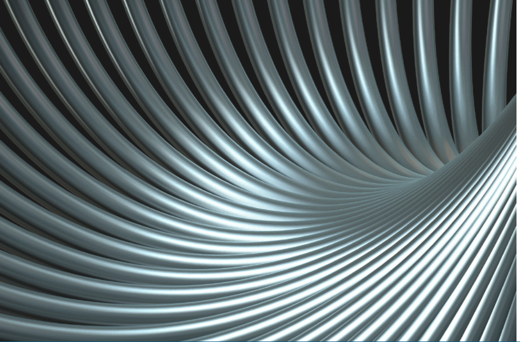

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ANALYSIS

RECENT DOJ CRIMINAL AND CYBER FRAUD DEVELOPMENTS—PREPARING FOR THE SIGNALED STEP-UP IN ENFORCEMENT

By Geeta Malhotra, Sujit Raman, Brenna Jenny, Jackie Pruitt and Allison L. Dapper[1]

In recent months, the U.S. Department of Justice (DOJ) has taken multiple steps and made several public statements that collectively signal more aggressive scrutiny of alleged corporate wrongdoing. Most notably, in the criminal context, U.S. Deputy Attorney General Lisa Monaco announced three changes to DOJ corporate enforcement policies and previewed other steps to "surge resources" and evaluate corporate compliance in the context of such enforcement.

Through separate speeches by Monaco and Acting Assistant Attorney General Brian Boynton, DOJ also recently announced a new Civil Cyber-Fraud Initiative that will leverage the federal False Claims Act to pursue cybersecurity-related fraud.

Companies should review these developments—each of which is discussed below—to critically assess their applicability and, if appropriate, consider steps they may take to help prepare for and mitigate the risk of the signaled forthcoming enforcement.

Recent Changes to Enforcement Policies

DOJ recently announced three significant changes to DOJ corporate enforcement policies that (1) emphasized a renewed focus on individual accountability, (2) expanded the scope of relevant misconduct to be considered in the context of corporate resolutions and (3) removed the previously imposed default presumption against the use of corporate monitors. These changes broadly impact enforcement policies across all components of DOJ.

Regarding the first change, Monaco explained that DOJ would restore the more aggressive principles found in guidance issued in 2015—commonly referred to as the "Yates Memo," as it was released by then-Deputy Attorney General Sally Yates—that required companies seeking cooperation credit to provide all non-privileged information about "all individuals" involved in or responsible for corporate misconduct, regardless of an individual's status, seniority, position or level of involvement. In 2018, the principles outlined in the Yates Memo were subsequently narrowed by the Trump administration, which limited the scope of required disclosure to individuals "substantially involved" in the corporate misconduct. According to Monaco, companies will again be required to disclose "all non-privileged information about individual wrongdoing," and DOJ's "first priority in corporate criminal matters" is the prosecution of "individuals who commit and profit from corporate malfeasance."

As to the second policy change, Monaco announced that DOJ will significantly expand the scope of prior corporate misconduct to be considered when determining the appropriate corporate resolution. Under the previous framework, for example, in criminal cases, DOJ considered only past criminal misconduct that was similar to the conduct under investigation. The new framework will take into account a company's "whole criminal, civil and regulatory" record, even actions in other countries or states, "whether or not that misconduct is similar to the conduct at issue in a particular investigation." The change is focused on evaluating a company's overall commitment to compliance and whether the company culture as a whole disincentivizes misconduct. Nevertheless, such an expansive scope suggests the possibility of stricter criminal settlement resolutions for companies that

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have a history of civil or regulatory misconduct and could pose challenges to companies in heavily regulated industries, which often are more susceptible to the risk of investigation and enforcement.

The third policy change is focused on the use of an independent monitor to assess and monitor a company's forward-looking compliance with corporate resolutions. Monaco rescinded any prior DOJ guidance suggesting that corporate monitors are "the exception and not the rule" or that such appointments are "disfavored." In doing so, she emphasized the importance of the company's compliance program—noting that corporate resolutions "involve[] a significant amount of trust on the part of the government…that a corporation will commit itself to improvement, change its corporate culture, and self-police its activities"—and highlighted the usefulness of monitorships when that "trust is limited or called into question."

In a policy shift, DOJ will significantly expand the scope of prior corporate misconduct to be considered when determining the appropriate corporate resolution. The new framework will take into account a company's "whole criminal, civil and regulatory" record, even actions in other countries or states, "whether or not that misconduct is similar to the conduct at issue in a particular investigation."

Finally, while not a change to formal policy, Monaco explained that DOJ is devising ways to provide more resources to prosecutors; highlighted new tools (including data analytics) to be used to identify misconduct and investigate cases; emphasized the national security aspects of corporate crime (including as related to sanctions, export controls and cybersecurity); and encouraged white collar prosecutors to be "bold" in their work. She also announced the formation of the Corporate Crime Advisory Group, which will, among other things, review corporate resolutions to identify "repeat offenders" and determine whether pretrial diversion remains appropriate for those companies. DOJ will also evaluate current compliance by companies with pre-existing deferred prosecution agreements (DPAs) and non-prosecution agreements (NPAs) and will enforce consequences for noncompliance.

According to Monaco, these changes represent "the first steps to reinforce [DOJ's] commitment to combat corporate crime," and companies therefore should "look[] to the future."

More recently, on December 6, 2021, the Biden administration released its first ever United States Strategy on Countering Corruption (Strategy). The Strategy, which follows President Biden's June 3rd national security memorandum identifying corruption as a core national security interest, further highlights the administration's heightened focus on combatting fraud and corruption. The Strategy outlines "five mutually-reinforcing pillars" with several accompanying strategic objectives including, among other things: modernizing U.S. government efforts and leveraging new technology (*e.g.*, data analytics); devoting additional resources to anti-corruption efforts; holding corrupt actors accountable as well as parties who enable and facilitate corruption; enhancing enforcement of existing laws and working with partners to create complementary regimes; and encouraging the adoption and enforcement of compliance programs in the privacy sector. For more information about the Strategy, see the Sidley Update available here.

Government actions and statements to date signal an impending uptick in corporate enforcement, particularly criminal matters, and an emphasis on the importance of strong corporate compliance programs, individual accountability and the rooting out of recidivism. With such considerations in mind, below are some questions that companies should consider, as appropriate, when evaluating their own compliance posture and readiness to confront the signaled shifts.

- Does the company exhibit an appropriate tone at the top, emphasizing its commitment to a culture of compliance and lawfulness by its top management and governance?
- Are the company's existing compliance policies and practices designed to proactively stop misconduct and hold individuals accountable?
- Do the policies address relevant issues that the company and its employees may face in the course of business as well as relevant market risks and developments in law and technology? Relatedly, is the company engaging in risk assessments?

- Are corporate communication channels open such that lessons learned from prior misconduct are communicated and implemented effectively?
- Is the company adequately investing in its compliance personnel function and allocating sufficient resources to help anticipate, identify and address compliance problems?
- Are there new tools, services or techniques, including through the use of data analytics or third-party services, that the company could implement to proactively identify and remediate potential misconduct?
- Is the company monitoring and auditing its compliance program, including through the potential periodic use of third-party compliance assessments where appropriate?
- Does the compliance program address not just potential corporate criminal fraud issues but also the relevant civil and regulatory frameworks under which the company operates?
- Are employees aware of the company's compliance hotline and nonretaliation policies and encouraged to use the hotline? Are hotline submissions appropriately investigated?
- Do the company's investigations procedures facilitate objective fact-finding regardless of the subject matter or position(s) of the personnel at issue, including through the use of outside counsel where appropriate?
- If the company has faced past enforcement actions—in the criminal, civil or regulatory context—has the company been attentive to and compliant with its obligations as set forth by the governing resolution agreement? Has the company remediated prior issues?
- Does the company's discipline policy adequately deter misconduct and hold individuals accountable as appropriate?
- Ultimately, would the compliance program instill confidence if tested by regulators and reflect that the company can be trusted to commit itself to ongoing improvement and change?

New Cyber-Fraud Initiative

DOJ recently launched a new Civil Cyber-Fraud Initiative that, according to U.S. Deputy Attorney General Lisa Monaco, will leverage the False Claims Act "to identify, pursue, and deter cyber vulnerabilities and incidents that arise with government contracts and grants and that put sensitive information and critical government systems at risk."

DOJ also recently launched a new Civil Cyber-Fraud Initiative that, according to Monaco, "will leverage civil enforcement tools to pursue…government contractors who receive federal funds, when they fail to follow required cybersecurity standards."

This new initiative focuses on government contractors (and subcontractors) and federal grant recipients and does not create new cybersecurity obligations or requirements. Instead, DOJ will leverage the False Claims Act "to identify, pursue, and deter cyber vulnerabilities and incidents that arise with government contracts and grants and that put sensitive information and critical government systems at risk."

The focus, according to Boynton, will be on cases where "federal agencies are the victims." In his remarks, Boynton identified "at least three common cybersecurity failures" that would be "prime candidates" for such enforcement:

- the knowing failure by a company to comply with cybersecurity standards, including specific terms or standards outlined by contract
- the knowing misrepresentation of security controls, services or practices—for example, representations concerning system security plans that detail controls in place, the company's practices for system monitoring or password and access requirements
- the knowing failure by a company to timely report suspected breaches to the government, if required by law or contract

Use of the False Claims Act can have significant implications for companies. Application of this statute has the potential to result in the imposition of large financial penalties as well as the possibility of treble damages and the risk of more far-reaching consequences such as suspension, debarment or exclusion. The False Claims Act also includes a provision that allows whistleblowers (employees or others) to file *qui tam* actions on the government's behalf and to share in funds recovered. This provision in particular was highlighted by Monaco and Boynton in their respective remarks and is likely to attract whistleblowers from, for instance, the defense sector—which, even prior to this initiative, had seen False Claims Act cases tied to allegations of cybersecurity noncompliance—and further increase *qui tams* in other industries where cybersecurity is relevant to the products and services provided to the government and this statutory tool is already used with frequency, such as healthcare.

Companies that are federal contractors, subcontractors or grant recipients should take note of the recently launched Cyber-Fraud Initiative and pay special attention to the program's stated objectives, the common areas of concern cited to date by DOJ, and future developments in this area. In addition, to help mitigate potential risk, they should consider the following steps, as applicable:

- Examine cybersecurity policies and practices to identify any weaknesses.
- Update cybersecurity and information security policies to align with best practices—including the standards that apply to certain government contractors, as announced in President Biden's "Executive Order on Improving the Nation's Cybersecurity" in May 2021 as well as general industry standards—and identify potential weaknesses.
- Critically assess for accuracy contractual representations as well as other certifications, attestations or communications provided to the government regarding company security controls, practices, processes and capabilities.
- Understand reporting obligations—imposed by contract as well as by law—and ensure that relevant company personnel are knowledgeable about, among other things, these obligations, as well as the triggers, window and process for cyber-incident reporting.
- Ensure that the company has an effective compliance hotline in place, that the existence of the hotline is communicated effectively, that reports are investigated appropriately and that issues are remediated in a timely and effective manner.
- In the context of whistleblower risk, ensure that company non-retaliation policies are in place, communicated effectively and enforced.
- Continue to monitor government remarks, enforcement actions and court decisions to understand enforcement trends and what may constitute material noncompliance in this area.

SEC DRAMATICALLY CHANGES THE RULES FOR PROXY CONTESTS, ADOPTS UNIVERSAL PROXY

By Kai H.E. Liekefett, Derek Zaba and Beth E. Berg[2]

In November 2021, the Securities and Exchange Commission (SEC) adopted new Rule 14a-19 and amendments to existing rules under the Securities Exchange Act of 1934 to require the use of "universal" proxy cards in all non-exempt director election contests at U.S. public companies. The new universal proxy rules will take effect for shareholder meetings after August 31, 2022. We expect a significant increase in proxy contest threats once the rules go into effect.

While comparable to the vacated Rule 14a-11, which allowed shareholders holding at least 3% of a company's outstanding shares for three years to put dissident directors in the

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company's proxy statement, the universal proxy rules confer substantially more significant rights to shareholders without any minimum ownership requirements (*e.g.*, owning only one share for one day will be sufficient). The new rules will reshape the process by which hostile bidders, activist hedge funds, social and environmental activists and other dissident shareholders may use director elections to influence control and policy at public companies.

The central feature of a contested corporate election is that shareholders are asked to vote, or give voting instructions by proxy, for two competing slates of director nominees: a company slate assembled by the board of directors and a "dissident slate" assembled by one or more dissident shareholders. Under existing SEC rules, shareholders are not easily able to give voting instructions picking selectively from the company and the dissident proxy cards unless they attend and vote at a shareholder meeting virtually or in person. Shareholders voting by proxy have generally been limited, instead, to giving voting instructions on the "company proxy card," for or against the company's nominees, or on the "dissident proxy card," for or against the dissident nominees and, in the case of "short slates," additionally for and against any company nominees supported by the dissident. Under the existing system, the company and dissident shareholder disseminate to shareholders both their own separate proxy statements and their own separate proxy cards that feature their distinct slates.

The new universal proxy rules will reshape the process by which hostile bidders, activist hedge funds, social and environmental activists and other dissident shareholders may use director elections to influence control and policy at public companies. Unlike comparable rules previously adopted by the SEC, the new universal proxy rules do not require a minimum amount or duration for stock ownership.

Under the new, mandatory universal proxy card system, a proxy card will have to include both the company nominees and the dissident nominees. Shareholders will be able to give voting instructions in favor of any combination of properly nominated candidates they choose, up to the number of authorized seats for election at the meeting. This article discusses the key components of the new universal proxy rules and related guidance for public companies. For a more comprehensive discussion of the new rules and their implications, see the Sidley Update available here.

The rules do not require the company and dissident to use identical cards, only that their respective universal proxy cards adhere to certain ground rules, such that proxy cards must contain options to give voting instructions for any of the candidates nominated by the company and any dissident shareholder. If the dissident has nominated a full slate of dissident candidates, the universal proxy card may permit shareholders to grant voting authority for either all company nominees or all dissident nominees, as a group. Otherwise, the universal proxy card must give shareholders the ability to grant voting authority to any combination of nominees they select from both the company and dissident slates.

The rules also include presentation, formatting and disclosure requirements for universal proxy cards. These must:

- clearly distinguish among the company's director nominees, the dissident's nominees (and among the nominees of multiple dissidents, if any) and nominees pursuant to proxy access
- list nominees in alphabetical order by last name within each group (*i.e.*, the company slate and the dissident slate)
- present all nominees in the same font type, style and size
- prominently disclose the maximum number of nominees for which authority to vote can be granted
- prominently disclose the treatment and effect of a proxy executed in a manner that grants authority to vote for more nominees than the number of directors being elected, either granting authority to vote for fewer nominees than the number of directors being elected or not granting authority to vote with respect to any nominees

Additionally, the company and the dissident will each be required to include a statement in its respective proxy statement referring shareholders to the other party's proxy statement for information about such other party's director nominees.

Rule 14a-19 includes new notice and solicitation requirements for companies and other people soliciting proxies for director nominees. Dissidents who fail to comply with these requirements are prohibited from using the universal proxy card and continuing with their solicitation of proxies.

The dissident and company must timely provide to each other the names of all nominees for whom it intends to solicit proxies. The dissident and company must do this at least 60 and 50 calendar days, respectively, before the anniversary of the prior year's annual meeting. If no annual meeting took place in the prior year, or if the date of the next annual meeting has been changed by more than 30 calendar days from the prior year, the deadlines are different. This new notice requirement does not replace, but rather supplements, provisions in a company's governing documents that provide more specific requirements regarding the timing and content of a dissident shareholder's notice of director nominations. Under a new rule, the company must disclose in its annual proxy statement the deadline for shareholders to give timely notice to the company of dissident nominations for inclusion on a universal proxy card in connection with the next annual meeting.

Members of Sidley's shareholder activism and corporate defense practice sent a formal comment letter to the SEC regarding the proposed rules suggesting material amendments that would protect against the potential for misuse of a mandatory universal proxy system.

The dissident must file a definitive proxy statement by the later of (1) 25 calendar days prior to the date of the election meeting and (2) five calendar days after the date the company files its definitive proxy statement. With respect to solicitation, the dissident must solicit the holders of shares representing at least 67% of the voting power of shares entitled to vote on the election of directors and include a statement to that effect in its proxy statement. However, a dissident may choose to use the less costly e-proxy delivery method—the "notice and access" method of mailing a notice of internet availability and posting the proxy materials on a website—should it desire.

The new rules revise the "bona fide nominee" rule, which provides that no proxy card can confer authority to vote for any director nominee who has not "consented to being named" in the applicable proxy statement and to serve if elected. In practice, candidates have rarely consented to being named in the other party's proxy statement. As amended, the rules permit proxy cards to confer voting authority for nominees who consent to be named in any proxy statement relating to the election meeting.

Rule 14a-4(d)(4), the "short slate rule," permits a dissident shareholder seeking to elect a minority of dissident candidates to the board to "round out" its slate by soliciting from shareholders their proxy authority to vote for some of the company's nominees through the dissident card. As the short slate rule is unnecessary in a mandatory universal proxy card system, the universal proxy rules eliminate the rule altogether.

Guidance for Public Companies

- **Boards of directors may expect dissident shareholders to use the availability of the universal proxy card—and the uncertainty it creates—as an additional source of leverage when they make demands to, and negotiate with, boards.** It is unknown whether the new regime will give dissidents new advantages at the ballot box. Public advocates of shareholder activism have, however, championed the adoption of the new rules. Their enthusiasm may reflect a premonition that the universal proxy card will provide dissidents with additional leverage when negotiating with boards and ultimately allow them to place more dissident candidates on boards through negotiations and proxy contests.
- **The rules constitute a seismic shift in the regulatory regime governing proxy contests at public companies, but they contain few guardrails to protect against misuse.** Unlike comparable rules previously adopted by the SEC, the new rules do not require any minimum amount or duration for stock ownership. They provide no meaningful consequences for shareholders that initiate a proxy contest insincerely, causing a company to expend resources but without the intent to follow through. **To the extent a company**

has not been thoroughly evaluating its shareholder activism preparedness and defenses outside of the proxy season, the coming year is a good time to start.

- **Advance notice bylaws — which impose requirements on dissident shareholders to provide information about themselves and their candidates in advance of the dissemination of proxy statements — have become all the more important as a means of obtaining information regarding dissidents and their nominees, including the intentions of dissidents.** To help ensure the quality of dissident director candidates and to protect a company and its shareholders from misuse of annual elections and proxy machinery, a company's advance notice bylaws should be thorough and designed in the interest of obtaining the information a company needs to vet director candidates before they are nominated and elected to a board of directors. Advance notice bylaws have long been enforced by state courts. The Delaware Court of Chancery recently validated their function and importance as discussed in the piece below titled *Delaware Court of Chancery Enforces Advance Notice Bylaw Where Stockholders Failed to Supply Required Information.*
- **Public companies should review the applicability of the rules to their peacetime disclosure requirements.** The new rules require, among other things, that a company disclose in its annual proxy statement the deadline for shareholders to give timely notice to the company of dissident nominations for the next annual meeting and that a company include specific disclosures concerning its voting standards.
- **If faced with dissident nominations in the coming year, it will be particularly important for companies to comply with the rules applicable to their disclosures and solicitation process.** The SEC is likely to be vigilant with respect to proxy materials in contested elections in upcoming proxy seasons because of the new rules. Consulting with counsel experienced in proxy contests will smooth the path to clearing SEC review and other regulatory barriers, as well as soliciting proxies quickly and efficiently.

Companies should consider disclosing in their 2022 proxy statements the deadline for shareholders to give timely notice to the company of dissident nominations for inclusion on a universal proxy card in connection with the 2023 annual meeting.

BOARD OVERSIGHT: KEY FOCUS AREAS FOR 2022

By Holly J. Gregory[3]

Boards of directors function in a complex and dynamic business setting in which stakeholder expectations are expanding, as are demands for board attention. The challenges of operating through the COVID-19 pandemic in an uncertain environment continue to be felt as companies anticipate a new post-pandemic "normal." Companies face pressure on multiple fronts, including resistance to returning to in-person work in a highly competitive talent market, supply chain bottlenecks and inflation, the potential for a global and national economic slowdown, and increasing risk of cyberattacks, unusual climate events and regulatory action (including antitrust enforcement and taxation), all in an atmosphere of heightened scrutiny of board oversight.

Ensuring that directors are well positioned to satisfy their oversight responsibility requires periodic assessment of board agenda priorities and the related structures, processes and controls that are in place to ensure that the board is well-informed on a timely basis of matters requiring attention. This article summarizes directors' duty of oversight and highlights issues that are likely to require significant board attention in 2022, including:

- strategy and risk
- corporate purpose and environmental, social and governance (ESG) matters

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- talent management and workforce issues
- shareholder engagement and activism
- crisis management
- board-management relationships and board culture

Duty of Oversight

While the board is responsible under state corporate law for the direction and management of the company, it typically delegates significant authority to the CEO and senior management to run the business. Once the board has delegated broad authority, its primary responsibility is to oversee management's performance (while attending to areas that are not delegated to management, such as governance matters, CEO compensation and succession, retention and oversight of the independent auditor, approval of major transactions, determination of dividend payments and bylaw amendments).

Oversight is the continual inquiry by directors into whether the board's delegation of authority to management is reasonable and whether the information that management provides to the board can be relied on. Typical areas of oversight include strategic initiatives, financial performance, risk management and compliance. Boards have a responsibility to identify and monitor risk and compliance on an ongoing basis, and they must do so rigorously with respect to "mission-critical" risks. This requires that the board understand the risks associated with corporate strategy and business operations, the risk management and compliance systems in place and the information and control systems designed to bring risk and compliance issues to management's and the board's attention.

Boards should evaluate whether they are appropriately structured for risk and compliance oversight. A majority of public companies vest oversight responsibility for the full range of corporate risks in their audit committees, which, as required by listing rule, are populated by individuals with financial literacy, but who may or may not have experience with non-financial risks. Given its already heavy workload, the audit committee may not be ideally positioned to attend to mission-critical risks at the level required.

Strategy and Risk

The board should remain focused on providing guidance and oversight, with the majority of its time reserved for discussing corporate strategy and assessing the quality of management's performance. The board plays a key role in assisting management in understanding and focusing on the risks associated with corporate strategies, the drivers of corporate performance, and the business and political environment, determining the company's risk appetite, and devoting appropriate resources to risk identification and management activities. Additionally, in light of recent Delaware case law emphasizing the role of the board with respect to mission-critical risks, board attention to the fundamental drivers of the business, the most critical risks facing the company, and how those forces may be impacted should account, along with strategic matters, for a significant portion of the board's agenda. Issues of strategy are increasingly intertwined with issues of the corporate purpose and ESG matters as discussed below.

The board should:

- ensure that a considerable proportion of board time is focused on strategic issues, including not only specific strategic plans and transactions but also the company's broader long-term direction
- understand the risks associated with strategic decisions and operations and the processes management has in place to identify, monitor and manage risk
- monitor management's performance in carrying out the strategy and managing associated risks

- reach a well-informed business judgment about what compliance, safety or other risks might be mission critical
- consider whether the board has clearly delegated to a committee the responsibility to assist in oversight of mission-critical risks; committee charters should clearly reflect this responsibility, and committee members should have appropriate experience (or access to appropriate expertise) and receive relevant information
- review the reporting processes that ensure information about mission-critical risks (including compliance) is brought to board and committee attention; the board should consider periodically engaging a third party to assist in reviewing these information and control systems
- regularly discuss risk and compliance, including mission-critical risks, at board and committee meetings, with the board reviewing enterprise risk management and mission-critical risks at least annually
- ensure that board and committee agendas, minutes and meeting materials reflect discussions of risk and compliance issues
- hold management accountable for creating and maintaining a corporate culture grounded in integrity and professionalism and for implementing and maintaining compliance, risk management and information and control systems that are "fit for purpose"

Corporate Purpose and ESG Matters

Shareholders and large institutional investors are more closely evaluating how companies address ESG matters, as they view strong performance on ESG issues as linked to the company's ability to create long term value.

In an environment of rising expectations about the role of companies in society, boards should remain focused on ensuring that the company innovates in providing goods and services to fill a need in a way that meets the fair expectations of a range of stakeholders. Fiduciary obligations to act in the best interests of the company and its shareholders remain the same. However, directors have considerable discretion (outside of sale of control transactions) to consider non-shareholder interests as long as there is a plausible connection to a rational business purpose that ultimately is intended to benefit the company and its shareholders over the long term.

Concerns about climate change, the COVID-19 pandemic and racial and other inequity have focused attention on environmental and social issues. Many stakeholders are looking to companies for help in finding solutions. How a company addresses ESG matters is increasingly viewed as linked to its resiliency in the face of crisis and its ability to create value over the long term, as a matter of strategic importance. Many large institutional investors believe that strong performance on ESG issues is related to value creation, and as a result they are more frequently seeking to engage with companies on environmental issues and other ESG matters, such as diversity, equity and inclusion (DEI). They are more likely to vote in favor of environmental and social shareholder proposals than in the past, which accounts for the record number of these proposals that received majority support in 2021.

The board should:

- understand how management is ensuring that stakeholder considerations and ESG matters are integrated into strategic and business decisions as well as enterprise risk management; this includes consideration of appropriate metrics to measure performance against goals, whether disclosure controls and procedures are designed to support both voluntary and mandated ESG disclosure and the degree to which management compensation should include some element of ESG incentive-related compensation
- review how the board, including board committees, provides appropriate oversight of ESG
- consider articulating a company-specific "statement of purpose" that describes how the goods or services the company provides, and related corporate activities, serve the interests of stakeholders and the broader social good, and consider how to use this articulated purpose as a guide for corporate decisions

- set standards and other policies regarding sustainability and social responsibility
- discuss with management:
  - its efforts to reassess business practices to identify unintentionally discriminatory practices, for example, in the treatment of customers
  - the contours and objectives of ESG efforts, including support for education, health care, food security, supplier diversity and social justice
  - ESG disclosure and related materiality considerations
- stay informed of developments and trends in ESG disclosure

Talent Management and Workforce Issues

The COVID-19 pandemic, together with the shift to a knowledge-based economy, have highlighted the value of human capital and triggered changes in business needs, work preferences, the market for human capital and associated risks (*e.g.*, cybersecurity and compliance). Human capital management issues are critical to corporate culture and are a key area for board oversight. These issues include:

- talent management, including employee recruitment, promotion and retention
- employee health and safety
- fair compensation and benefits
- DEI at all levels of the company
- training and career development initiatives
- efforts to combat discrimination, harassment and bullying
- treatment of whistleblowers

Human capital measures will continue to be a major focus during the 2022 proxy season, given the high level of investor interest in these matters and the enhanced disclosure about human capital resources required by recent amendments to Regulation S-K.

Management succession continues to be a key board priority, and boards should review emergency succession plans to ensure they are up to date as regards the CEO and other key officers.

The board should:

- understand through discussions with management how the current market for talent is affecting the company, including the impact of return-to-work policies
- attend to the corporate culture, emphasizing expectations that management will foster within the company a culture of ethical behavior, fair dealing, respect for DEI and integrity
- consider whether incentive plans need to be reworked in light of the circumstances, to ensure that appropriate behaviors are encouraged

Shareholder Engagement and Activism

The onus is on boards and senior executive teams to inform and engage with shareholders about corporate purpose and strategy, key board decisions and the rationales for those decisions. While directors should consider shareholder viewpoints, they cannot defer to those viewpoints but must always make informed business judgments that they believe are in the best interests of the company.

One benefit of building a trust relationship with key shareholders is that shareholders may be more willing to support the board and management in the face of shareholder activism and other pressures. With increased volatility in the stock market, and as hedge fund war chests continue to grow, hostile takeover activity and other shareholder activism threats are increasing. Boards can expect well-capitalized activists to exploit the enhanced vulnerability of target companies.

The board should ensure that the company is well prepared to respond, including through a review of takeover and activist preparedness with financial and legal advisors. If activists approach the company, the board and management should consider the issues they raise and not automatically default to a defensive mode.

The board should:

- continue to actively oversee and participate as appropriate in engagement with key shareholders, with an emphasis on listening to shareholder viewpoints and developing enduring relationships
- stay informed of proxy advisor perspectives (without assuming that they necessarily reflect the views of the company's shareholders)
- consider with management how various types of shareholder activists are likely to view the company, including its strategies and governance practices, to identify vulnerabilities
- confirm that management is monitoring changes in stock ownership
- update or activate defense preparation plans with management, including by identifying special proxy fight counsel, reviewing structural defenses, putting a poison pill "on the shelf" and developing a "break the glass" communications plan

Crisis Management

Every board is likely to face a crisis that requires it to become more actively engaged in overseeing management's response or even in developing and undertaking the response itself if the crisis involves issues of management integrity, credibility or capacity. To prepare the company to react quickly, the board and management should consider sources of potential crisis and develop plans to address them.

If a crisis occurs, the board should try to ensure that the attorney-client privilege will not be waived (to the extent appropriate). Once all the facts are known, and the immediate crisis has been addressed (including through reports to regulators, disciplinary action or both), the board should consider whether compliance or control systems should be strengthened.

To prepare for a crisis, the board should:

- consider whether the company has a strong business continuity and crisis management plan in place
- ensure it can act effectively when a crisis occurs by embracing governance structures and practices that support a board culture in which consensus can be readily achieved after full and informed discussion

Board-Management Relationships and Board Culture

Shareholders continue to scrutinize the composition of boards, particularly with respect to director diversity and qualifications, and related company disclosures.

While the board monitors management's performance and provides direction, it should also act as a sounding board where management can test and hone ideas and as a resource of expertise. The board needs to develop a strong working relationship with the CEO and other members of the management team and at the same time be able to provide constructive guidance and criticism.

Board composition and refreshment are under increased scrutiny by shareholders (including activists), who are paying closer attention to director qualifications and diversity and scrutinizing company disclosure on this topic. Large institutional investors continue to view board diversity as a key priority, and various states and Nasdaq have imposed diversity requirements for boards.

The board should:

- ensure clarity in the delegation of authority to management
- monitor CEO and executive officer performance and continually assess whether reliance on these key executives is reasonable

- encourage management to focus on the long term, and withstand undue short-term pressures
- at least annually discuss development of potential candidates for both emergency and normal succession
- determine whether to continue to hold some meetings virtually
- consider board refreshment mechanisms, including age and tenure limits and individual director evaluation
- avoid treating the re-nomination process as a foregone conclusion, and base re-nomination decisions on assessment of relevant expertise, time commitment and actual performance

NEWS[4]

JUDICIAL DEVELOPMENTS

Delaware Court of Chancery Enforces Advance Notice Bylaw Where Stockholders Failed to Supply Required Information

In October 2021, Vice Chancellor Joseph R. Slights III issued a post-trial decision affirming the CytoDyn Inc. board of directors' decision to reject a stockholder nomination of directors for failure to supply information required by the company's advance notice bylaw. This is the first decision from a Delaware court addressing informational deficiencies in such a nomination notice and provides important guidance for the many public companies with similar bylaws.

CytoDyn has had an advance notice bylaw in place since 2015. These are common provisions that require a stockholder who wishes to nominate directors to provide information about the nominations by a certain deadline before the annual meeting. On July 1, 2021, the day before the pertinent deadline, a group of activist stockholders delivered a nomination notice to CytoDyn. On July 7, the board met to discuss the nomination notice and determined to retain advisors. On July 20, the stockholder plaintiffs filed their preliminary proxy materials with the SEC, disclosing for the first time that they had formed a Delaware LLC, CCTV (CytoDyn Committee to Victory) to raise funds for their campaign.

On July 30, the CytoDyn board sent a letter rejecting the nominations for failure to comply with the company's bylaws. Although many deficiencies were identified, of particular import were two categories:

- **Failure to Disclose Those Supporting the Nominations.** Although the bylaw mandated disclosure of those "supporting" the nominations, or any "agreements, arrangements, or understandings" regarding the nominations, the stockholders did not disclose the existence of CCTV or those providing funding or other support to the proxy contest.
- **Failure to Disclose Conflicts of Interest.** One nominee, Bruce Patterson, and one nominating party, Jeffrey Beaty, had potential conflicts of interest relating to their ownership of the common stock of another entity, IncellDx. Patterson was IncellDx's founder, CEO and director and the owner of roughly one-third of its common stock; nominating party Beaty was an IncellDx director and owned roughly 2.3% of its common stock. The nominating notice did not disclose that in 2020, Patterson proposed that CytoDyn acquire IncellDx for $350 million — a proposal the company rejected but that would have earned Patterson and Beaty roughly $123 million. It also did not explain whether Patterson intended to pursue that transaction if placed on the CytoDyn board.

4 The following Sidley lawyers contributed to the research and writing of the pieces in this section: Julia L. Bensur, Elizabeth A. Buescher, Jim Ducayet, Claire H. Holland, Benjamin N. Kelton, Rebecca Lewis, Charlotte K. Newell, Andrew W. Stern and Robert S. Velevis. Some of the pieces first appeared in Sidley's Enhanced Scrutiny blog, which provides timely updates and thoughtful analysis on M&A and corporate governance matters from the Delaware courts and, on occasion, from other jurisdictions.

In early August, CytoDyn sued the stockholders in federal court for violations of the federal securities laws, pointing to these and other deficiencies. In the weeks that followed, to resolve that action, the stockholders provided several pages of additional and corrective disclosures. These included the names of roughly 70 individuals and businesses who provided financial support for their proxy contest (some of whom were IncellDx investors).

On August 24, more than three weeks after the rejection letter was sent, the nominating stockholders filed suit against CytoDyn and its board in the Delaware Court of Chancery seeking a declaratory judgment that the board erred in rejecting the notice and an injunction prohibiting the board from disregarding their nominations. The Court ruled for CytoDyn and its board in full. As the Court explained,

> "Where Plaintiffs ultimately went wrong here is by playing fast and loose in their responses to key inquiries embedded in the advance notice bylaw, and then submitting their Nomination Notice on the eve of the deadline, leaving no time to fix the deficient disclosures when the incumbent Board exposed the problem."

Several aspects of the opinion are noteworthy and provide guidance for other public companies with similar provisions:

- **Reaffirming Propriety of Advance Notice Bylaws.** The Court reaffirmed the "indisputably legitimate purpose" of advance notice bylaws and that the terms of the CytoDyn bylaw at issue "comport[ed] with bylaws our courts have characterized as 'commonplace.'"
- **Failure to Supply Information Rendered Notice Deficient.** The Court held that the nomination notice "was deficient" because it failed to comply with the "unambiguous terms of the Advance Notice Bylaw." Each of the above-mentioned omissions rendered the notice deficient: (1) the failure to disclose the stockholders' "supporters" and (2) the failure to disclose a potential conflict of interest vis-à-vis IncellDx. As to the former, the Court found that "provisions asking stockholders to disclose supporters" are "ubiquitous" and seek "vitally important information." Although evidence (and plaintiffs' subsequent public disclosures) revealed that multiple individuals had provided the plaintiffs with financial support, "Plaintiffs elected to say nothing." As to the latter, the Court held that the "prospect that a nominee may seek to facilitate an insider transaction is the type of potential conflict that stockholders are entitled to know about when voting for directors." Plaintiffs' failure to disclose the prior $350 million proposal was doubly problematic due to "evidence [that] clearly reveals that such a transaction was" being contemplated by certain of the nominees on an ongoing basis (*e.g.,* emails stating "we view the 13D as an opportunity to bring this together in a 1+1=3 scenario").
- **Key Role of Clear Day Adoption.** The Court underscored that when such a bylaw is adopted on a "clear day"—here, six years before the nomination notice was received—there is no basis to challenge the board's decision to put the bylaw in place. The fact of a longstanding bylaw can also play a role in assessing a plaintiff's compliance. Discovery revealed that the plaintiffs had begun analyzing the bylaw months before they submitted the notice, underscoring their ability to have complied (*e.g.,* a March 2021 email sent by one plaintiff "which summarized the Bylaws pertaining to director candidate nominations" and instructed it was "critical to strictly follow all of these procedures" because otherwise such "nomination shall be disregarded").
- **Bylaws Are Interpreted as Contracts, Absent Evidence of "Manipulative Conduct."** In line with the Delaware Supreme Court's decision last year in *Saba Capital* (discussed in our March 2020 issue of *Sidley Perspectives*), the Court confirmed that "the canons of contract construction apply when construing bylaws." Although plaintiffs argued that enhanced scrutiny should apply to the board's decision to reject the nominations, the Court refused to do so. *Blasius* enhanced scrutiny review did not apply to a decision to enforce a bylaw, standing alone. And although plaintiffs also argued that another form of equitable review applied—*Schnell*, a famed case holding that what may be legal may not be

The CytoDyn *decision reaffirms the importance of advance notice bylaws in director elections and confirms that reasonable informational requirements will be enforced absent extreme circumstances where equitable intervention would be warranted.*

equitable—that too failed due to the circumstances. To invoke *Schnell* required plaintiffs to show "compelling circumstances" requiring equity to intervene on their behalf. Plaintiffs' clear failure to comply with the bylaw and otherwise prove facts amounting to those "compelling circumstances" meant this equitable relief was unavailable.

The *CytoDyn* decision is a reminder of the importance of advance notice bylaws in director elections. It also confirms that reasonable informational requirements will be enforced absent extreme circumstances that mandate equitable intervention. Public companies should consider their own such bylaws and whether their informational requirements include the terms at issue in *CytoDyn* and if they would be well served by amending or augmenting their existing provisions. Adoption of such measures on a clear day is critical—waiting to consider these matters after a nomination has arrived could lead to a different result.

Controller's Reliance on a "Sham" Opinion of Counsel to Effect a Take-Private Leads to $700M Damages Award

Once in a while, a court decision not only provides guidance for participants in corporate transactions but also can serve as a wake-up call for legal advisors. Such is the case with the post-trial decision in *Bandera Master Fund LP et al. v. Boardwalk Pipeline Partners, LP* (Del. Ch. Nov. 12, 2021), in which Vice Chancellor J. Travis Laster resolved various disputes regarding a transaction through which Boardwalk Pipeline Partners, LP was taken private by its controller, Loews Corporation. The resulting nearly $700 million damages award, and sharp criticism of the legal opinions provided in support of the transaction, has garnered headlines, but the decision is also notable for its review of several long-standing principles of Delaware law that provide guidance for both contract negotiations and litigation.

Loews formed Boardwalk as a master limited partnership (MLP) and holding company for interstate pipeline systems for the transportation and storage of natural gas, a business regulated by the Federal Energy Regulatory Commission (FERC). In drafting Boardwalk's partnership agreement before a public offering in 2005, Loews (the General Partner) wanted to reserve the option to take Boardwalk private if FERC took regulatory action that would have a material adverse effect on Boardwalk. To this end, Loews included in the agreement a call right, which could be invoked by the General Partner if two conditions were met. First, the General Partner had to receive "an Opinion of Counsel" that Boardwalk's entity status "has or will reasonably likely in the future have a material adverse effect on the maximum applicable rate that can be charged to customers." Second, the General Partner also had to determine that the Opinion was "acceptable."

In March 2018, FERC proposed a package of new regulatory policies that were subject to review and comment, with potential implementation in the following months. In that period of uncertainty, the General Partner explored exercising the call right to acquire the limited partners' interests at what the Court described as "a highly attractive price." The General Partner hired the lawyer who originally had drafted the call right provision in the partnership agreement to provide the legal opinion the partnership agreement required as a pre-condition for exercise of the call.

In the lawsuit brought by holders of the common MLP units, the Court held that neither condition was satisfied. As to the first, the Court held, among other things, that the opinion of counsel was based upon a series of "counterfactual assumptions" designed to yield a desired result. As to the second, the Court held that although the provision was ambiguous, the board that included several independent directors needed to assess the opinion's acceptability (rather than the General Partner's sole member, comprised of insiders).

While this lengthy and complex opinion is replete with practical guidance for practitioners, a few key takeaways are as follows:

Delaware Court of Chancery in Bandera: *"The General Partner cannot invoke the Reliance Provision when it knows that the opinion in question was contrived to generate a result. Under those circumstances, the General Partner is not relying on the contrived opinion. The opinion is window dressing to enable the General Partner to take action. That reality prevents the General Partner from relying on the Opinion for purposes of the Reliance Provision. The General Partner not only knew the Opinion was contrived but the General Partner's representatives participated actively in the manufacturing of the Opinion."*

- **Opinions of Counsel as a Condition Precedent Can Pose Risks.** This decision highlights the risks associated with any contractual provision that makes a future opinion of counsel a condition precedent. The Court of Chancery previously warned of this issue in *Williams Cos., Inc. v. Energy Transfer Equity, L.P.* (Del. Ch. June 24, 2016), explaining that when parties agree to an opinion of counsel condition precedent, "it is [counsel]'s subjective good-faith determination that is the condition precedent." In *Boardwalk*, Vice Chancellor Laster explained that an opinion giver "plainly must have competence in the particular area of law" (which counsel here did not) and that proceeding regardless "is not acting in good faith."
- **Be Mindful of Potential Conflicts.** As with any critical decision, it is wise to consider the interests and independence of those involved. This includes counsel. Here, the lawyer who drafted the call right was then retained, years later, to spearhead the opinion drafting process — a conflict that the attorneys involved arguably intentionally overlooked. Although the Court disclaimed any finding relating to attorney ethics, the Court noted in a lengthy footnote the pitfalls of not taking seriously the connection between the two retentions when evaluating conflicts. Further, at the risk of stating the obvious, any legal opinion should reflect objective, unbiased judgment and should never be based on the client's desired result or on fabricated facts.
- **Beware of *Contra Proferentem*.** The Court held that the acceptability provision was ambiguous because it did not specify whether the General Partner's sole member or board of directors had to make that decision. The Court therefore applied the doctrine of *contra proferentem*, which can apply when a contract is ambiguous, and calls for the ambiguous provision to be construed against the drafter. As for the acceptability provision, the interpretation most favorable to the non-drafter (*e.g.*, the limited partners) was that the acceptability decision be made by the board of directors, with several independent actors, rather than the insider-controlled sole member. This decision offers an important reminder of the potential power of the *contra proferentem* doctrine (and of course, the importance of attempting to avoid contractual ambiguities where possible).
- **A Material Adverse Effect Remains Difficult to Prove.** The Court also offered an important reminder for analyzing when a material adverse effect is likely to occur, noting that under Delaware law, there must be a showing of "a basis in law and in fact" for the "serious adverse consequences prophesied by the party claiming the MAE." Put simply, "proclaiming that bad things can happen" is insufficient to establish a material adverse effect. The analysis should be performed in good faith with a holistic view of the actual, not hypothetical, facts.

In a Rare Move, Delaware Court of Chancery Enjoins Stockholder Meeting for Disclosure Violations

In October 2021, the Delaware Court of Chancery issued a rare preliminary injunction delaying the stockholder vote on a proposed merger between QAD Inc., a cloud-based enterprise software company, and the private equity fund Thoma Bravo. *Nantahala Capital Partners II LP v. QAD Inc.* (Del. Ch. Oct. 8, 2021). The Court required additional disclosures to stockholders but stopped short of enjoining the deal entirely. The case provides useful guidance on conflicts-related disclosure where a controlling stockholder and minority stockholders are "competing" for consideration from a third-party acquirer. It also highlights Delaware's reluctance to enjoin a transaction that offers stockholders a premium in the absence of a rival bidder, leaving post-closing damages claims as the sole remedy for stockholders who believe the deal involved contractual or fiduciary duty violations.

QAD had two classes of equity, Class A shares and Class B shares. Class A shares had limited voting rights, giving voting control to Class B shares, primarily held by Pam Lopker, a co-founder. Under QAD's charter, Class A stockholders were protected by a "no less favorable provision" providing that in any merger, "[t]he holders of Class A Common Stock shall be entitled to receive an amount and form of consideration per share no less favorable than the per share consideration, if any, received by any holder of the Class B Common Stock…"

In early 2021, QAD began a formal sale process, forming a special committee and retaining financial advisers. It received a merger proposal from Thoma Bravo. Under the final terms of the offer, all stockholders would receive the same consideration: $87.50 per share, in cash. However, Lopker was allowed to roll $300 million of her QAD shares and $30 million of her children's shares into equity in the new entity. She also received a board seat. The merger required a majority vote of all outstanding shares as well as a majority of all shares not owned by Lopker, corporate officers and directors.

In seeking the injunction, the plaintiffs argued that the terms of the merger violated the corporate charter. According to the plaintiffs, Lopker's right to roll over her shares provided her with both an "amount" and a "form" of consideration more favorable than that provided to Class A shares. They argued that the rollover provided benefits including tax savings and the opportunity to share in the upside of Thoma Bravo's investment—benefits not available to Class A stockholders.

The plaintiffs also claimed that the special committee of the QAD board of directors negotiated with Lopker's interests in mind rather than the best interests of the minority stockholders. They pointed to numerous references by committee members to Lopker's personal financial goals. And they noted that negotiations with Thoma Bravo appeared to seek not simply improved prices for stockholders but also special benefits, such as a board seat, for Lopker. The plaintiffs argued that the merger proxy statement sent to stockholders failed to disclose these conflicts, making an informed vote impossible.

The Delaware Court of Chancery agreed. In particular, it ordered disclosure of communications indicating that "even before the special committee was formed, a director of QAD provided Thoma Bravo with deal parameters that would personally satisfy Lopker, the controller, from which Thoma Bravo could formulate its bidding strategy." According to the Court, "[t]he crux of all of these issues is that Lopker's interests loomed over the [negotiating] process," and it ordered disclosures that would accurately reflect that fact.

Nevertheless, the Court refused to enjoin the merger entirely. While the Court noted the plausibility of the plaintiff's contract claim for the breach of the charter provision, it determined that enjoining the merger risked substantial harm to QAD stockholders given the 20% premium offered and the absence of any rival bidder. The Court noted that a contract claim would survive the merger, and it expressed confidence that "after-the-fact money damages" have "some value as a remedial instrument in this case."

This approach is consistent with a long line of cases in Delaware that have compelled additional disclosure but refused to enjoin a transaction outright for fear that it would jeopardize stockholders' ability to enjoy the benefits of an otherwise beneficial deal. Such refusals are often in spite of potential violations of fiduciary duty or breaches of contract. As the Delaware Supreme Court has explained, where there is no claim by a rival bidder that it was unable to make a bid, and stockholders are fully informed of all the facts and not coerced, "the Court of Chancery should be reluctant to take the decision out of their hands." The case reinforces the centrality of an informed stockholder vote as well as the prudential limits of a court's equitable power where there may be no better offer available to stockholders.

One final takeaway: The case also adds to a body of caselaw involving independence and corporate aircraft. In 2016, the Delaware Supreme Court found that the co-ownership of a plane by a board member and the controlling stockholder contributed to doubts about the board member's independence. *Sandys v. Pincus*, 152 A.3d 124 (Del. 2016). Here, the plaintiffs made a similar argument, suggesting that Lopker's co-ownership of a plane with a board member demonstrated that the board member was not truly independent. While the Delaware Court of Chancery did not ultimately find the plane co-ownership dispositive, this suit, following *Sandys*, suggests that board members may do well to fly commercial.

Delaware Supreme Court Confirms Appraisal Rights May Be Waived Contractually—Query What Else May Be

In September 2021, over a rare dissent, the Delaware Supreme Court affirmed the Court of Chancery's dismissal of a petition for appraisal filed by minority stockholders of Delaware corporation Authentix Acquisition Company, Inc. *Manti Holdings, LLC, et al. v. Authentix Acquisition Co., Inc.* (Del. Sep. 13, 2021). The high court agreed that the petitioners could waive the statutory right to an appraisal through provisions in a stockholder agreement. Significantly, this ruling may open the door for corporations to contractually waive other permissive portions of the Delaware General Corporation Law (DGCL).

The Delaware Supreme Court's opinion in Manti Holdings *leaves the door open for what portions of the DGCL other than the statutory right to an appraisal may be waived through a contractual stockholder's agreement.*

Nearly 15 years ago, petitioners became minority investors in Authentix after an acquisition by a private equity firm; as part of that transaction, the petitioners entered into a stockholders agreement and agreed to refrain from invoking their appraisal rights in the event of a future merger.

Nearly 10 years later, in 2017, Authentix merged with a "third-party entity." After application of the consideration and a waterfall provision, common stockholders were left with "little to no consideration" for their canceled stock. They, therefore, sent timely appraisal demands and then petitioned in the Court of Chancery to exercise their statutory appraisal rights under DGCL § 262.

On October 1, 2018, the Court of Chancery granted Authentix's motion for summary judgment, holding that the petitioners had waived their appraisal rights under the stockholders agreement. Following the Court of Chancery's final memorandum opinion on August 11, 2020, the petitioners appealed this result to the Delaware Supreme Court.

The Delaware Supreme Court majority identified two main issues regarding the petitioners' request for appraisal: (1) whether the petitioners by the terms of the stockholder agreement clearly waived their appraisal rights with respect to the 2017 merger and (2) whether a Delaware corporation "can enforce a waiver of appraisal rights against its own stockholders." The Court answered each in the affirmative and affirmed the Court of Chancery in full. For details regarding the Court's reasoning, see the Enhanced Scrutiny blog post available here. Justice Karen Valihura dissented from the majority, averring that appraisal rights under § 262 are fundamental features of corporate governance, modification of which should be permitted only in the corporate charter.

While the Court recognized that there are some provisions of the DGCL that are so fundamental that they are essential to a corporation's identity and cannot be waived, the Court did not clarify what makes such a provision fundamental. Thus, the *Manti Holdings* decision leaves unanswered which provisions of the DGCL corporate entities may waive by agreement.

CORPORATE GOVERNANCE DEVELOPMENTS

ISS and Glass Lewis Release Policy Updates for 2022

Institutional Shareholder Services Inc. (ISS) and Glass Lewis & Co. have each released updates to their proxy voting policies for the 2022 proxy season. The key policy updates are summarized below and will be discussed in greater detail in a forthcoming *Sidley Update* once ISS releases an updated FAQ document with more information about its updated policies.

Board Diversity

Beginning in 2023, Glass Lewis will shift its gender diversity policy to a percentage-based approach where it will generally recommend against the nominating/ governance committee chair if the board of a Russell 3000 company does not meet a threshold of at least 30% "gender diverse" members.

- **Gender Diversity.** Under its current policy, ISS generally recommends voting against the nominating committee chair (and potentially other directors on a case-by-case basis) at a company in the Russell 3000 or S&P 1500 indices with no women serving on the board of directors. ISS is expanding the coverage of this policy and, beginning in 2023, will apply it to all companies subject to its U.S. policies.

  For 2022, at Russell 3000 companies, Glass Lewis will generally recommend voting against the nominating/governance committee chair of a board that has fewer than two women and the entire nominating/governance committee of a board that has no women. Beginning in 2023, Glass Lewis will shift its gender diversity policy from a numerical approach to a percentage-based approach where it will generally recommend against the nominating/governance committee chair if the board of a Russell 3000 company does not meet a threshold of at least 30% gender diverse members (which would include individuals who identify as non-binary).
- **Racial and Ethnic Diversity.** ISS's previously adopted policy on board racial and ethnic diversity will go into effect in 2022 now that the one-year grace period has expired. Accordingly, ISS will generally recommend voting against the nominating committee chair (and potentially other directors on a case-by-case basis) at a company in the Russell 3000 or S&P 1500 indices where the board has no apparent racially or ethnically diverse members. ISS will make an exception to the policy if there was racial and/or ethnic diversity on the board at the preceding annual meeting and the board makes a firm commitment to appoint at least one racially and/or ethnically diverse member within a year.
- **Diversity disclosures.** Glass Lewis will evaluate the quality of disclosure of S&P 500 companies relating to board diversity and director skills, including by rating how their proxy statements present (1) the board's current percentage of racial/ethnic diversity, (2) whether the board's definition of diversity explicitly includes gender and/or race/ethnicity, (3) whether the board has adopted a policy requiring women and minorities to be included in the initial pool of candidates when selecting new director nominees and (4) board skills disclosure. Glass Lewis will use the ratings when assessing a company's overall governance and may factor them into vote recommendations when it has identified additional board-related concerns. In 2022, Glass Lewis may recommend voting against the nominating/governance committee chair if a company exhibits particularly poor disclosure. Beginning in 2023, Glass Lewis will generally recommend voting against the nominating/governance committee chair if a company does not provide disclosure of individual or aggregate racial/ethnic minority board demographic information.

Board Accountability on Unequal Voting Rights. ISS announced that beginning in 2023, it will recommend voting against directors at *all* U.S. companies (rather than just newly-public companies) with a common stock structure with unequal voting rights. The new policy notes that a newly added reasonable sunset (which ISS generally considers seven years or less) would ward off negative vote recommendations in subsequent years. Beginning in 2022, Glass Lewis will recommend voting against the nominating/governance committee chair at companies with a multi-class share structure and unequal voting rights if they are not subject to a reasonable sunset (generally seven years or less).

Board Accountability on Climate-Related Issues. ISS has adopted a new board accountability policy focused on companies deemed to be contributing greatly to climate change through high levels of greenhouse gas (GHG) emissions. Under the new policy, for companies that are "significant GHG emitters" through their operations or value chain, which for 2022 will mean the 167 companies currently identified on the Climate Action 100+ Focus Group list, ISS will generally recommend voting against the incumbent chair of the appropriate committee (and potentially other directors on a case-by-case basis) where ISS determines the company has not taken specified "minimum steps" needed to understand, assess and mitigate climate change risks to the company and the larger economy.

Board Accountability for Risk Oversight Failures Related to Environmental and Social Issues. Glass Lewis will generally recommend voting against the nominating/governance committee chair at S&P 500 companies that have not provided explicit disclosure regarding the board's role in environmental and social risk oversight. In 2022, a lack of disclosure will be highlighted as a concern at Russell 1000 companies but will not result in negative vote recommendations.

Climate-Related Proposals

- **Management proposals.** ISS has codified a framework for analyzing management proposals that request shareholders to approve the company's climate transition action plan. ISS will vote on such proposals on a case-by-case basis, taking into account the completeness and rigor of the plan and certain other factors. Under a new policy, Glass Lewis will evaluate such management say-on-climate proposals on a case-by-case basis, taking into account specified factors including (1) the request of the proposal, (2) the board's role in overseeing climate strategy, (3) the company's industry and size, (4) whether the company's GHG emissions targets and related disclosure seem reasonable in light of its operations and risk profile and (5) "where the company is on its climate reporting journey." Glass Lewis expects companies to articulate clearly their climate transition plans in a "distinct and easily understandable document," that it suggests should be aligned with Task Force on Climate-Related Financial Disclosures (TCFD) recommendations.
- **Shareholder proposals.** Under a new policy ISS will vote on a case-by-case basis on shareholder proposals that request the company to disclose a report providing its GHG emissions levels and reduction targets and/or its upcoming/approved climate transition action plan and provide shareholders the opportunity to express approval or disapproval of its GHG emissions reduction plan, taking into account certain factors. In 2022, Glass Lewis will generally oppose shareholder say-on-climate proposals but will take into account specified factors including (1) the request of the proposal, (2) the company's existing climate governance framework, initiatives and reporting, (3) the company's industry and size and (4) the company's exposure to climate-related risks.

Shareholder Proposals Requesting Racial Audits. ISS will take a case-by-case approach on shareholder proposals asking companies to conduct an independent racial equity and/or civil rights audit. ISS will consider factors including whether the company (1) has developed a process or framework for addressing inequalities internally, (2) has engaged with stakeholders and made racial justice efforts and (3) has been the subject of recent controversy.

SEC DEVELOPMENTS

SEC Proposes to Rescind Final Rules Adopted in July 2020 Regulating Proxy Advisors

In November 2021, the SEC proposed rule amendments that would rescind significant parts of rules the SEC adopted in July 2020 governing proxy voting advice furnished by proxy advisors such as ISS and Glass Lewis. The rule proposal was approved by a 3-2 vote along party lines, with Hester Peirce and Elad Roisman, the two Commissioners appointed by former President Donald Trump, dissenting.

In July 2020, the SEC adopted rule amendments to (1) codify its view that proxy voting advice generally constitutes a "solicitation" subject to the federal proxy rules, (2) clarify that the omission of certain information from proxy voting advice may, depending on the particular facts and circumstances, violate the anti-fraud provisions and (3) impose additional disclosure and procedural requirements on proxy advisors as conditions for being able to continue relying on exemptions from the information and filing requirements of the federal proxy rules.

In the 2020 amendments, the SEC added in Note (e) to Rule 14a-9 as a new example of the type of information that, depending on the particular facts and circumstances, may be misleading if omitted from proxy voting advice, including the failure to disclose material information regarding the proxy voting advice, such as the proxy advisor's methodology, sources of information or conflicts of interest. The addition—which largely codified existing SEC guidance on the applicability of Rule 14a-9 to proxy voting advice—was designed to give proxy advisor clients greater insight as to the processes and methodologies proxy advisors use to formulate their proxy voting recommendations.

To rely on the exemptions from the information and filing requirements of the federal proxy rules, the SEC added two new conditions in Rule 14a-2(b)(9)(ii) that would require proxy advisors to (1) make their proxy voting advice available to companies before or at the time it is provided to clients and (2) provide clients with a way to reasonably be expected to become aware of any written statements by the company regarding the proxy advisor's proxy voting advice. The rule amendments took effect on November 2, 2020, and proxy advisors were required to comply with the new conditions by December 1, 2021. See the Sidley Update available here for more details.

As discussed in our June issue of *Sidley Perspectives*, in June 2021, SEC Chair Gary Gensler issued a statement directing the SEC staff to consider whether to recommend further regulatory action regarding proxy voting advice and to "revisit" prior rules and guidance. Concurrently, the SEC's Division of Corporation Finance announced that it would not recommend enforcement action to the SEC based on such rules and guidance while the SEC considers potential changes.

On November 17, 2021, the SEC proposed rule amendments that would rescind two aspects of the 2020 rules purportedly to address investor concerns about the impact those rules had on the ability of proxy advisors to deliver timely, independent proxy voting advice to clients. First, the proposed rules would delete Note (e) from Rule 14a-9 while affirming that proxy advisors may still be subject to liability under Rule 14a-9 for a materially misleading statement or omission of fact, including with respect to its methodology, sources of information or conflicts of interest. Second, the proposed rules would remove the new Rule 14a-2(b)(9)(ii) conditions and related safe harbors and exclusions. The SEC will accept public comments on the rule proposal until December 27, 2021.

SEC Enforcement Action Targets Inadequate Disclosure of Perks and Stock Pledges

In November 2021, a Texas-based oilfield services company and its former CEO reached a settlement agreement with the SEC for failing to properly disclose the former CEO's executive perquisites and two stock pledges.

Between January 2017 and December 2018, the company paid approximately $380,000 in credit card expenses and private air travel for the former CEO that was not integrally and directly related to the performance of his duties as CEO. Additionally, during the same period, the company spent about $50,000 in perquisites benefitting the former CEO, including charitable donations and event tickets, which the company failed to disclose as additional executive compensation due to failures in the company's internal accounting controls that caused them to be improperly recorded.

The SEC's sixth perquisite case in the past year and a half, this settlement signals the Commission's continued focus on undisclosed perks, a priority articulated in 2020.

In 2017 and 2018, the former CEO obtained two separate loans to purchase real estate and pledged all of his company stock as collateral to secure the debt. He failed to obtain prior consent from the company in accordance with company policies. However, the second lender took steps to perfect its security interest and notified the company's general counsel. The former CEO and the second bank agreed to execute a "negative pledge" whereby the CEO agreed to refrain from selling his shares until the loan to the bank was fully paid off. The company's board of directors agreed to allow the negative pledge. The company failed to disclose the pledge in its SEC filings until March 2020.

Additionally, the SEC noted that between 2017 and 2019, the former CEO either left relevant parts of the annual directors and officers (D&O) questionnaire blank (specifically, those related to perquisites and stock ownership) or failed to submit a D&O questionnaire at all. As a result, the company issued public filings that included material misstatements regarding his executive perks and stock ownership.

The SEC found that the company violated reporting, books and records, internal accounting controls and proxy provisions of the federal securities laws, and that the former CEO violated proxy provisions and negligence-based antifraud provisions and caused the company's reporting and books and records violations. The former CEO paid back nearly $350,000 to the company and paid nearly $200,000 to the SEC as a civil penalty.

The SEC did not impose a civil penalty on the company due to its cooperation in the investigation and its prompt and extensive remedial efforts, which included (1) hiring an entirely new management team with significant public company experience, (2) hiring additional finance department personnel, (3) installing several new directors (including adding new Audit Committee members and creating a Disclosure Committee with its own disclosure counsel), (4) developing new internal controls, policies, procedures and training regarding internal auditing matters, credit card and expense reimbursement and travel and (5) enhancing the D&O questionnaire process.

In light of this enforcement action, public companies (and their audit/compensation committees) should consider reviewing all policies, procedures, controls and training to ensure they contemplate proper internal controls and reporting procedures and enable for proper disclosures of perks or other personal benefits and stock pledges or stock ownership changes.

SIDLEY RESOURCES

Corporate Governance; ESG

Key Takeaways: *People Places Planet: The Enforcement Angle* Podcast Featuring SEC's Kelly Gibson (December 13, 2021). This Sidley Update provides key takeaways from the most recent "The Enforcement Angle" episode as part of the Environmental Law Institute's *People Places Planet* podcast. Justin Savage and Ranah Esmaili, partners in Sidley's Washington, D.C. office, talk with Kelly Gibson, director of the Philadelphia Regional Office for the SEC and leader of the Climate and ESG Task Force within the SEC Division of Enforcement. They discuss ESG areas of focus for the SEC and the Climate and ESG Task Force, potential rulemaking related to climate and ESG disclosures, the overlap between ESG and special purpose acquisition companies (SPACs) in certain SEC enforcement matters and the SEC's response to President Biden's all-of-government approach to ESG.

SEC Climate Change Comment Letters Signal Early Action on Environmental, Social, and Governmental Disclosures (October 7, 2021). The SEC staff has begun issuing climate comment letters based on the SEC's 2010 Guidance Regarding Disclosure Related to Climate Change. This Sidley Update provides tips on how companies should respond and what considerations may be relevant for updating future disclosures given the Biden administration's focus on climate and the environment.

On All Fronts: Preparing for the Unexpected—Best Practices in Crisis and Risk Management (September 30, 2021). The events of the past year have vividly illustrated the need for corporate leaders to anticipate and prepare for a crisis. Cybersecurity breaches, expanding expectations of businesses and their leaders related to social and environmental concerns and an increasingly polarized political environment all create the risk of incidents that could lead to media firestorms, government investigations or high-profile litigation. In this edition of Insights for Leaders, lawyers from Sidley's Crisis and Risk Management team discuss what constitutes a corporate crisis, how business leaders can navigate a crisis should one arise, and above all, how to manage risk and prevent a crisis before it happens.

SEC Rulemaking

Proposed SEC Rules Would Require More Detailed, Next-Business-Day Disclosure of Corporate Buybacks (December 20, 2021). In December 2021, the SEC proposed rule amendments to require more frequent and detailed disclosure regarding repurchases of an issuer's registered equity securities. Most notably, the proposed rules would introduce a new disclosure form—Form SR—on which an issuer would be required to disclose details regarding share repurchases made by the issuer or any of its "affiliated purchasers" within one business day of the execution of the corresponding share repurchase order. The SEC also proposed to amend Item 703 of Regulation S-K to expand the share repurchase disclosures required in periodic reports.

SEC Proposes Significant Changes to Rule 10b5-1 Trading Regime and Related Disclosures (December 20, 2021). In December, the SEC proposed rules that would significantly alter the Rule 10b5-1 framework and provide substantial new disclosure requirements. The SEC proposed to add new conditions to the availability of the affirmative defense to insider trading liability provided by Rule 10b5-1(c)(1) including subjecting a Rule 10b5-1 plan adopted by a director or officer to a 120-day cooling-off period before any trades under the plan may be executed. In addition, the proposed rules would impose new disclosure requirements on public companies regarding the adoption, termination and modification of Rule 10b5-1 plans by companies or their insiders and first-ever disclosure requirements regarding issuers' insider trading policies. Finally, the SEC proposed new disclosure requirements relating to the timing of stock awards and proposed certain changes to Section 16 reporting requirements.

SEC Enforcement

SEC Division of Enforcement Annual Report Reveals Record Highs and Lows (December 13, 2021). The SEC's Enforcement Division released its annual report detailing the agency's enforcement efforts during fiscal year 2021. The division brought its lowest number of enforcement actions since 2014, and its disgorgement amount was a five-year low. On the other hand, the division obtained the highest penalties since 2016 while also receiving the most whistleblower tips in the program's history. This Sidley Update discusses how teleworking and recent legislative changes could be affecting these figures and how these trends may shed light on the division's shifting priorities.

Financial Services and Reporting

FinCEN Proposed Rule Will Require Many Domestic and Foreign Entities to Report Beneficial Ownership Information to the U.S. Government (December 13, 2021). In December 2021, the Financial Crimes Enforcement Network (FinCEN) issued a notice of proposed rulemaking to require certain domestic and foreign entities doing business in the United States to file reports with FinCEN identifying and providing information about their beneficial owners and company applicants. The collection of this type of information by the U.S. government is unprecedented. Given the U.S. government's clear determination to make the database operational, now is the time for domestic and foreign entities to determine whether they must provide this information to the government or fit within an exclusion.

SIDLEY SPEAKERS

Small Cap Companies: Ins and Outs for Boards of Directors

January 19 | Webinar

Derek Zaba, a partner in Sidley's Palo Alto and New York offices and co-chair of Sidley's Shareholder Activism practice, will participate in a webinar hosted by the Silicon Valley Directors' Exchange. The speakers will discuss unique challenges for small caps, how directors might best build trust within a small cap board and with the company leadership, as well as best practices that small cap boards are deploying on matters related to diversity, ESG and similar hot topics. Click here for more information.

Shareholder Litigation Developments and Trends

January 24-26 | Coronado, CA

Sara Brody, a partner in Sidley's San Francisco office, will participate in a panel titled *Securities Class Action and Shareholder Litigation: Key Developments and Trends—Views from the Plaintiff and Defense Sides* at the Northwestern Pritzker School of Law's 49th Annual Securities Regulation Institute on January 26. Click here for more information.