Securities Regulation Daily Wrap Up, TOP STORY—Leo Strine's swan song is a proposal for responsible corporate governance, (Oct. 1, 2019)

Securities Regulation Daily Wrap Up

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By Anne Sherry, J.D.

Just before retiring, the influential Delaware jurist has released a sweeping proposal for corporate governance reform that would prioritize employees, hold institutional investors accountable, and tax financial transactions.

Delaware Chief Justice Leo Strine released a proposal to overhaul American corporate governance. The "fair and sustainable capitalism proposal" emphasizes corporations' responsibility to treat employees fairly, as well as the role of institutional investors in effecting this change. Strine would also impose a tax on financial transactions and reassess legal decisions that have privileged corporate elites. The jurist, who is retiring this fall, summarized the ideas in a *Financial Times* op-ed and also sat for an interview with the newspaper.

Concrete steps. Strine's emphasis on corporate responsibility echoes the recent statement by the Business Round table that corporate stakeholders include not just shareholders but also employees, suppliers, customers, and communities. But he said in his op-ed that "skepticism rightly exists over whether this woke talk will be backed up by real action." Although he credited Business Round table with "put[ting] down a marker" and is optimistic that the group's statement is a step forward, Strine goes further by laying out specific steps in his proposal.

The proposal starts from the premise that incentives underlying corporate governance have failed to encourage long-term investment, sustainable business practices, and "fair gainsharing" between shareholders and workers. Strine takes aim at institutional investors, which wield 75 percent of shareholder voting power but tend to escape the criticism that falls on CEOs and boards. Middle-class investors saving for retirement rely on mutual funds, but those fund companies, not the individual investors, get the vote. Strine believes that corporations will not prioritize social responsibility or the treatment of employees unless institutional investors also support these goals.

Focusing on employees is critical as 99 percent of Americans owe most of their wealth to their job, Strine said. Since the early 1970s worker productivity has risen by about 70 percent while hourly pay has grown by only 12 percent, and corporate profits have reached record highs. The proposed reforms are aimed at giving workers a voice within the boardroom and greater access to collective bargaining. Strine gives some institutional investors credit for considering environmental, social, and governance (ESG) issues, but said that all of them must factor in EESG—the extra E standing for "employees." As he told the *FT* interviewers, "You can go to entire conferences where people will talk about sustainability, everything, and they will not mention how the company treats its workers."

Institutional investor reforms. Strine would modify the fiduciary duties of institutional investors to require them to consider their ultimate beneficiaries' specific investment objections and horizons. The proposal would also empower institutional investors to consider beneficiaries' economic and human interest in having companies create quality jobs and act ethically and responsibly towards people and the environment. They would no longer be allowed to rely on the recommendations of proxy advisory firms unless tailored to the fund's investment style and horizon. Institutional investors would be required to explain how their voting policies and stewardship practices take into account EESG factors, and activist hedge funds would have to disclose their economic interests in the companies they seek to influence. Finally, Strine proposes to require the SEC to study the investor protection risks from private funds that are subject to only limited disclosure requirements.

Corporate reforms. Strine also proposes a suite of measures that would complement the other reforms to promote long-term economic growth. The SEC, in consultation with the Department of Labor and several other agencies, would develop rules—applicable to public and private companies alike—for the annual reporting of corporations' business impact on EESG factors. In general, the proposal argues against differentiating between companies based on whether they are public or private, instead focusing on the size of the company to avoid "the perverse effect of encouraging companies to go private or discouraging emerging companies from going public." Along these lines, companies with more than $1 billion in annual sales would be required to create and maintain a board committee focused on workplace concerns. This would be effected via a joint rule by the SEC, DOL, and National Labor Relations Board. The proposal also calls for amending the National Labor Relations Act to allow for European-style "works councils" without impeding union formation and representation.

The SEC would also instruct FASB to revise GAAP to treat investments in human capital as capital expenditures, and the Commission would develop rules requiring narrative disclosures of human capital investments. Companies would have to situate their quarterly guidance within a long-term plan for earnings growth. Finally, acknowledging the Business Round table statement about corporate social responsibility, Strine would make it easier for large corporations to adopt the model of benefit corporations (which is already an option in Delaware).

Strine also proposes some measures that corporations would likely welcome. First, he would reduce the frequency of say-on-pay votes on executive compensation. "It is insane that we have say-on-pay votes at every company every year," he told *FT*. "There is no way we want chief executives paid on year-to-year contracts and there is no way that institutional investors can vote thoughtfully on that many votes every year." Strine would also raise the ownership threshold for shareholder proposals, requiring that shareholders making an economic proposal hold $2 million or 1 percent of the company's stock, whichever is less. Shareholders attempting to change a company's governance would have to disclose their net beneficial ownership interest in the company's stock.

Tax and legal overhauls. The proposal sets out reforms to the tax system by establishing a financial transaction tax of 0.5 percent for transactions in equity securities, 0.1 percent for bonds, and 0.005 percent for derivatives. Strine says that the tax would generate over $2 trillion over ten years, which would go into a trust fund for investment in infrastructure and other projects. He would also close the carried-interest loophole and change the holding period for long-term capital gains from one year to five. A one-year long-term capital gain is an oxymoron, he told *FT*.

Finally, Strine proposes measures to curb excessive corporate power. Public companies would be barred from political spending without the consent of at least 75 percent of their shareholders. The proposal would amend the Federal Arbitration Act to limit the enforceability of certain forced arbitration clauses and restore state sovereignty over state-law claims. And unions that can fairly show that they have majority support would be recognized and given the right to bargain on behalf of the workforce.

Why this proposal, and why now? In the *FT* interview, Strine explained that he has been trying to forge common ground between business and labor for a long time, and as the country heads into the 2020 election cycle, some people had asked him to put his ideas into a solid form. "My entire reason for being a public servant is because I believe in the idea that self-governing societies can make things better for their entire citizenry," he told the newspaper. Strine opined that change will come about through elections, leadership, and focus. The 2016 presidential election and Brexit referendum demonstrate what happens when there is economic insecurity, he said.

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