INSIGHTS

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PROXY VOTING

SEC Proposes Enhanced Proxy Voting Disclosure by Investment Funds

After a long delay, the SEC proposed rules that would enhance the disclosures made by mutual funds and exchange-traded funds about how they vote annually at portfolio companies on their Forms N-PX. The proposed rules would also require "institutional investment managers" to vote annually on "say-on-pay" for the first time.

By Donald R. Crawshaw, Eric M. Diamond, Joseph A. Hearn, Sarah P. Payne, Marc Trevino, and Jonathan B. Beek

On September 29, 2021, the Securities and Exchange Commission (SEC) issued proposed rulemaking to enhance the information mutual funds, exchange-traded funds, and other registered management investment companies (funds) report annually about their proxy votes. The proposal also would require so-called institutional investment managers subject to Section 13(f) of the Securities Exchange Act of 1934 (Exchange Act) (managers), which includes a broad range of investors in US publicly traded equities, including some who are not "managers" in the conventional sense, to report annually regarding their voting of proxies related to executive compensation "say-on-pay" matters. The proposed rulemaking—the first to be issued under the leadership of SEC Chairman Gary Gensler—touches on key policy issues for the new Chairman, including ESG, proxy voting and greater transparency for securities lending.[1]

As described in greater detail below, the proposal, if adopted, would require:

- Managers to report annually on Form N-PX how they voted proxies on "say-on-pay" matters;
- Funds and managers to categorize their voting by type (such as environment or climate; human rights; corporate governance; diversity, equity and inclusion; political activity; and others) using the same language as the issuer's form of proxy to identify proxy voting matters;
- Funds and managers to disclose the number of shares that were voted (or, if not known, the number of shares that were instructed to be cast) and the number of shares held by the funds that were loaned out on the record date and not recalled for voting;
- Information reported on Form N-PX to be in a structured data language as a custom Extensible Markup Language (XML) file; and
- Funds to provide their proxy voting records on or through their websites.

The Commissioners voted 4-1 in favor of advancing the proposal, with Commissioner Hester Peirce dissenting. Comments on the proposed rulemaking are due 60 days after it is published in the Federal Register.

Background

Section 951 of the Dodd-Frank Act added new Section 14A to the Exchange Act, which generally requires public companies to hold non-binding shareholder advisory votes to: (1) approve the compensation of their named executive officers; (2) determine the frequency of such votes; and (3) approve "golden parachute" compensation in connection with a merger or acquisition (collectively, say-on-pay votes). Section 14A(d) requires that every manager report at least annually how it voted on say-on-pay votes, unless such vote is otherwise required to be reported publicly.

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In 2011, the SEC adopted rules concerning shareholder approval of executive compensation and "golden parachute" compensation arrangements.[2] The SEC, in 2010, also proposed rules to implement Section 14A(d) of the Exchange Act that would have required managers to file their record of say-on-pay votes with the Commission annually on Form N-PX, and would have amended Form N-PX to accommodate the new manager filings (the 2010 proposal). However, the 2010 proposal was never finalized.[3]

Overview of the Proposed Rulemaking

Scope of Funds' Form N-Px Obligations

Currently, every registered management investment company (other than a small business investment company registered on Form N-5) must file its proxy voting record annually on Form N-PX. A fund must currently report information for each matter relating to a portfolio security considered at any shareholder meeting held during the reporting period with respect to which the fund was entitled to vote.

The proposal would amend the scope of reporting obligations on Form N-PX by also including portfolio securities on loan as of the record date for the meeting because the fund could recall these securities and vote on them. The proposed amendment aims to ensure that a fund's filings on Form N-PX reflects the effect of its securities lending activities on its proxy voting.

Scope of Managers' Form N-PX Reporting Obligations

The proposal would extend the Form N-PX reporting obligations for say-on-pay votes to each person that (1) is an "institutional investment manager" as defined in the Exchange Act and (2) is required to file reports under Section 13(f) of the Exchange Act. An "institutional investment manager" is any person, other than a natural person in certain limited circumstances, investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person.[4] This category is not limited to investment advisers or persons who otherwise render investment management services to others; rather, under the broad Section 13(f) definition, non-financial businesses investing for their own account, including companies, investment partnerships and family offices, among others, may be considered "institutional investment managers."

An institutional investment manager (or "manager" in this memorandum) generally is required to file reports under Section 13(f) of the Exchange Act on Form 13F if the manager exercises investment discretion with respect to accounts holding at least $100 million in "Section 13(f) securities."[5]

Under the proposal, a manager required to report on Form 13F would be required to disclose its say-on-pay votes on Form N-PX. The proposal requires that a manager report a say-on-pay vote for a security only if the manager "exercised voting power" over the security.[6] This standard differs from that of the 2010 proposal, which would have covered securities with respect to which the manager "had or shared the power to vote, or to direct the voting of" the security.[7] Managers also would be required to report securities on loan as of the record date that are not recalled.

Proxy Voting Information Reported on Form N-Px

The proposal is intended to enhance current Form N-PX disclosures so investors can more easily understand and analyze proxy voting information. The proposal requires funds and managers (together, "reporting persons") to use the same language from the issuer's form of proxy to identify proxy voting matters on Form N-PX, and also requires reporting persons to select from standardized categories and subcategories to identify the subject matter of each of the reported proxy voting items. The proposed categories and subcategories, which are "designed to cover matters on which funds frequently vote,"[8] include:

- Board of directors (subcategories: director election, term limits, committees, size of board, or

other board of directors' matters (along with a brief description));

- Say-on-pay votes (subcategories: executive compensation, say-on-pay vote frequency, or votes on "golden parachute" compensation in M&A and similar transactions);
- Audit-related (subcategories: auditor ratification, auditor rotation, or other audit-related matters (along with a brief description));
- Investment company matters (subcategories: change to investment management agreement, new investment management agreement, assignment of investment management agreement, business development company approval of restricted securities,[9] closed-end investment company issuance of shares below net asset value, business development company asset coverage ratio change, or other investment company matters (along with a brief description));
- Shareholder rights and defenses (subcategories: adoption or modification of a shareholder rights plan, control share acquisition provisions, fair price provisions, board classification, cumulative voting, or other shareholder rights and defenses matters (along with a brief description));
- Extraordinary transactions (subcategories: merger, asset sale, liquidation, buyout, joint venture, going private, spinoff, delisting, or other extraordinary transaction matters (along with a brief description));
- Security issuance (subcategories: equity, debt, convertible, warrants, units, rights, or other security issuance matters (along with a brief description));
- Capital structure (subcategories: stock split, reverse stock split, dividend, buyback, tracking stock, adjustment to par value, authorization of additional stock, or other capital structure matters (along with a brief description));
- Compensation (subcategories: board compensation, executive compensation (other than say-on-pay), board or executive anti-hedging, board or executive anti-pledging, compensation clawback, 10b5-1 plans, or other compensation matters (along with a brief description));
- Corporate governance (subcategories: articles of incorporation or bylaws, board committees, codes of ethics, or other corporate governance matters (along with a brief description));
- Meeting governance (subcategories: approval to adjourn, acceptance of minutes, or other meeting governance matters (along with a brief description));
- Environment or climate (subcategories: greenhouse gas (GHG) emissions, transition planning or reporting, biodiversity or ecosystem risk, chemical footprint, renewable energy or energy efficiency, water issues, waste or pollution, deforestation or land use, say-on-climate, environmental justice, or other environment or climate matters (along with a brief description));
- Human rights or human capital/workforce (subcategories: workforce-related mandatory arbitration, supply chain exposure to human rights risks, outsourcing or offshoring, workplace sexual harassment, or other human rights or human capital/workforce matters (along with a brief description));
- Diversity, equity, and inclusion (subcategories: board diversity, pay gap, or other diversity, equity, and inclusion matters (along with a brief description));
- Political activities (subcategories: lobbying, political contributions, or other political activity matters (along with a brief description)); or
- Other (along with a brief description).

When categorizing a particular voting matter, a reporting person would be required to select multiple categories or subcategories for the matter if applicable. If a vote did not fall within a specified subcategory, the reporting person would select the "other" subcategory and provide a brief description.[10]

Quantitative Disclosures

In an additional effort to enhance transparency, the proposal includes changes to Form N-PX to require information about the number of shares

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that were voted (or, if not known, the number of shares for which votes were instructed to be cast).[11] These quantitative disclosure requirements would apply to a manager's say-on-pay votes and to *all* of a fund's votes.

In addition, in a departure from the 2010 proposal, the proposal would require disclosure of the number of shares that the reporting person loaned and did not recall. In support of such quantitative disclosures, the proposal states, "the context given by disclosing the number of shares voted would allow investors to better understand how securities lending activities affect the voting practices of the reporting person. Without disclosing the amount voted, the amount of shares on loan for a given vote would not provide meaningful insight into how a fund or manager voted."[12] The disclosure aims to provide transparency with regard to whether a reporting person chose to recall a security and vote the accompanying proxy or to keep the security out on loan.

Other Amendments

The proposal includes additional amendments to Form N-PX to improve the usability of Form N-PX reports and to clarify existing form requirements, including a standardized order to the Form N-PX disclosure requirements. The proposed amendments to Form N-PX also require a fund that offers multiple series of shares to provide Form N-PX disclosure separately by series (for example, provide Series A's full proxy voting record, followed by Series B's full proxy voting record). In addition, the SEC is proposing a technical amendment to require reporting persons to disclose whether each reported vote was "for or against management's recommendation" as opposed to the current requirement to disclose whether a vote was "for or against management." In circumstances where management may not provide a voting recommendation, reporting persons can disclose "none" for the applicable matter in response to the disclosure requirement.

Joint Reporting and Related Form N-PX Amendments to Accommodate Manager Reporting

Unless such votes are otherwise required, Section 14A(d) of the Exchange Act requires a manager to report its say-on-pay votes at least annually unless such vote is otherwise required to be reported publicly by a Commission rule or regulation. The proposal presents three sets of amendments to Form N-PX to implement this provision and allow joint reporting, as well as associated disclosure requirements to identify all of a given manager's votes:

1. The first proposed amendment would permit a single manager to report say-on-pay votes in cases where multiple managers exercise voting power;
2. The second proposed amendment would permit a fund to report its say-on-pay votes on behalf of a manager exercising voting power over some or all of the fund's securities; and
3. The third proposed amendment would permit affiliates to file joint reports on Form N-PX notwithstanding that they do not exercise voting power over the same securities.

In all three cases, where another reporting person reports say-on-pay votes on a manager's behalf, the report on Form N-PX that includes the manager's votes would be required to identify the manager(s) on whose behalf the filing is made and separately identify the securities over which the non-reporting manager exercised voting power.

The proposal also includes changes to the cover page of Form N-PX to include information to identify more readily whether the reporting person is a fund or a manager.[13] In addition to changes to the Form N-PX cover page, the proposal adds a new summary page to Form N-PX for investors to readily identify any additional managers other than the reporting person with say-on-pay votes included on the Form N-PX. The summary page would require identification of the names and total number of additional managers with say-on-pay votes included in the report.

Form N-PX Reporting Data Language

The proposal would require reporting persons to file reports on Form N-PX in a structured data language in order to make the filings easier to analyze. Currently, reports on Form N-PX are required to be filed in HTML or ASCII. In an effort to make it easier for a reporting person to prepare and submit information required by Form N-PX, and to make the submitted information more useful, the proposal would require filing Form N-PX reports in a custom eXtensible Markup Language (XML) -based structured data language created specifically for reports on Form N-PX.

Time of Reporting

The proposal would retain the current reporting timing for funds and apply it to managers' reporting of say-on-pay votes. Accordingly, funds and managers would be required to report their proxy voting records and say-on-pay votes annually on Form N-PX no later than August 31 of each year, for the most recent 12-month period ending June 30.

Requests for Confidential Reporting

Managers requesting confidential treatment of all or certain positions reported on their Form 13F also may request confidential treatment for such information reported on Form N-PX. However, the proposal notes that confidential treatment could be justified only in narrowly tailored circumstances and that such treatment would not be merited solely in order to prevent proxy voting information from being made public.[14]

Proposed Website Availability of Fund Proxy Voting Records

The proposal would require a fund to disclose that its proxy voting record is publicly available on its website and available upon request, free of charge.[15] A fund can comply with this requirement by using the human-readable version of its Form N-PX report that would appear on EDGAR, for example by providing a direct link on its website to the HTML-rendered Form N-PX report on EDGAR.

Compliance Dates

The proposal states that compliance dates would vary depending on when the amendments become effective relative to the Form N-PX reporting deadline. If the amendments are effective six months before June 30, the first reports on amended Form N-PX would be required to be filed by the August 31 that follows the rule's effective date. For a fund, the first report would disclose votes occurring at least six months after the effective date in conformance with the amended form, while applicable votes occurring before this period could be reported in conformance with current form requirements.

A manager's requirement to report votes would begin six months after the effective date, since managers are not currently subject to Form N-PX reporting requirements. If the amendments are not effective six months before June 30, funds and managers would be required to file their first reports on amended Form N-PX by August 31 of the first complete reporting timeframe following the effective date of the proposed rule.

Notes

1. *See* 17 C.F.R. Parts 232, 240, 249, 270, and 274, *https://www.sec.gov/rules/proposed/2021/34-93169.pdf*; *See, e.g.*, Chair Gary Gensler, Testimony Before the House Committee on Financial Services (May 6, 2021), *https://www.sec.gov/news/testimony/gensler-testimony-20210505*.
2. *See* SEC Adopts Rules for Say-On-Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act (Jan. 25, 2011), *https://www.sec.gov/news/press/2011/2011-25.htm*; *see also* Final Say-on-Pay and Say-on-Golden Parachute Rules (January 31, 2011), *https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Final_Say_on_Pay_and_Say_on_Golden_Parachute_Rules.pdf*.
3. *See* Exchange Act Release No. 63123 (Oct. 18, 2010) [75 FR 66622 (Oct. 28, 2010)] (2010 Proposing Release); *see also* SEC Proposes Say-on-Pay and Golden Parachute Rules for Proxy Statements: Highlights Include: No Need for Preliminary Proxy for Say-on-Pay Votes; CD&A Must Address Previous Say-on-Pay Votes; New Detailed Disclosure of Golden Parachute Arrangements; and

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Annual Disclosure of Institutional Investment Managers' Votes on These Matters (October 22, 2010), *https://www.sullcrom.com/siteFiles/Publications/SC_Publication_SEC_Proposes_Say_on_Pay_and_Golden_Parachute_Rules_for_Proxy_Statements.pdf*.

4. *See* 15 U.S.C. Section 78m(f).
5. "Section 13(f) securities" means equity securities of a class described in Section 13(d)(1) of the Exchange Act that are admitted to trading on a national securities exchange or quoted on the automated quotation system of a registered securities association. In determining what classes of securities are Section 13(f) securities, an institutional investment manager may rely on the most recent list of such securities published by the Commission pursuant to Section 13(f)(4) of the Exchange Act (15 U.S.C. 78m(f)(4)). *See* 17 C.F.R. 240.13f-1.
6. *See* 17 C.F.R. Parts 232, 240, 249, 270, and 274, *https://www.sec.gov/rules/proposed/2021/34-93169.pdf*.
7. The language in the 2010 proposal was similar to the language of Rule 13d-3(a) under the Exchange Act. *See* 17 C.F.R. 240.13d-3(a).
8. Commissioner Roisman expressed concern with the categorization framework. *See* Commissioner Elad L. Roisman, Statement on Proposed Changes to Asset Managers' Proxy Voting Disclosures (September 29, 2021), *SEC.gov | Statement on Proposed Changes to Asset Managers' Proxy Voting Disclosures.*
9. It is not clear what is meant by "business development company approval of restricted securities."
10. *See* 17 C.F.R. Parts 232, 240, 249, 270, and 274, *https://www.sec.gov/rules/proposed/2021/34-93169.pdf*.
11. The proposal modifies the 2010 proposal with respect to the disclosure of the number of shares voted because reporting persons may not be able to determine with certainty how many of the votes they instructed to be cast were actually voted in a particular matter. This change would permit a reporting person to use the number of shares voted as reflected in its records at the time of filing a report on Form N-PX. If a reporting person has not received confirmation of the actual number of votes cast, Form N-PX instead may reflect the number of shares instructed to be cast on the date of the vote. *See* 17 C.F.R. Parts 232, 240, 249, 270, and 274, *https://www.sec.gov/rules/proposed/2021/34-93169.pdf*.
12. *See* 17 C.F.R. Parts 232, 240, 249, 270, and 274, *https://www.sec.gov/rules/proposed/2021/34-93169.pdf*. Commissioner Roisman expressed concern with disclosures about securities out on loan, noting that there may be sound reasons for an investment manager to elect to leave securities out on loan rather than recalling them in order to vote them, and that the proposed disclosure requirement may operate to influence investment managers to recall loans when doing so may not be in the best interests of their clients. *See* Commissioner Elad L. Roisman, Statement on Proposed Changes to Asset Managers' Proxy Voting Disclosures (September 29, 2021), *SEC.gov | Statement on Proposed Changes to Asset Managers' Proxy Voting Disclosures*.
13. The reporting person would be required to check a box to identify the report as one of the following four types of reports: Registered management investment company report; Manager "voting" report when the report contains all say-on-pay votes of the manager; Manager "notice" when the report contains no say-on-pay votes of the manager and all say-on-pay votes are reported by other managers or funds under the joint reporting provisions; and Manager "combination" report when the report contains some say-on-pay votes of the manager and some say-on-pay votes of the manager are reported by other managers or funds under the joint reporting provisions.
14. *See* 17 C.F.R. Parts 232, 240, 249, 270, and 274, *https://www.sec.gov/rules/proposed/2021/34-93169.pdf*.
15. The proposal notes that this would be accomplished with amendments to Forms N-1A, N-2 and N-3.

Green and Sustainability-Linked Loans: What Companies Need to Know

There are a variety of loan principles and frameworks that guide how a loan can qualify as sustainability-linked or "green."

By David Miles and Jecolia Horn

Many companies have been focused on environmental, sustainability and governance (ESG) matters for some time, and rightly so. However, those that have not are having to catch up quickly. There is, as yet, no general legal requirement for companies to set and/or achieve ESG-related goals. However, for many shareholders and other stakeholders it is no longer sufficient for a company to demonstrate profitability, that profitability must come alongside the achievement of ESG-related goals.

That is the case whatever sector(s) the company operates in. Indeed, many companies are learning that achievement of ESG-related goals can help drive profitability or, at the very least, maintain or increase market share. One only has to look at the number of brands linking their products to the achievement of green and sustainability goals in their TV advertising campaigns to see that such things are now a key factor in how a company is perceived by the public.

The Rise in Green and Sustainability-Linked Loans

While advertising is used to raise consumer awareness of an entities' ESG commitments, one way in which to raise awareness of those commitments to the market is through the terms on which that entity borrows or lends money. Loans made specifically to finance "green" projects have been a core product in the project finance world for years. However, what is new is the creation of a direct link between the pricing of a loan and the borrower's achievement of sustainability goals and the requirement to enshrine rigorous reporting requirements into the loan documentation.

Both company borrowers and their lenders have identified advantages to including green or sustainability-related provisions in their loan documentation. Company borrowers across all sectors see it as a tangible way of demonstrating their commitment to achieving ESG-related goals (effectively, in the case of sustainability-linked loans, putting their money where their mouth is).

In parallel, it is becoming more common for lenders to be subject to their own ESG-related targets (including around the ESG commitments of the entities to whom they are lending). Lenders also increasingly view a borrower prepared to commit to achieving defined ESG-related goals as one with the sort of governance to likely make it a better credit risk.

As a result, there has seen an exponential increase in green and, particularly sustainability-linked, loans recently. By way of example, while still lagging behind volumes in the European markets, data from Bloomberg has the amount of debt advanced under sustainability-linked loans originated in the US markets at about US$52 billion in the period January to the end of May of this year, a 292 percent increase on volumes across the whole of 2020.

The GLP and SLLP

To assist this market trend of linking ESG matters to loan terms, the leading bodies for participants in the EMEA, United States and Asia Pacific loan markets (the Loan Market Association (LMA), the Loans Syndications and Trading Association (LSTA) and

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the Asia Pacific Loan Market Association (APLMA), respectively) have jointly published the Green Loan Principles (GLP)[1] and the Sustainability-Linked Loan Principles (SLLP).[2] The LMA/LSTA/APLMA also have produced accompanying guidance notes, notes on best practice and glossaries to assist in the implementation of these principles.[3]

While it is possible for a single loan instrument to satisfy the requirements of both the GLP and the SLLP, it would be more typical for a loan instrument to adhere to either the GLP or the SLLP, given the differences in the two sets of principles. It is therefore important to be aware of these differences when considering whether a GLP or SLLP-compliant lending arrangement is right for a particular situation or borrower.

Green Loans

Under the GLP, green loans are loans where the proceeds are applied specifically towards underlying "Green Projects." What amounts to a "Green Project" is set out in Annex 1 of the Green Loan Principles (GLP), but examples include the financing of renewable energy, water or wastewater management and waste-to-energy projects. While the GLP have been designed to be applied to both term and revolving facilities, as alluded to above, the loan instruments that are most likely to satisfy the purpose clause requirements of the GLP are traditional project financings.

However, the GLP have wider requirements than just the purpose of the loan. The documentation for a green loan must also include reporting undertakings (often subject to third party audit) to ensure the ongoing "green" credentials of the financed asset.

There are no direct economic implications for either borrower or lender to a loan being classified as a green loan. Rather, a green loan classification opens up access to the liquidity provided by the increased number of creditors with a mandate to build a portfolio conforming to green principles.

Sustainability-Linked Loans

In contrast, under the SLLP, the proceeds of sustainability-linked loans can be applied for (within reason) any purpose. The focus of the SLLP is on measuring whether a borrower achieves certain agreed "sustainability performance targets" (SPTs), which are measured periodically, often by third parties, by reference to agreed key performance indicators.

Common SPTs include reducing CO_2 emissions, regeneration of production waste or increasing female and ethnic minority diversity percentages amongst employees, but can vary widely depending on the particular borrower and its business. The borrower's performance against the SPTs then results in a direct economic implication, typically in the form of a deduction or increase in the margin element of the loan interest rate.

The variety of SPTs that can be included in the loan documentation makes sustainability-linked loans applicable to companies operating in any sector, not just those active in sectors that are typically seen as being "green."

Documenting Green and Sustainability-Linked Loans

The provisions mentioned above for both green loans and sustainability-linked loans (together with related reporting requirements and events of default for material non-compliance with SPTs) are included in a borrower's loan documentation, alongside typical terms appropriate for that particular borrower. While the market is not yet mature enough for recognized "standardized" drafting to have evolved, the UK's Chancery Lane Project has produced some useful template language for both green loans[4] and sustainability-linked loans.[5]

It is too early to say whether sustainability-linked terms will follow the path taken by Foreign Account Tax Compliance Act (FATCA) and sanctions compliance over the past decade and become enshrined in the laundry list of "market standard" provisions

typically included in loan agreements across all sectors and product lines. However, the increase in loans complying with the GLP and SLLP is certainly likely to continue, for the reasons set out at the beginning of this article.

"Greenwashing" and Taxonomies

As mentioned above, there is, as yet, no general legal requirement for companies to set and/or achieve ESG-related goals. Similarly, there is no clear legal framework by which a company's ESG goals and achievements are benchmarked. The GLP and SLLP are extremely helpful, but they are guidance only and auditing of compliance with the GLP and SLLP can be subjective. This has given rise to concerns around so-called "greenwashing."

This is where a company exaggerates or invents its ESG credentials, or intentionally sets itself too easily achievable ESG goals, in order to attract investment, improve its market or consumer perception or obtain favorable loan pricing. Impact of this phenomenon in the loan markets can hopefully be addressed through the growing expertise of lenders and the use of third-party consultants to initially set and then audit a borrower's compliance with the ESG components of loan documentation.

It also is an issue that governments and regulators are alive to. In part to tackle greenwashing, the European Union has brought in a Green Taxonomy which seeks to define what a green investment looks like. The United Kingdom is planning to introduce its own version in 2022.

The obvious repercussion is that, if the implementation of different taxonomies becomes a trend, many companies may find themselves subject to multiple requirements across different jurisdictions in which they operate. A single global taxonomy framework, or a system of mutual recognition, would undoubtedly go some way to addressing this potential issue. However, until then, navigating taxonomies looks set to be an increasingly complex aspect of a company's approach to ESG generally and specifically the terms of any ESG-linked loans that it incurs.

Conclusion

It is increasingly likely that all companies will need to be familiar with at least the SLLP and related legal and market developments over the coming years, for the purposes of negotiating their loan terms. If nothing else, it will make a refreshing change from the focus on LIBOR transition, discussions of which have dominated the loan markets for the last several years.

Notes

1. *https://www.lma.eu.com/application/files/9716/1304/3740/Green_Loan_Principles_Feb2021_V04.pdf.*
2. *https://www.lma.eu.com/application/files/6816/2668/7155/Sustainability_Linked_Loan_Principles._V09.pdf.*
3. *https://www.lma.eu.com/sustainable-lending.*
4. *https://chancerylaneproject.org/climate-clauses/green-loan-starter-pack/.*
5. *https://chancerylaneproject.org/climate-clauses/sustainability-linked-loans/.*

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SEC ENFORCEMENT

SEC Enforcement Director on New Enforcement Priorities

In remarks for the "PLI Broker/Dealer Regulation and Enforcement" conference on October 6, 2021, SEC Enforcement Director Gurbir Grewal set forth his views about how his Division's priorities may evolve going forward. An excerpt of these remarks follows.

By Gurbir Grewal

Thank you for that introduction and for having me here today. At the [Securities and Exchange (SEC)] Division of Enforcement, ensuring that broker-dealers and associated individuals follow our laws and regulations is critical to our mission, so it's only fitting that my first speech as Director is at this event.

While I just referred to it as "our mission" at the Division of Enforcement, what I'd like to talk to you about today is how we all share the responsibility to maintain market integrity and enhance public confidence in our securities markets.[1]

- SEC Charges Broker Who Defrauded Seniors Out of Almost $1 Million[2]
- SEC Charges Ernst & Young, Three Audit Partners, and Former Public Company CAO with Audit Independence Misconduct[3]
- SEC Charges Disbarred New York Attorney and Florida Attorney with Scheme to Create False Opinion Letters[4]
- Merrill Lynch Admits to Misleading Customers about Trading Venues[5]
- SEC Charges US Congressman and Others with Insider Trading[6]

These are not headlines from some bygone era of market participants behaving badly; these are all from cases the Commission has brought since 2018. In fact, here's one from just last week: "SEC Charges Investment Bank Compliance Analyst with Insider Trading in Parents' Accounts."[7]

Nearly a dozen years ago, one of my predecessors held a press conference to announce charges against more than 20 defendants, including "Wall Street professionals, corporate insiders, analysts and lawyers," in a pair of alleged insider trading schemes. In explaining the importance of the cases, Director Khuzami said: "There is a basic principle that governs our capital markets, and that is that there is one set of rules, and everyone is expected to play by that one set of rules. That principle gives investors confidence that the markets are fair."[8] He was right then, and his words remain true today: Enforcement is, in significant part, animated by the idea that we will pursue potential violations by any market participant, and, in so doing, attempt to shape the behavior of all participants going forward.

But I believe more is required. Because despite all of the strong enforcement actions the SEC has brought over the years and despite all the speeches that SEC Chairs, Commissioners, Enforcement Directors, and others have given at events like this one, the types of behavior described in the headlines I read to you persist, and as a result, a significant part of the public continues to feel that our markets are essentially a game that is rigged against them.[9]

So rather than issue warnings about how aggressively we will pursue you or your clients if you misbehave—which we, of course, will—I want to invite each of you—the lawyers, counselors, and gatekeepers who have such influence over market behavior—to join me. By working together, we can dispel the notion that the deck is stacked in favor of the few and powerful, promote better conduct among market participants, and ensure that the markets work

fairly for all. This, after all, should be our shared mission.

I see three key steps towards achieving this mission, and the first starts with each of you. In a speech he gave in May, Chair Gensler said: "[I]f you're asking a lawyer, accountant, or adviser if something is over the line, maybe it is time to step back from the line. Remember that going right up to the edge of a rule or searching for some ambiguity in the text or a footnote may not be consistent with the law and its purpose."[10] This is a critical point and let me explain why.

This morning you heard discussions on a number of topics, including special purpose acquisition companies (SPACs), ESG investments, and Regulation Best Interest, or "Reg BI". I defer to your able presenters as to the best substantive takeaways from each of those sessions. But what you should not take away from them is that, if regulators are particularly focused on issues X or Y in a given area, that means you or your clients may be able to push the envelope on issue Z—or the grey areas around X or Y. That approach is a surefire way to foster misconduct and, potentially, lead to an enforcement action.

You should be thinking, instead, about modeling excellence in your compliance efforts, as you do in your performance.

You should be thinking, instead, about modeling excellence in your compliance efforts, as you do in your performance. This means that firms need to think rigorously about how their specific business models and products interact with both emerging risks and Enforcement priorities, and tailor their compliance practices and policies accordingly. For example, with respect to Reg BI, firms should recognize that the new regime draws upon key fiduciary principles, and is intended to enhance previous broker-dealer standards of conduct significantly beyond the suitability obligation.[11] Armed with this recognition, firms should then give their registered representatives the tools and information that will enable them to identify, disclose, and mitigate conflicts prohibited under Reg BI.

Let me be clear here, I am talking about more than putting together a stock policy and giving a check-the-box training. This requires ***proactive*** compliance, and this type of approach has never been more important than today—a time of rapid and profound technological change. This change is exciting; it can help amplify the dynamism of our markets and increase access for investors. But at the same time, it also creates new avenues for misconduct, and new responsibilities for compliance.

Recordkeeping violations may not grab the headlines, but the underlying obligations are essential to market integrity and enforcement. Take for example an enforcement action the Commission brought last year against a California broker-dealer for failing to preserve business-related text messages.[12] The SEC's order found that some of the firm's registered representatives used their personal devices when communicating with each other, with firm customers, and with other third parties concerning, among other things, the size of orders, the timing of trades, and the pricing of certain securities. These messages were potentially responsive to a records request SEC Staff made to the firm in an unrelated investigation and the firm's failure to retain and produce them directly impacted that investigation.

Unfortunately, this is not an isolated example. We continue to see in multiple investigations instances where one party or firm that used off-channel communications has preserved and produced them, while the other has not. Not only do these failures delay and obstruct investigations, they raise broader accountability, integrity and spoliation issues.

A proactive compliance approach requires market participants to not wait for an enforcement action to put in place appropriate policies and procedures to preserve these communications and anticipate these emerging challenges. Listen, many of these are not even new technological advances. After all, my 75-year-old mother has been texting my 13-year-old

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daughter for years, and I am certain many in this room have sent or received professional communications on personal devices or unofficial communications channels. You need to be actively thinking about and addressing the many compliance issues raised by the increased use of personal devices, new communications channels, and other technological developments such as ephemeral apps.

Let me turn to the second part of our shared mission, which I'll call proactive enforcement. While this falls primarily on us, each of you have a role to play here as well.

I'm from New Jersey, and I know a thing or two about the Turnpike, and the Garden State Parkway, and about enforcement of my State's laws, having served as a County Prosecutor and as Attorney General. And one thing I know is that if you post a 65 mile-per-hour speed limit and don't enforce it, people drive 75. Not me, of course, but other people. And they eventually do so with a sense of impunity. And then after a while they will drive 80 or faster, with a growing sense of confidence. As speeds climb higher and higher, you eventually have situations where accidents increase and heightened enforcement follows. But for all of the victims, it's too late.

It's a stark analogy, but the point is that we are not waiting for accidents to happen. We are trying to address emerging risks before they cause harm to investors. For example, this summer, the Commission brought enforcement actions against a SPAC, its sponsor, its CEO, the proposed merger target, and the target's founder and former CEO.[13] The SEC's settled order against everyone but the target's CEO found that the target had made misleading claims about its technology and about national security risks associated with its founder and former CEO, and that the SPAC had repeated those misstatements in public filings and failed its due diligence obligations to investors. By bringing this action prior to consummation of the merger, the Commission protected the SPAC's investors from potential harm.

A similarly forward-looking enforcement initiative this past summer involved the new requirement that firms file and deliver Client or Customer Relationship Summaries, known as "Forms CRS." A Form CRS is designed to help retail investors better understand the nature of their relationships with financial firms and individual professionals. In July, the Commission brought enforcement actions against more than two dozen firms that had failed to timely file or to deliver their Forms CRS to their clients and customers.[14] As I said when we announced these cases, they "reinforce the importance of meeting [filing and disclosure] obligations and providing retail investors with information that is intended to help them understand their relationships with their securities industry professionals."[15] Providing retail investors that essential information is the point of the Form CRS requirement, and we will continue to ensure that firms are satisfying their obligations to do so because that's what's required to prevent future investor harm.

Over the last several months, I have heard time and again that we are insufficiently clear regarding our views on cooperation.

You also have a key role to play in spotting and addressing emerging risks, and that's both by ensuring that your proactive compliance efforts continue even after violative conduct has occurred and by working with us in addressing that conduct. Firms' cooperation with our investigations, including through voluntary self-reporting of potential violations, benefits all market participants.

Over the last several months, I have heard time and again that we are insufficiently clear regarding our views on cooperation. So let me try and offer some clarity. First, let me be clear about what cooperation is *not*: cooperation is not the mere absence of obstruction. We do not recommend that parties receive credit for simply living up to their legal and

regulatory obligations. Cooperation—at least the sort of cooperation that results in credit—means more than responding to lawful subpoenas. It means more than making witnesses available for lawfully-compelled testimony. Any defense counsel who advises that credit may be on the table for taking these standard steps is doing their client a disservice.

Cooperation also means more than "self-reporting" to the SEC only when your violation is about to be publicly announced through charges by another regulator or an article in the news media. And it certainly means more than conducting a purportedly independent investigation and making a presentation to the staff that does not fairly present the facts, but instead is nothing more than an advocacy piece.

Penalties are among the most important of our tools, in part because of our ability to tailor them to the violation.

The behaviors that can earn cooperation credit are no secret: the *Seaboard Report* turns 20 years old this month;[16] the SEC's Policy Statement Concerning Cooperation by Individuals was issued in 2010;[17] and the Enforcement Manual includes pages of discussion concerning the relevant tools and analytical frameworks.[18] And in several recent orders, the Commission has described the kinds of behavior that can garner cooperation credit.[19] For example, last September, the Commission charged BMW for disclosing inaccurate and misleading sales numbers in connection with a bond offering.[20] The SEC's order detailed the many steps BMW took during the global pandemic to collect, synthesize, translate where necessary, and present significant volumes of relevant materials to Staff. The order highlighted how "BMW also made multiple current and former employees available for interviews by the Staff, and provided presentations and narrative submissions that highlighted critical facts."[21] In short, BMW's cooperation "substantially advanced the quality and efficiency of the Staff's investigation and conserved Commission resources," and this was reflected in the Commission's decision to impose a reduced penalty against BMW.

But in case it's helpful, let me also tell you how I specifically think about cooperation. I look to whether the would-be cooperator took significant, tangible steps that enhanced the quality of our investigation, allowed us to conserve resources and bring charges more quickly, or helped us to identify additional conduct or other violators that contributed to the wrongdoing. If any or all of these occurred, then credit may be appropriate.

One last thing on cooperation. If you think you deserve credit, and the staff disagrees, I encourage you take a hard, objective look at your conduct during the investigation before trying to convince me the staff is wrong. As someone who has served as a federal prosecutor, local prosecutor, and state Attorney General, I firmly believe that frontline Staff are best-positioned to assess cooperation with the investigations they conduct. They know the record and they know whether you meaningfully benefited those investigations. I respect their experience and will not only seek their input on decisions, but will also generally defer to their expertise and judgment. At the same time, I will not look favorably on attempts to make an end run around staff to present the same, undisputed facts about your conduct to me in hopes of a more sympathetic ear.

Similarly, you should understand that we have a close relationship with our colleagues in EXAMS. If a party or its counsel engage in dilatory or obstructive tactics in an examination that gives rise to a referral, I will take a dim view of arguments that you deserve credit for cooperation with the ensuing enforcement investigation. As I said earlier, a key consideration in weighing cooperation is whether it conserves Commission resources, and this goes for those of our colleagues across the Commission.

Finally, I want to discuss the third step in our shared mission. This one applies when the first two steps have not worked. In that scenario, all of our

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enforcement tools are on the table, including monetary penalties.

Penalties are among the most important of our tools, in part because of our ability to tailor them to the violation. When Congress granted the SEC penalty authority in the Remedies Act of 1990, one perceived benefit was the SEC's ability to more finely calibrate its enforcement remedies against regulated entities, including broker-dealers.[22] By granting penalty authority, the Remedies Act empowered the Commission to impose remedies that were substantially more punitive than a censure, but less draconian than revoking a firm's registration or suspending its operations, and thereby potentially harming its customers.[23]

As we evaluate the relevant penalty factors, we will also be closely assessing whether prior penalties have been sufficient to generally deter the misconduct at issue.

The factors that guide us as we tailor our penalty recommendations are also no secret—we assess the conduct at issue in light of elements including statutory tiers, Commission guidance and judicial opinions, and resolutions in Commission actions involving comparable facts, violations, and parties. One crucial question we also try to answer is what penalty will appropriately deter future misconduct? After all, penalties calibrated to both the offense and the offender, serve two interlocking purposes: punishment of the wrongdoer and deterrence of future misconduct, both by the penalized party and by others in the market.

And central to deterrence is proportionality. The worse the conduct, the more strongly we want to disincentivize market participants from engaging in it. We must design penalties that actually deter and reduce violations, and are not seen as an acceptable cost of doing business.

What does this mean for our approach to penalties in enforcement actions? As Commissioner Crenshaw put it earlier this year: "[C]orporate penalties should be tied to the egregiousness of the actual misconduct."[24] I agree wholeheartedly. But this does not mean that roughly equivalent misconduct by comparable offenders should be penalized in the same amount the hundredth time it occurs as the first. Rather, to achieve the intended deterrent effect, it may be appropriate to impose more significant penalties for comparable behavior over time. Doing so will make it harder for market participants to simply "price in" the potential costs of a violation.

As we evaluate the relevant penalty factors, we will also be closely assessing whether prior penalties have been sufficient to generally deter the misconduct at issue. Where they have not been, you can expect to see us seek larger penalties, both in settlement negotiations and, if necessary, in litigation. Even if a firm or individual hasn't offended before, if they violate a law or rule for which the SEC has previously and publicly charged other actors in their industry, it may be appropriate for penalties or other remedies to be increased in response to the lack of deterrence. So, while penalties levied in the past are certainly a relevant data point for our conversations, you should not expect comparable cases to be the beginning and end of our analysis.

Similarly, one factor that has long weighed in our penalty assessments is the recidivism of the specific offender.[25] When a firm repeatedly violates our laws or rules, they should expect to be penalized more harshly than a first-time offender might be for the same conduct. This is the essence of specific deterrence.

I am confident that by engaging in proactive compliance and meaningful cooperation, and, where necessary, imposing significant, but appropriate penalties, through our enforcement efforts, we will not only reinforce market integrity, but also enhance public confidence in our markets. I look forward to

working with all of you in achieving this, our shared mission.

Notes

1. The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. This speech expresses the author's views and does not necessarily reflect those of the Commission, the Commissioners, or other members of the Staff.
2. Press Release 2020-132, SEC Charges Broker Who Defrauded Seniors Out of Almost $1 Million (June 12, 2020), available at *https://www.sec.gov/news/press-release/2020-132*.
3. Press Release 2021-144, SEC Charges Ernst & Young, Three Audit Partners, and Former Public Company CAO with Audit Independence Misconduct (Aug. 2, 2021), available at *https://www.sec.gov/news/press-release/2021-144*.
4. Press Release 2020-300, SEC Charges Disbarred New York Attorney and Florida Attorney with Scheme to Create False Opinion Letters (Dec. 2, 2020), available at *https://www.sec.gov/news/press-release/2020-300*.
5. Press Release 2018-108, Merrill Lynch Admits to Misleading Customers about Trading Venues (June 19, 2018), available at *https://www.sec.gov/news/press-release/2018-108*.
6. Press Release 2018-151, SEC Charges U.S. Congressman and Others With Insider Trading (Aug. 8, 2018), available at *https://www.sec.gov/news/press-release/2018-151*.
7. Press Release 2021-203, SEC Charges Investment Bank Compliance Analyst with Insider Trading in Parents' Accounts and Obtains Asset Freeze (Sept. 29, 2021), available at *https://www.sec.gov/news/press-release/2021-203*.
8. *See* Robert Khuzami, Remarks at November 5, 2009 Press Conference, available at *https://www.sec.gov/news/speech/2009/spch110509rk.htm*.
9. *See, e.g.*, "Survey: More than half of investors think the stock market is rigged against individuals" (Mar. 24, 2021), available at *https://www.bankrate.com/investing/stock-market-financial-security-march-2021/*; "Earning Investors' Trust: How the Desire for Information, Innovation, and Influence Is Shaping Client Relationships," at 4 (finding that "57% of retail investors with an adviser and just 33% of retail investors without an adviser" trust the financial services industry), available at *https://trust.cfainstitute.org/wp-content/uploads/2020/05/CFAI_TrustReport2020_FINAL.pdf*. *See also* "Redditors Are Right About the Unfairness of the Market," Bloomberg Opinion (Oct. 1, 2021), available at *https://www.bloomberg.com/opinion/articles/2021-10-01/ordinary-investors-don-t-get-a-fair-shot-when-the-powerful-flout-the-rules?srnd=premium&sref=R3I5j1tS*.
10. Gary Gensler, Remarks at 2021 FINRA Annual Conference (May 20, 2021), available at *https://www.sec.gov/news/speech/gensler-finra-conference*.
11. *See, e.g.*, Regulation Best Interest, Exchange Act Release No. 86031, at 253 (June 5, 2019) ("The Care Obligation significantly enhances the investor protection provided as compared to current suitability obligations by: (1) explicitly requiring in Regulation Best Interest that recommendations be in the best interest of the retail customer and do not place the broker-dealer's interests ahead of the retail customer's interests; (2) explicitly requiring by rule the consideration of costs when making a recommendation; and (3) applying the obligations relating to a series of recommended transactions (currently referred to as "quantitative suitability") irrespective of whether a broker-dealer exercises actual or de facto control over a customer's account."), available at *https://www.sec.gov/rules/final/2019/34-86031.pdf*.
12. *See* Administrative Summary File No. 3-20050, "SEC Charges Broker-Dealer with Failing to Preserve Required Electronic Records" (Sept. 23, 2020), available at *https://www.sec.gov/enforce/34-89975-s*.
13. *See* Press Release 2021-124, SEC Charges SPAC, Sponsor, Merger Target, and CEOs for Misleading Disclosures Ahead of Proposed Business Combination (July 13, 2021), available at *https://www.sec.gov/news/press-release/2021-124*.
14. *See* Press Release 2021-139, SEC Charges 27 Financial Firms for Form CRS Filing and Delivery Failures (July 26, 2021), available at *https://www.sec.gov/news/press-release/2021-139*.
15. *Id.*
16. *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency

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Enforcement Decisions, Securities Exchange Act Release No. 44969 (Oct. 23, 2001), available at *http://www.sec.gov/litigation/investreport/34-44969.htm*.

17. Policy Statement of the Securities and Exchange Commission Concerning Cooperation by Individuals in its Investigations and Related Enforcement Actions, Securities Exchange Act Release No. 61340 (Jan. 13, 2010), available at *http://www.sec.gov/rules/policy/2010/34-61340.pdf*.
18. *See* Securities and Exchange Commission Division of Enforcement, Enforcement Manual, § 6 (Nov. 28, 2017), available at *https://www.sec.gov/divisions/enforce/enforcementmanual.pdf*.
19. *See*, *e.g.*, *see* Press Release 2021-33, SEC Charges Gas Exploration and Production Company and Former CEO with Failing to Disclose Executive Perks (Feb. 24, 2021), available at *https://www.sec.gov/news/press-release/2021-33*; Administrative Summary File No. 3-20105, Denver Investment Adviser Settles Charges for Disclosure Failures (Sept. 30, 2020), available at *https://www.sec.gov/enforce/ia-5599-s*; Press Release 2020-169, Pharmaceutical Company and Former Executives Charged With Misleading Financial Disclosures (July 31, 2020), available at *https://www.sec.gov/news/press-release/2020-169*; Administrative Summary File No. 3-19532, SEC Charges PPG Industries with Fraudulent Financial Reporting (Sept. 26, 2019), available at *https://www.sec.gov/enforce/33-10701-s*.
20. *See* Press Release 2020-223, SEC Charges BMW for Disclosing Inaccurate and Misleading Retail Sales Information to Bond Investors (Sept. 24, 2020), available at *https://www.sec.gov/news/press-release/2020-223*.
21. *See* In the Matter of Bayerische Motoren Werke Aktiengesellschaft, et al., File No. 3-20060 (Sept. 24, 2020), available at *https://www.sec.gov/litigation/admin/2020/33-10850.pdf*.
22. *See* Philip R. Lochner. Jr., "The SEC's New Powers Under the Securities Enforcement Remedies and Penny Stock Reform Act of 1990," at 12 (Oct. 4, 1990) ("The availability of civil money penalties will provide both the courts and the Commission with greater flexibility to tailor a remedy to the seriousness of the violation. This flexibility will be particularly helpful in administrative proceedings against registered broker-dealers and other regulated entities"), available at *https://www.sec.gov/news/speech/1990/100490lochner.pdf*.
23. *Id*. at 12-13.
24. *See* Caroline A. Crenshaw, Moving Forward Together—Enforcement for Everyone (Mar. 9, 2021), available at *https://www.sec.gov/news/speech/crenshaw-moving-forward-together*.
25. *See*, *e.g*., 15 U.S.C. § 78u-2(c)(4) ("In considering under this section whether a penalty is in the public interest, the Commission or the appropriate regulatory agency may consider . . . whether such person previously has been found by the Commission, another appropriate regulatory agency, or a self-regulatory organization to have violated the Federal securities laws, State securities laws, or the rules of a self-regulatory organization, has been enjoined by a court of competent jurisdiction from violations of such laws or rules, or has been convicted by a court of competent jurisdiction of violations of such laws . . ."). *See also*, S.E.C. v. Haligiannis, 470 F.Supp.2d 373, 386 (S.D.N.Y. 2007) ("In determining whether civil penalties should be imposed, and the amount of the fine, courts look to a number of factors, including . . . whether the defendant's conduct was isolated or recurrent.")

NASDAQ LISTINGS

Nasdaq Makes It More Difficult for Companies Based in "Restrictive Markets" to List

The SEC has approved Nasdaq's proposal that will impose additional listing conditions on companies located in countries which do not provide access to the PCAOB to inspect the public accounting firms in those jurisdictions, including China.

By Iris Leung, Lipton Li, and Jeffrey Cohen

The US Securities and Exchange Commission (SEC) has approved the Nasdaq Stock Market's (Nasdaq) revised proposal to impose further listing conditions on companies in jurisdictions, such as China, that do not provide the US Public Company Accounting Oversight Board (PCAOB) with access to conduct inspections of public accounting firms that audit Nasdaq-listed companies (a Restrictive Market).[1]

For a company that chooses to list on Nasdaq through a traditional initial public offering (IPO) or a merger with a special purpose acquisition company (SPAC), the additional condition is a minimum amount or market value of securities in public hands. For a company that lists through a direct listing, Nasdaq will only allow listing on the Nasdaq Global Select Market or Nasdaq Global Market, and not the Nasdaq Capital Market.

Background

Companies that are public in the United States are required to file audited financial statements with the SEC. Under the Sarbanes-Oxley Act of 2002, the auditor of the financial statements filed with the SEC must be registered with the PCAOB, which means that the audit firm is subject to regular PCAOB inspections to assess the auditor's compliance with applicable US laws and professional standards in connection with its audits of public companies. Auditing firms that are based in China, including the local affiliates of the "Big Four" accounting firms, have to date refused to allow PCAOB inspections.

The China-based auditors maintain that the production of audit papers would violate Chinese law, potentially as a disclosure of state secrets. The SEC and PCAOB have made accommodations for this situation, to enable listings of China-based issuers, under a 2013 Memorandum of Understanding with Chinese securities regulators. However, PCAOB access to the work papers of China-based auditors has remained restricted.

In 2020, the US Congress adopted legislation, known as the Holding Foreign Companies Accountable Act (HFCA Act), which requires the SEC to prohibit from trading, on a US securities exchange or "over-the-counter," the securities of SEC-reporting issuers whose financial statements have not been audited, for three consecutive years, by accounting firms subject to PCAOB inspection.[2] It also requires non-US issuers that use accounting firms not subject to PCAOB inspection to disclose ownership and control by non-US governmental entities, and to identify Chinese Communist Party officials on their boards of directors.

Earlier this year, the SEC took its first step towards implementing the HFCA Act by adopting an interim final rule that will require certain SEC-reporting companies, mainly those based in China, to make specific disclosures regarding government control and influence over these companies.[3] However, the SEC has not yet identified the affected issuers and

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not acted on the HFCA Act provisions that would require trading prohibitions on the securities of these companies.

Nasdaq's Revised Amendments

Nasdaq is concerned that the lack of transparency in Restrictive Markets compromises the accuracy of disclosures, accountability, and access to information, which is compounded when a "Restrictive Market Company" lists with a small offering size or a low public float percentage because they may not attract market attention and develop sufficient public float, investor base, and trading interest to provide the depth and liquidity necessary to promote fair and orderly trading.

Consequently, the new listing conditions with respect to listings through IPOs and SPAC mergers focus on a minimum amount or market value of publicly held securities. The new restrictions include:

- **Listing by IPO.** New Nasdaq Rule 5210(k)(i) will require a Restrictive Market Company listing its primary equity securities on Nasdaq in connection with its IPO to offer a minimum number of securities in a firm commitment offering in the United States to public holders that: (i) will result in gross proceeds to the company of at least $25 million or (ii) will represent at least 25 percent of the company's post-offering market value of listed securities, whichever is lower. Public holders include both beneficial holders and holders of record, but do not include any holder who is, either directly or indirectly, an executive officer, director, or the beneficial holder of more than 10 percent of the total shares outstanding. A Restrictive Market Company listing on the Nasdaq in connection with an IPO that is subject to the new rule would also need to comply with all other applicable listing requirements.
- **Listing by SPAC Merger.** New Nasdaq Rule 5210(k)(ii) will require a company that is conducting a business combination with a Restrictive Market Company to have a minimum market value of unrestricted publicly held shares following the business combination equal to the lesser of (i) $25 million or (ii) 25 percent of the post-business combination entity's market value of listed securities. Unrestricted publicly held shares are publicly held shares (that is, not held directly or indirectly by an officer, director or any person who is the beneficial owner of more than 10 percent of the total shares outstanding) that are not restricted securities. A Restrictive Market Company subject to the proposed rule would also need to comply with all other applicable listing requirements.

Under the new rules, a Restrictive Market Company may not list on the Nasdaq Capital Market (which has easier listing requirements than the other Nasdaq markets) in connection with a direct listing, but may list on the Nasdaq Global Select Market or Nasdaq Global Market, provided that it meets all applicable initial listing requirements for those markets.

Earlier versions of Nasdaq's proposals would have required Restrictive Market Companies to certify that they had a member of senior management or a director with relevant employment experience at a US-listed public company. Nasdaq was also considering imposing additional conditions on Restrictive Market Company listings such as higher equity, assets, earnings or liquidity measures; any offering to be underwritten on a firm commitment basis; and the imposition of lock-up restrictions on officers and directors.

"Restrictive Markets" previously had been defined more broadly to include jurisdictions with secrecy laws, blocking statutes, national security laws, or other laws or regulations restricting access to information by regulators of US-listed companies in these jurisdictions.

What Is a "Restrictive Market Company"?

Nasdaq will consider a company's business to be principally administered in a Restrictive Market if: (i)

the company's books and records are located in that jurisdiction; (ii) at least 50 percent of the company's assets are located in such jurisdiction; or (iii) at least 50 percent of the company's revenues are derived from such jurisdiction.

If Company X's books and records are located in Country Y (not a Restrictive Market), while 90 percent of its revenues are driven from operations in Country Z (a Restrictive Market), Nasdaq would consider Company X's business to be principally administered in Country Z, so Company X would be considered a Restrictive Market Company.

If Company A's books and records are located in Country B (a Restrictive Market), but 90 precent of its revenues are derived from Country C (not a Restrictive Market, Nasdaq would consider Company A's business to be principally administered in Country B, so Company A would be considered a Restrictive Market Company.

Notes

1. *https://www.sec.gov/rules/sro/nasdaq/2021/34-93256.pdf.*
2. *https://www.linklaters.com/knowledge/publications/alerts-newsletters-and-guides/2020/december/07/us-listed-chinese-companies-face-delisting-risk-under-new-us-law.*
3. *https://www.linklaters.com/knowledge/publications/alerts-newsletters-and-guides/2021/march/30/sec-takes-first-steps-to-put-in-force-the-holding-foreign-companies-accountable-act.*

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INSIDE THE SEC

Coming Soon? A Finalized Clawback Rule from the SEC

By Allison Handy and Kelly Reinholdtsen

After a false start, when the Securities Exchange Commission (SEC) canceled an open Commission meeting to re-open the comment period on its 2015 clawback rule proposal, the SEC's Commissioners unanimously approved in seriatim re-opening the proposal the following day.[1]

As stated in the new release providing a 30-day comment period and the related fact sheet, the SEC may interpret the Dodd-Frank provision mandating this rulemaking more broadly this time around. Here's an excerpt from the fact sheet driving this point home:[2]

> These requests for comment include, among other things, whether "an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws" as used in the Dodd-Frank Act should be read more broadly than initially proposed and whether the proposed "reasonably should have concluded" standard for triggering a lookback should be revised.

While there are several new requests for comment outlined in this re-opening release (and the public is free to comment on all aspects of the 2015 proposal as well), the one that is of greatest interest to many is the question of whether certain restatements that are often called "little r" or "revision" restatements should trigger clawbacks. An error is corrected through a "little r" restatement when the error is immaterial to the prior period financial statements.

The proposal notes that there are concerns that "issuers may not be making appropriate materiality determinations for errors identified." The implication is that management might push for a "revision" restatement rather than a material restatement to avoid compensation recovery under clawback policies.

On the other hand, there is also a concern that making this change could create an undue burden on companies to analyze the potential for clawbacks when the restatement involved would result in insignificant or no actual difference in executive compensation. The latest Regulatory Flexibility Agenda indicated that this re-opening of the comment period would happen by next April, so the SEC is ahead of schedule.

Allison Handy *and* **Kelly Reinholdtsen** *are attorneys of Perkins Coie LLP.*

Notes

1. *https://www.sec.gov/news/upcoming-events/open-meeting-101321*.
2. The release is available at *https://www.sec.gov/rules/proposed/2021/33-10998.pdf*. The fact sheet is available at *https://www.sec.gov/rules/proposed/2021/33-10998-fact-sheet.pdf*.

IN THE COURTS

Delaware Supreme Court Adopts a New "Universal" Test for Establishing Demand Futility

By Paul J. Walsen, Molly K. McGinley, Nicole C. Mueller, and Ashley E. Gammell

The Supreme Court of Delaware recently adopted a new three-part "universal" test to determine whether pre-suit demand upon a company's board should be excused as futile. The new test, endorsed by the Court in *United Food and Commercial Workers Union and Participating Food Industry Employers Tri-State Pension Fund v. Zuckerberg*, may make it easier for boards of directors to obtain dismissal of putative stockholder derivative suits on a motion to dismiss. In adopting the new test, the Court also reaffirmed its commitment to the "cardinal precept" of Delaware law, which posits that absent extraordinary circumstances, directors, rather than stockholders, should control a company's litigation decisions.

This decision arose from the decision by the board of directors of Facebook, Inc. (Facebook) to approve a stock reclassification that allowed Mark Zuckerberg, Facebook's controller, chairman, and chief executive officer, to sell most of his Facebook stock while maintaining voting control of the company. Shortly thereafter, a number of stockholders filed class action lawsuits in the Delaware Court of Chancery challenging the reclassification.

The suits were consolidated into a single action which was mooted shortly before trial when Facebook abandoned the reclassification. Facebook spent more than US$21 million in defense of the consolidated litigation, and paid counsel for the plaintiffs more than US$68 million in attorney fees pursuant to the corporate benefit doctrine.

Paul J. Walsen, Molly K. McGinley, Nicole C. Mueller, *and* **Ashley E. Gammell** *are attorneys at K&L Gates LLP.*

United Food and Commercial Workers Union and Commercial Workers Union and Participating Food Industry Employers Tri-State Pension Fund (Tri-State), then brought this derivative action, seeking to recoup the approximately US$90 million Facebook had spent in connection with the prior class action. Tri-State's complaint named as defendants Mr. Zuckerberg and five other individuals who served on Facebook's board at the time the reclassification was approved. (At the time Tri-State filed its complaint, the board included the six defendants as well as three directors who joined the board after the reclassification was approved.)

Rather than making a pre-suit demand on the board under Court of Chancery Rule 23.1, Tri-State alleged that demand was excused as futile because, among other things, (1) the board's negotiation and approval of the reclassification was not a valid exercise of its business judgment and (2) a majority of the Facebook directors lacked independence from Mr. Zuckerberg.

Facebook and the defendants moved to dismiss the complaint, arguing that Tri-State did not adequately allege that demand was futile under *Aronson v. Lewis.*[1]

The *Aronson* and *Rales* Tests for Demand Futility

In order for a stockholder to bring a derivative claim (that is, an action asserted on behalf of the corporation), the stockholder must either make a demand on the company's board of directors or allege particularized facts establishing that demand would be futile. As the Delaware Supreme Court explained in *Tri-State*, "[t]he purpose of the demand-futility analysis is to assess whether the board should be

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deprived of its decision-making authority because there is reason to doubt that the directors would be able to bring their impartial business judgment to bear on a litigation demand."

Prior to *Tri-State*, the Delaware Supreme Court had established two tests to determine whether a pre-suit demand should be excused as futile: the *Aronson* test[2] and the *Rales* test.[3]

The *Aronson* test was applied when the litigation challenged a decision by the same board that would be charged with considering a pre-suit demand. Under *Aronson*'s two-part test, a pre-suit demand was excused if the complaint alleged facts with particularity which raised a reasonable doubt that either the directors are disinterested and independent, or the challenged transaction was otherwise the product of valid business judgment.

The *Rales* test was applied in all other circumstances. Under *Rales*, demand is excused as futile if the complaint alleged particularized facts creating a reasonable doubt that, as of the time the complaint was filed, a majority of the board could have properly exercised independent and disinterested business judgment in responding to the demand. As the Supreme Court observed in Tri-State, "the broader reasoning of Rales encompasses *Aronson*, and therefore the *Aronson* test is best understood as a special application of the *Rales* test."

Section 102(b)(7) of the General Corporation Law of the State of Delaware (Section 102(b)(7)) was enacted shortly after *Aronson* was decided. Section 102(b)(7) permits Delaware corporations to adopt a corporate charter provision which exculpates directors from monetary liability for breaches of the duty of care. Before the enactment of Section 102(b)(7), "rebutting the business judgment rule through allegations of care violations exposed directors to a substantial likelihood of liability" which could prevent them from independently and disinterestedly responding to a demand.

Following the adoption of Section 102(b)(7), some courts struggled with the question of whether a claim for breach of the duty of care could satisfy the second prong of the *Aronson* test. The *Tri-State* decision resolves that question by holding that allegations that a director breached his or her duty of care cannot establish demand futility where a director is protected by a Section 102(b)(7) provision, and consolidates the *Aronson* and *Rales* tests into a single test of universal application.

The Universal Tri-State Test for Demand Futility

The Court of Chancery dismissed the *Tri-State* action pursuant to Court of Chancery Rule 23.1 for failure to adequately allege facts establishing demand futility. In reaching this result, the court combined elements of the *Aronson* and *Rales* tests to create a hybridized three-part test to determine whether pre-suit demand is excused. The Delaware Supreme Court affirmed the Court of Chancery's ruling and formally adopted "as the universal test for assessing whether demand should be excused as futile" the same three-part test used by the lower court. Under the *Tri-State* test, courts should evaluate the following three questions on a director-by-director basis:

1. Whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand;
2. Whether the director faces a substantial likelihood of liability on any of the claims that would be the subject of the litigation demand; and
3. Whether the director lacks independence from someone who received a material personal benefit from the alleged misconduct that would be the subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand.

If the answer to any of the questions is yes for at least half of the members of the board who would be considering the demand, demand is excused as futile. The Delaware Supreme Court stressed that the new test "is consistent with and enhances Aronson, Rales and their progeny" and thus "cases properly applying those holdings remain good law."

To the extent there was any confusion previously, the Delaware Supreme Court clarified that the first prong of *Aronson*, which is now the first prong of *Tri-State*, considers whether the directors had a "personal financial benefit from the challenged transaction that is not equally shared by the stockholders," which is different from the consideration as to whether the directors face a substantial likelihood of liability for approving the challenged transaction.

Importantly, the Delaware Supreme Court also held that exculpated duty of care claims do not satisfy the second prong of *Aronson*, and cannot give rise to a substantial likelihood of liability for purposes of the universal test adopted by the Court in *Tri-State*.[4]

Finally, the Court emphasized that the demand futility inquiry is analytically distinct from an inquiry into the propriety of the underlying transaction being challenged, and thus should be conducted without reference to the standard of review applicable to the transaction. The Court explained that the question addressed by the demand futility test—"whether the board should be stripped of its decision-making authority because there is reason to doubt that the directors would be able to bring their impartial business judgment to bear on a litigation demand"—is a "different consideration than whether the derivative claim is strong or weak because the challenged transaction is likely to pass or fail the applicable standard of review."

Applying the new three-part test to the *Tri-State* complaint on a director-by-director basis, the Delaware Supreme Court held the complaint failed to allege that pre-suit demand should be excused as futile and concluded that the Court of Chancery properly dismissed Tri-State's complaint for failing to make a demand on the board. Delaware Courts of Chancery have already begun applying the *Tri-State* test to pending derivative lawsuits.

Notes

1. Aronson v. Lewis, 473 A.2d 805 (Del. 1984).
2. *Id*. at 814.
3. Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993).
4. See *Genworth Financial, Inc. Consolidated Derivative Litigation*, C.A. No. 11901-VCS, 2021 WL 4452338, at *16 (Del. Ch. 29 Sept., 2021) (dismissing derivative lawsuit and noting that the *Tri-State* test resolved prior conflicting authority on whether purposeful inaction by a board was analyzed under the *Aronson* or *Rales* framework).

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CLIENT MEMOS

A summary of recent memoranda that law firms have provided to their clients and other interested persons concerning legal developments. Firms are invited to submit their memoranda to the editor. Persons wishing to obtain copies of the listed memoranda should contact the firms directly.

Davis Polk & Wardwell LLP
New York, NY (212-450-4000)

SEC Reopens Comment Period for its Dodd-Frank Clawback Rule (October 18, 2021)

On October 14, 2021, the Securities and Exchange Commission (SEC) announced that it is reopening the comment period for its proposed clawback rule, which has languished ever since Congress directed the SEC to adopt it in the Dodd-Frank Act.

NYSE Proposes to Amend "Votes Cast" (October 4, 2021)

A proposed NYSE amendment would eliminate the requirement to include abstentions as "votes cast" against a company's proposal. Instead, companies would be able to follow their own governing documents and state law.

Dechert LLP
Washington, DC (202-261-3300)

Second Circuit Upholds Enforceability of SEC Tolling Agreements (October 4, 2021)

Recently, the US Court of Appeals for the Second Circuit issued its decision in *SEC v. Fowler*, 6 F.4th 255 (2d Cir. 2021), rejecting an argument that a federal district court lacked subject matter jurisdiction over a SEC enforcement action that relied on a tolling agreement. The decision largely eliminates any lingering uncertainty that may have remained as to whether certain tolling agreements with the SEC may be vulnerable to a jurisdictional challenge based on the statute of limitations.

Jones Day LLP
Dallas, TX (214-220-3939)

SEC Announces $110 Million Award to Whistleblower and $1.1 Billion in Total Awards to 214 Individuals Since 2012 (October 11, 2021)

The accelerated pace and size of awards to whistleblowers totaling more than $530 million in SEC Fiscal Year 2021 underscores the commitment to the whistleblower program under new SEC leadership.

Kirkland & Ellis LLP
New York, NY (212-446-4800)

Preparing for Potential Updates to Human Capital Management & Board Diversity Disclosure Requirements (October 1, 2021)

In 2021, in response to new Regulation S-K amendments, companies expanded disclosures related to HCM and DEI matters in their proxy statements and 10-Ks and saw a marked increase in investor support for DEI-related shareholder proposals compared to prior years.

Latham & Watkins LLP
Chicago, IL (312-876-7700)

Climate Disclosures and the SEC (October 8, 2021)

SEC Chair Gary Gensler has publicly stated that the SEC will propose a rule to require climate-related disclosures in public filings and that the proposal will likely be made before the end of this year.

Norton Rose Fulbright LLP
Washington, DC (202-662-0200)

US Justice Department's "Surging" Resources to Corporate Enforcement (October 6, 2021)

High-level officials at the US Justice Department are warning that the DOJ is "surging" resources in a new effort to combat corporate crime.

Paul Weiss LLP
New York, NY (212-373-3000)

Private Equity Firms Face Increasing False Claims Act Scrutiny (October 1, 2021)

This summer, the US Department of Justice announced a $15.3 million settlement with medical testing company Alliance Family of Companies LLC, resolving claims brought under the False Claims Act, 31 U.S.C. §§ 3279 et seq. Notably, the Justice Department also reached a $1.8 million settlement with Alliance Family's minority owner, the private equity firm Ancor Holdings LP, based on allegations that it discovered the alleged activity of its portfolio company during diligence but took no actions to stop it.

Sidley Austin LLP
Chicago, IL (312-853-7000)

SEC Climate Change Comment Letters Signal Early Action on Environmental, Social, and Governmental Disclosures (October 7, 2021)

On September 22, the SEC released a Sample Letter to Companies Regarding Climate Change Disclosure. The letter illustrates the type of comments the SEC's Division of Corporation Finance has been issuing to companies asking detailed and specific questions regarding climate-related disclosure or the absence of such disclosure in companies' recent Form 10-Ks.

Skadden, Arps, Slate, Meagher & Flom LLP
New York, NY (212-735-3000)

The Informed Board (October 2021)

Take stock of the Biden administration's dramatic reorientation of antitrust enforcement, and understand how directors should cope with accusations against senior executives and how to ensure that a shareholder records demand doesn't result in the disclosure of casual communications.

Sullivan & Cromwell LLP
New York, NY (212-558-4000)

White House Issues Roadmap to Address Climate-Related Financial Risk (October 18, 2021)

On October 14, 2021, the White House issued a report entitled "A Roadmap to Build a Climate-resilient Economy," which was mandated by President Biden's May 2021 executive order on "Climate-Related Financial Risk." It presents the Administration's "roadmap for measuring, disclosing, managing and mitigating climate-related financial risk across the economy," while "catalyzing public and private investment to seize the opportunity of a net-zero, clean energy future."

California Governor Signs AB 663, Enabling California Corporations to Hold Virtual Shareholder Meetings During Emergencies (October 11, 2021)

California Governor Gavin Newsom signed into law AB 663, which provides corporations with greater flexibility to hold virtual-only shareholder meetings during emergencies, and also expands corporations' ability to permit remote participation at physical meetings, even absent an emergency.

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Troutman Pepper LLP
Wilmington, DE (302-777-6500)

Delaware Supreme Court Adopts New Three-Part Test for Demand Futility (October 1, 2021)

There is a new demand futility test in Delaware, adopted on September 23th by the Delaware Supreme Court in affirming dismissal of a stockholder derivative action against Facebook founder, Mark Zuckerberg, and other members of Facebook's board of directors.

Vinson & Elkins LLP
Dallas, TX (215-220-7700)

Document Management: An Ounce of Prevention (October 7, 2021)

You cannot overstate the importance of document management as a risk mitigation strategy for corporations. Provides a "Top 10 Tips" list for setting up and using a DMS.

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