limit where those claims are litigated. Salzberg is currently on appeal to the Delaware Supreme Court.

For the first time in Salzberg, a Delaware court confronted the question of whether Delaware law permits corporations to use their charters and bylaws to restrict shareholders’ control over their federal securities claims, and the location and manner in which they bring those claims. While the Salzberg ruling may carve the path for mandatory arbitration bylaws to be struck down, the trend is crystal clear: the number of corporations maneuvering to limit shareholder litigation is on the rise.

This is problematic for shareholders. As mentioned, mandatory arbitration would impair investors’ access to justice, reduce public transparency, and discourage everyday investors from bringing meritorious securities claims. Given the seriousness of this issue, we will continue to update our readers as the Salzberg and Johnson & Johnson cases proceed through the courts.

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The Dutch
Lead the Way in Europe
Dutch Legislation Allows American-Style Class Action Claims for Monetary Relief

By Anatoli van der Krans, Director of European Client Development

New legislation allows litigants in Dutch courts to band together, like litigants in US courts, to claim monetary damages in a class action lawsuit.

On March 19, 2019, after years of debate and significant opposition from corporate lobbyists and trade organizations, the Dutch Senate approved legislation introducing collective damages actions in the Netherlands. The legislation, which grew out of numerous drafts and iterations, allows litigants in Dutch courts to band together, like litigants in American courts, to claim monetary damages in a class action lawsuit.

While not having previously offered a formal class action option to seek monetary damages, the Netherlands has always been at the forefront of collective redress in Europe. Since the early nineties, claims organizations representing groups of investors have had the option of using class action claims to obtain declaratory (but not monetary) relief. With this declaratory relief in hand, investors could then commence a separate procedure to sue for monetary damages or negotiate a settlement. After reaching agreement, the parties could jointly petition the Amsterdam Court of Appeal to declare the settlement binding on the class of investors as defined in the settlement agreement.

Under the previous system, shareholders successfully settled disputes against, among others, Royal Dutch Shell (2009, $350 million), Vedior (2009, $5.7 million), Converium (2010, $58.4 million), and Fortis (2018, $1.3 billion).

Under the new law, however, which will likely become effective next year, a class of plaintiffs may for the first time seek monetary damages directly. Because the European Commission has been pressuring member countries to improve access to justice for claimants who suffered relatively small monetary damages — particularly in the antitrust context — this development in the Netherlands will likely have ripple effects on other legal systems throughout Europe. The Dutch law shows that European justice systems, consistent with their own local laws and
While the Netherlands has not previously offered a formal class action option to seek monetary damages, the Netherlands has always been at the forefront of collective redress in Europe. Since the early nineties, claims organizations representing groups of investors have had the option of using class action claims to obtain declaratory (but not monetary) relief.

Legal cultures, may offer litigants the ability to seek redress for monetary claims.

Key Features Of The New Legislation

The new legislation has several key features. First, the legislation introduces an option to claim monetary damages in a collective action or on an opt-out basis, lifting the current prohibition on representative organizations seeking monetary damages in a collective action. Similar to the American system of class action litigation, however, the proposed action may result either in a judgment, upon which the presiding court will award damages, or in a settlement, which the court must approve, that is then binding upon the class.

Second, the new legislation utilizes an opt-out mechanism, which creates closure for defendants by preventing subsequent collective actions — based on the same facts and legal issues — to be filed once the collective action has concluded. Initially, the Dutch legislature intended to not limit the size or nationality of the class, so the class could, conceivably, have contained international class members if a majority of the individuals on behalf of whom the collective action is initiated resided in the Netherlands. After heavy criticism, however, the legislature amended the draft law to limit the class to Dutch class members only, while still allowing foreign class members the ability to opt-in. However, in cases in which foreign class members are relatively “easily identifiable,” the presiding court may order that the class automatically extends to those members.

Finally, the legislation provides for the appointment of an Exclusive Representative — similar to the role of a lead plaintiff in a US class action suit — if more than one collective action organization wishes to file an action based on the same facts or legal issues. The Exclusive Representative will litigate the case on behalf of the organizations involved in the collective action. The law is still unsettled, however, as to what criteria the court will utilize to select an appropriate Exclusive Representative. After the appointment of the Exclusive Representative, class members may opt-out to pursue individual actions.

The Legal Process And Proceedings Under The New Legislation

After appointment of the Exclusive Representative, the court immediately sets a schedule, during which the parties attempt to negotiate a settlement. If the parties reach a settlement agreement that the court declares binding, class members have a second opportunity to opt-out of the class-wide settlement. If the parties do not reach a settlement agreement, the litigation proceedings continue. Throughout the proceedings, however, the court has discretion to order the parties to file a settlement proposal when it deems appropriate, and based on the parties’ proposal, the court can determine the amount of compensation that the defendant owes to the class. The law remains unsettled as to whether a court may issue an order that departs from — or ignores altogether — the parties’ proposal.

Similar to the motion to dismiss stage in American litigation, the collective action organizations also must overcome an
assessment, at an early stage of the proceedings, into their standing and admissibility. One of the significant admissibility requirements under the new law is the “scope rule” — which states that the action must have a sufficiently close connection to the Dutch jurisdiction. The scope rule is satisfied if either: a majority of the individuals on behalf of whom the collective action is initiated reside in the Netherlands; the defendant resides in the Netherlands; or the circumstances on which the collective action is based took place in the Netherlands.

The standards for the collective action organizations’ governance, funding, and representation are enhanced under the new Dutch law. The collective action organization must, among other requirements, appoint various boards and an accountant. It must also have a website and the ability to communicate with its stakeholders.

Similar to Rule 23 of the American Federal Rules of Civil Procedure — which sets forth the criteria a lawsuit must meet in order to proceed as a class action — the Dutch legislation also imposes requirements governing the collective action. For instance, echoing Rule 23, the proponents of the Dutch class action must show that collective action is more efficient and effective than initiating individual claims, because the factual and legal questions to be answered are sufficiently common; the number of persons whose interests are protected by the claim is sufficiently numerous; and the class members’ financial interest in the matter is sufficiently large.

The collective action for monetary damages is a significant and welcome piece of legislation. Together with the mechanisms already available to litigants in the Netherlands, the new Dutch law will put the country at the forefront of collective redress in Europe, and it may serve as a model for similarly innovative legislation across Europe. Do not hesitate to contact BLB&G should you wish to obtain further information on the introduction of the collective damages action in the Netherlands.

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“With the money we’ll save by shutting down quality control, we can issue some truly spectacular apologies.”
ESG principles are wide-ranging but may include proposals such as requiring companies to increase disclosures related to political contributions and lobbying, their gender pay gap, or their carbon footprint.

In recent months, the SEC and legislators have proposed rules meant to limit shareholder activism — and particularly investors’ focus on so-called “ESG investing.” ESG investing considers environmental, social, and governance factors when making investment decisions. ESG principles are wide-ranging but may include proposals to require companies to increase disclosures related to political contributions and lobbying, their gender pay gap, or their carbon footprint. Many argue that the consideration of ESG principles is beneficial to a Company’s long term returns — lowering risk and ensuring the sustainability of company policies and practices.

In April 2019, the Republican-controlled Senate Committee on Banking, Housing, and Urban Affairs (the “Banking Committee”) called on the SEC to restrict institutional investors, fund managers, and proxy advisory firms from including ESG principles in their shareholder proposals. The motivation behind this call to the SEC was, in part, certain senators’ belief that ESG proposals burden companies with the added expense of reporting on metrics that are, arguably, unimportant to investors. Evidence, however, points to the contrary: in 2018, ESG proposals comprised the largest category of shareholder proposals on proxy ballots.

Lawmakers and researchers have also suggested increasing the monetary threshold for shareholders to introduce proposals, which would further limit shareholder activism. Under current SEC rules, shareholders who hold at least $2,000 of a company’s stock, and have held that stock for at least a year, may submit a shareholder proposal for consideration on a company’s proxy ballot. However, James Copland, Senior Fellow and Director of Legal Policy at the Manhattan Institute, recommended at a Banking Committee hearing that the SEC increase the monetary threshold to “a material percentage” of the company’s shares, though he did not provide an
ESG investing proponents claim that these proposals add accountability to companies where accountability is sorely lacking and otherwise help make companies more competitive in the global market for products and services.

exact amount. Concurring, Senator Pat Toomey (R-PA) claimed that “the threshold[s] for introducing [shareholder proposals] are clearly too low. People who have no real financial interest in the company are nevertheless able to tie up huge amounts of resources on behalf of that company.” Senator Toomey even suggested that ESG proposals are partly responsible for the decline in the number of companies that are currently going public.

Mr. Copland and Senator Phil Gramm (R-TX) also suggested that the Committee seek to implement rules limiting the role of proxy advisors. Committee Chairman Mike Crapo (R-ID) questioned whether proxy advisors who proposed increasing ESG disclosures were “voting to drive productivity in our economy and increase investors’ return on their hard-earned investments” or were instead acting as “intermediaries” to advance certain investors’ “environmental, social and other political policies.” Crapo’s question implies that ESG proposals damage companies’ bottom lines.

However, critics of the Banking Committee’s concerns argue that these fears are overstated and that studies show that better governance, social, and environmental practices often result in stronger financial results. For example, according to a 2012 Deutsche Bank report, which reviewed over 100 studies, ESG investing “works for investors and for companies both in terms of cost of capital and corporate financial performance” and thus “can be a clear win for investors and for companies.”

In addition to potential financial benefits, proponents of ESG principles argue that the ability to make ESG proposals is a right owed to shareholders as owners of the company. These proponents claim that the current SEC rules are stringent enough, including the thresholds for shareholder proposals. For instance, shareholders may only submit for consideration one resolution per year, per company and if that proposal fails to garner sufficient shareholder support, it cannot be reintroduced for at least three years.

Moreover, ESG proponents assert that these proposals add accountability where it is sorely lacking and otherwise help make companies more competitive in the global market for products and services. For example, according to Calvert Research and Management, in 2011, “[J]ust 20 percent of the S&P 500 provided any type of reporting on relevant ESG risks. Today, 85 percent of companies in the S&P 500 actively report on ESG risks factors.” As Senator Sherrod Brown (D-OH) stated, “Investors know there are many environmental, social, or political risks that could reduce long-term value, but companies are not providing that information. Enhancing and standardizing these disclosure requirements will merely bring the SEC up-to-date with other rules around the world.” While the perception around ESG investing appears to follow party lines, one thing is certain: ESG investing is on the rise and shows no signs of slowing.

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at some potential changes in the shareholder proposals that have to do with refiling thresholds and things like that. But, the worst was avoided there, I think. I think there is definitely still concern about mandatory arbitration provisions and some signaling from the SEC that they might be open to letting companies put that in corporate charters and such.

On another front, it is also not something we think about too much in the corporate space, but there are some things going on at the Department of Labor that merit mention. The Department of Labor oversees pension plans including union pension plans, and they offer interpretive bulletins of the fiduciary duties of the pension trustees. Are they just supposed to maximize returns? Can they take other things into account like the environmental/social/governance factors? Things like that. A few months ago, the White House issued an executive order to the Department of Labor, basically asking them to revisit the question of fiduciary duty of pension funds that are filing shareholder proposals on the environment. Frankly, it appears that a bunch of oil companies went to the Trump administration and said they are getting these shareholder proposals from pension funds that ask us to do X, Y, and Z about global warming and they want that shut down. The Trump administration sent a shot across the bow asking the Department of Labor to revisit the question. I don’t think it is going to go anywhere, but it shows a measure of hostility to shareholders rights in yet another context. Those are some of the main, most relevant, developments in the regulatory front.

And given those developments, is there anything right now that institutional shareholders should be doing or should be focusing on?

I would say continue to fight against arbitration provisions and lobby the SEC not to go in that direction. Arguing that this is not a shareholder friendly move that would be welcome. Being very careful to protect shareholders’ proposal rights and argue on their behalf. Some tweaking around the margins of some of the rules wouldn’t be the end of the world. But shareholder proposals are a key element of the shareholder voice and they should be preserved.

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Supreme Court Roundup

Revisiting Lorenzo

The Supreme Court Forces Investment Managers to Take Responsibility For Their Conduct

By Kyle Panton

As we reported in the fall 2018 issue of The Advocate, the case Lorenzo v. SEC concerned an investment manager who sent emails to prospective investors containing false representations about a company’s financials. Because the investment manager’s boss authored the false representations — and the investment manager distributed the emails at his boss’s instruction — a legal ambiguity emerged: is a person who merely repeats a false and misleading statement authored by another liable under SEC Rule 10b-5(a), which prohibits any individual from using any instrument of interstate commerce to defraud in connection with the purchase of a security, and SEC Rule 10b-5(c), which prohibits any business practice that operates as a fraud in connection with the purchase or sale of a security?

The Supreme Court’s 2018 Lorenzo decision followed the Court’s 2011 case Janus Capital Group, Inc. v. First Derivative Traders in which it held that only the “maker” of a statement — that is, “the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it” — can violate SEC Rule 10b-5(b). With this precedent in place, the courts considering the Lorenzo case had to determine if the “maker” requirement applied to SEC Rules 10-b5 (a) and (c) as well. Both the SEC and the D.C. Circuit Court of Appeals found that, in Lorenzo, the investment manager’s behavior did not violate Rules 10-5(b), (a), or (c). Justice Kavanaugh (then-Judge Kavanaugh) dissented in connection with the D.C. Court of Appeals opinion and thus recused himself once the Supreme Court agreed to hear the appeal.

In March 2019, the Court determined that although Lorenzo did not qualify as a “maker” of a statement under Rule 10b-5(b), he was indeed liable for violating SEC Rules 10b-5 (a) and (c). Although the investment manager did not “make” the false statements himself, he understood that he was distributing material that contained “untruths,” in violation of section (a), and he understood that he engaged in a course of business that operated as a fraud, in violation of section (c). With this decision, the Court may be hinting at its openness to expand liability for dissemination of false statements beyond its earlier ruling in Janus.

With its decision in Lorenzo, the Court may be hinting at its openness to expand liability for dissemination of false statements beyond its earlier ruling in Janus.

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A Chink In The Armor

The Supreme Court Leaves Section 14(e) Claims Intact — For Now

By Jesse Jensen

On April 23, 2019, the Supreme Court unexpectedly dismissed the appeal in *Emulex Corp. v. Varjabedian* as having been improvidently granted. The Supreme Court had granted certiorari in *Emulex* to address whether Section 14(e) of the Securities Exchange Act of 1934, which protects investors from fraudulent acts committed in connection with a tender offer, required a showing of mere negligence (the position of the Ninth Circuit Court of Appeals) or a showing of knowledge or recklessness (the position of the Second, Third, Fifth, Sixth, and Eleventh Circuits). Once the case was on its way to the Supreme Court, however, the defendants broached a more fundamental question: can investors sue under Section 14(e) at all? For decades, courts have recognized an implied private right of action under Section 14(e) — even though none exists in the text of the law. Before the Supreme Court, the defendants seized on Section 14(e)’s silence to argue that the absence of express language meant investors could not bring claims under the statute. Corporate lobbying groups, including the Chamber of Commerce, joined this attack on Section 14(e), and the Solicitor General of the United States argued that the right to enforce Section 14(e) belonged solely to the government — not to private investors.

On April 15, 2019, the debate over the private right of action dominated the *Emulex* oral argument before the Supreme Court. While Chief Justice Roberts, Justice Kavanaugh, and Justice Gorsuch appeared sympathetic to the defendants’ position, several Justices — from across the political spectrum — expressed skepticism about the defendants’ bait-and-switch. These Justices were concerned that, while defendants first asked the Court to address the circuit split over Section 14(e)’s pleading standards, they were now staking out a more consequential position—that private plaintiffs cannot sue under the law. For example, Justice Ginsburg chastised that the Supreme Court “is a court of review, not of first view,” and Justice Alito asked the defendants’ counsel why it was “appropriate” for the Court to reach an issue that had not previously been in dispute, inquiring whether doing so would be “the precedent you want us to set.”

One week later, the Supreme Court dismissed the appeal as improvidently granted. The Court’s procedural concerns were the likely cause, though the Court did not specify. However, that several Justices expressed their willingness to consider the existence of Section 14(e)’s private right of action all but guarantees that the issue will be back before the Supreme Court. Then, the onus will be on investors to persuade the Court not to disrupt a long-settled and important feature of the securities laws: Section 14(e)’s private right of action.

The fact that several Justices had expressed willingness to consider the existence of Section 14(e)’s private right of action all but guarantees that the issue will be back before the Supreme Court. Then, the onus will be on investors to persuade the Court not to disrupt a long-settled and important feature of the securities laws: Section 14(e)’s private right of action.

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On August 19, 2019, the Business Roundtable, which includes the CEOs of 181 American companies (including Walmart, JP Morgan, and AT&T), announced that it was officially abandoning its long-held belief in the so-called “shareholder primacy” theory of corporate governance. Instead, the Roundtable “moderniz[ed] its principles on the role of a corporation,” propounding the idea that corporations should operate for the benefit of all stakeholders, including customers, employees, suppliers, communities, and shareholders. The Roundtable’s revised statement is intended to serve as “one element of Business Roundtable’s work to ensure more inclusive prosperity” in America after decades of deepening economic inequality. The group also called on leading investors “to support companies that build long-term value by investing in their employees and communities.”

While some commentators have responded positively to the Roundtable’s announcement, many investor groups fear that this change will encourage companies to obfuscate shareholder rights and mask poor management with seemingly good intentions. The Council of Institutional Investors, comprised of entities with more than $4 trillion in combined assets under management, stated that this change “undercuts notions of managerial accountability to shareholders” while proposing no “new mechanism to create board and management accountability to any other stakeholder group.” Thus, a new focus on “stakeholder governance” could create “hiding places for poor management” that would undermine the efficiency of the US equity markets and “the economy more generally,” the Council added. Moreover, many have noted that under state law, companies still owe a fiduciary duty to shareholders only and thus shareholder primacy is still the law — a law which the proposed policy change might violate.

Time will tell whether American companies indeed adopt this new operational focus for the benefit of all stakeholders and, if so, whether it would be consistent with various state laws. We will keep our readers updated as this story develops.

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shortly before the company announced positive news, thereby allowing the executives in question to enjoy the resulting stock appreciation, while only 11 percent of such terminations occurred before negative news was released — suggesting that corporate management might very well be cancelling trading plans in order to profit from inside information.

With the support of investors, legislators are currently working to close some of these loopholes and improve transparency into executives’ 10b5-1 planning process. In January 2019, House Financial Services Committee Chairwoman Maxine Waters (D-CA) and Ranking Member Patrick McHenry (R-NC) introduced H.R. 624, the “Promoting Transparent Standards for Corporate Insiders Act” (the “Act”). The Act would require the SEC to examine potential modifications to Rule 10b5-1: (i) to limit insiders’ ability to trade at certain times, maintain multiple trading plans, or modify or cancel existing plans; (ii) to establish mandatory delays between the adoption of a trading plan and the execution of trades under it; and/or (iii) to require trading plan adoptions, amendments, and terminations to be publicly filed with the SEC. Institutional investors have reacted positively to the new legislation, which builds on years of investor efforts to rein in abusive insider trading practices. For example, shortly after the Act was introduced, the Council of Institutional Investors (“CII”) wrote to Representatives Waters and McHenry to praise the Act, noting that it reflected numerous concerns the CII had raised years earlier in a rulemaking petition to the SEC.

Executive compensation will likely remain a topic of heated public debate, but it looms especially large for shareholders. A lack of transparency allows unscrupulous executives to manipulate compensation arrangements to their benefit — and to shareholders’ detriment — in a variety of ways, including by extracting generous payouts for lackluster performance. In response, investors must continue demanding performance, transparency, and accountability.

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Rules mandating transparency are an important safeguard against overt fraud. With the support of investors, legislators are currently working to close some of these loopholes and improve transparency into the rules governing executives’ trading.

Anyone who thinks that the stock market is a level playing field obviously has no contact with reality.

The Hon. Jed Rakoff of the Southern District of New York to attorneys for the government prosecuting an insider trading case.
In the fall of 2019, BLB&G will open an office in Wilmington, Delaware led by Greg Varallo, one of Delaware’s most respected trial counsel and one of the top business litigators in the nation. BLB&G’s Corporate Governance litigation practice group has been prosecuting class and derivative actions to protect stockholders’ financial, governance, and voting rights interests before Delaware’s expert judiciary for more than a decade. The firm’s decision to open an office in Delaware, arguably the most important jurisdiction for the development of governance practices among US corporations, marks an important point in the evolution of the corporate governance practice, broadly expanding the nature of the services that BLB&G can provide to clients.

As BLB&G Partner Mark Lebovitch, who founded the firm’s Corporate Governance litigation practice group, stated, “A majority of the issues we prosecute for our clients are in Delaware, and in particular, before the Court of Chancery. Opening a Wilmington office is the logical next step, and now is the right time to deepen our commitment. We have long known Greg as an attorney of singular integrity and extraordinary skill. As our relationship with Greg has grown from being professional adversaries to trusted friends, it became evident to us that Greg’s skills, knowledge and expertise will add tremendous value as we continue to provide the full panoply of litigation services to our investor clients.”

BLB&G’s Corporate Governance practice has an unrivalled track record over the last two decades, achieving precedent-setting outcomes combating unfair deals,
creating billions of dollars in increased shareholder value, addressing egregious self-dealing and other issues in the boardroom and executive suite, holding individual wrongdoers accountable and protecting the shareholder franchise by improving corporate governance practices.

Varallo’s leadership of this new office, following a distinguished 36-year career in leadership roles at Richards Layton & Finger, will bring tremendous value for BLB&G clients, given his extensive experience litigating hundreds of complex business disputes for corporate boards and investors alike. His track record has earned Varallo a reputation as one of the country’s leading corporate governance experts and trial lawyers and led to him being named a fellow of both the American College of Trial Lawyers and the American College of Governance Counsel.

Varallo is excited to start this new chapter, stating, “after nearly four decades of working on a wide range of business issues at one of the best defense firms in the nation, I am excited to enter the next chapter of my career and focus squarely on investor rights. I joined BLB&G — which I think is the premier firm protecting investor rights in the bar — because it brings the most important, interesting, actionable and complex investor-rights cases being litigated today. I’m looking forward to helping them safeguard investors and continue to make a major contribution to Delaware law and the Wilmington community.”

Greg Varallo’s full professional biography can be found at www.blbglaw.com and he can be reached at: greg.varallo@blbglaw.com