INSIGHTS

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SECURITIES ENFORCEMENT

A Guide to SEC Investigations for Public Company Directors, Officers, and In-House Counsel

Public companies need to be prepared to respond to a SEC investigation quickly and with strategic foresight. Decisions made at the outset of an investigation frequently are critical and can shape the investigation's ultimate outcome.

By William Baker and Nathan Seltzer

Even public companies with a strong code of conduct, an exemplary tone at the top, robust internal controls, and a culture of compliance may face allegations of misconduct that can lead to an investigation by the Division of Enforcement of the U.S. Securities and Exchange Commission (SEC). For a public company, the initiation of an SEC investigation can be startling to the company's board and senior management.

A company may learn of an SEC investigation from a phone call to in-house counsel from Division of Enforcement staff notifying the company that the SEC has opened an investigation. Alternatively, a document preservation notice, voluntary request, or subpoena may arrive without warning. At other times, a public company may learn about the investigation from a third party, such as its auditors, a vendor, or a customer that receives a subpoena or request for information. Public companies should be prepared to respond to the investigation swiftly and with strategic foresight. The decisions made at the outset frequently are critical, will impact how the investigation unfolds, and can shape the investigation's ultimate outcome. Competently navigating the investigative process from the beginning is imperative and can help a company to avoid an enforcement action or to otherwise minimize the potential sanctions, while allowing senior management to focus on operating the company's business.

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Overview of SEC Investigations

The SEC begins investigations for a variety of reasons. The Enforcement Staff may initiate an investigation based on information in the news or reports from other SEC divisions, federal or state authorities, and self-regulatory organizations. Public companies also may self-report potentially improper conduct to the SEC staff. Self-reporting may occur because public disclosure of the underlying conduct is required (as with a financial restatement), because a company believes the SEC staff likely will learn about the conduct through other means, or simply because the company's board and senior management believe that self-reporting is consistent with good corporate governance. Obviously, public companies should make the decision whether to self-report carefully. Particularly since the passage of the Dodd-Frank Act—which added strong financial incentives and anti-retaliation protections for putative whistleblowers to the Securities Exchange Act of 1934 (Exchange Act)—the staff has received a significant number of reports of potential misconduct.[1] As of the end of Fiscal Year 2017, the SEC had paid more than U.S.$160 million to 46 whistleblowers since whistleblower rules went into effect in August 2011, with approximately U.S.$57 million paid in FY 2016 and approximately U.S.$50 million paid in FY 2017.[2]

SEC investigations are authorized by various federal securities statutes and are governed by the rules provided in 17 C.F.R. § 202.5, Enforcement

Activities, the Division's Enforcement Manual, and other SEC guidance. The Division does not need probable or reasonable cause to launch an investigation, public companies do not have judicial remedies for challenging the Enforcement staff's decision to open an investigation, and Enforcement staff have broad discretion in the conduct of an investigation.

Investigations may be either formal or informal.[3] In a preliminary inquiry, also known as a Matter under Inquiry (MUI), or in an informal investigation, the staff does not have the power to subpoena companies or individuals, and relies on the voluntary cooperation of those from whom information is sought. In a formal investigation, the staff obtains a formal order of investigation, authorizing them to issue subpoenas that could require the recipient to produce documents or provide testimony.[4] The formal order is not publicly available, but persons asked to produce documents or testify before the SEC can request it. The existence of an investigation does not mean that the staff necessarily will recommend an enforcement action to the SEC. Instead, the investigation means that the staff has identified an issue that it believes warrants investigative resources. The staff can and does close investigations without enforcement action at any stage of the investigation.

The duration of an SEC investigation can be difficult to predict. Typical investigations related to financial disclosures (to the extent such generalizations can be made) frequently take at least one year, and often take two or more years. Investigations lasting five years or even longer are not unheard of. A company can attempt to expedite this timeline by responding to investigation demands promptly and proactively, as well as by crafting a strategy involving internal fact-gathering and legal argument to respond to the staff's concerns.

Investigative Process and a Public Company's Response to an SEC Investigation

Regardless of whether the investigation is formal or informal, a company under investigation should take the matter seriously from beginning to end. The key action items and considerations discussed below can aid a company subject to an SEC investigation in crafting that tone from the outset.

Retaining Outside Counsel

When a company learns of a potential SEC investigation, the company should consider retaining outside counsel with experience in SEC investigations. A company faces a multitude of complex issues and strategic decisions, and outside counsel's experience in dealing with the Enforcement staff is important. Using outside counsel to conduct an investigation can minimize delays and free up in-house counsel to continue with their day-to-day responsibilities.

Public Disclosure of an SEC Investigation

A company should consider several strategic factors when determining whether and when to disclose publicly an SEC investigation. There is no specific line-item disclosure requirement, meaning a company must assess the materiality of the investigation, underlying conduct, and potential outcomes, before deciding whether disclosure is required.

In addition, a company may choose to disclose based on a variety of strategic considerations, including whether earlier disclosure will preserve credibility with investors and analysts (and whether that credibility may be harmed by delayed disclosure), the risk of leaks, and whether the SEC may contact customers or other third parties about the investigation. Alternatively, a company may choose not to publicly disclose an SEC investigation until disclosure is required pursuant to a specific requirement (such as Regulation S-K or if the company or auditors determine that the investigation constitutes a contingency with respect to which loss is "probable" or "reasonably possible"), or the company learns that the staff has decided to recommend that the SEC authorize an enforcement action against the company or its officers.[5] In any event, a company under investigation must not falsely deny the existence of an SEC investigation. However, a company may wish to consider a policy of not commenting

on the existence of a SEC investigation. Finally, the CEO and CFO (and any other certifying officers) should be aware of relevant information that affects their certifications pursuant to Sections 302 and 906 of the Sarbanes-Oxley Act as to the accuracy of SEC filings, including the financial reports included in those filings.[6]

Of course, the disclosure of an investigation (as well as any evidence of possible misconduct or other negative facts) likely will result in adverse publicity and possible private litigation, such as shareholder class actions or derivative actions. Therefore, a company should instruct all employees who deal with the media about how to respond to questions from the press, analysts, and shareholders about a disclosed investigation. Any communications related to the investigation should take into account public relations considerations, concerns about releasing inaccurate or misleading statements, waivers of privilege, and Regulation Fair Disclosure (Reg. FD).[7]

A company and its counsel also should consider whether the company should inform third parties of the investigation, including, for example, insurance carriers, lenders, customers, and other business partners.

Preserving and Producing Documents

During an investigation, the SEC often gathers information through document requests. At the beginning of any investigation, the company should take proactive steps to preserve relevant documents, which may include the suspension of document destruction routines or procedures.[8]

Document collection, processing, and review can be both time-consuming and expensive. Cases involving documents in foreign jurisdictions can add a layer of complexity to an SEC investigation due to data privacy laws. Through counsel, it is often worthwhile to discuss the scope of requests and the timing of the response with the Enforcement staff. In the event of production delays, counsel should contact the staff immediately with a status update to assure them of a client's continued cooperation.

SEC Interviews and Investigative Testimony

Witness interviews and investigative testimony (the latter of which is under oath and transcribed by a court reporter) also play an important role in the staff's fact gathering process. Generally, after document production is complete, the staff may consider whether to request witness interviews or testimony from company employees. The Division will expect that in cooperating with the investigation, a company will use its best efforts to make current employees available for testimony or interviews. However, the staff likely will not be able to compel the appearance for testimony of non-U.S. citizens (unless the staff can properly serve those non-U.S. citizens while they are in the United States).

If the SEC requests or subpoenas witness testimony, counsel will need to prepare witnesses to testify accurately and effectively. Witnesses have a right to be accompanied by counsel during testimony, and only counsel who represent the witness can attend investigative testimony. Company counsel should consider potential conflicts issues carefully throughout the investigation, including the need for any Upjohn warnings to make clear to employees that counsel represents the company and is not the attorney for the individual,[9] as well as whether for conflicts or for strategic reasons, a company employee may require individual counsel separate from counsel representing the company.

The Fifth Amendment privilege against self-incrimination is available to individuals throughout an SEC investigation and civil enforcement action. Whether an individual asserts the privilege will be the decision of the individual with advice from her or his counsel, but this can have significant ramifications for the company in both the SEC investigation and in related civil litigation—particularly if a senior executive makes the assertion. The SEC can draw an adverse inference from an individual's assertion of the right (against the individual and possibly the company) in deciding whether to proceed with an enforcement action, and may move the court to

do the same in subsequent enforcement proceedings.[10] In addition, a company may feel substantial pressure to fire any employee who asserts the Fifth Amendment privilege.

Cooperation with SEC Staff

Since 2001, when the SEC released its Seaboard Report[11] outlining considerations for the SEC in evaluating whether a public company would receive credit in the form of reduced charges or sanctions for "self-policing, self-reporting, remediation and cooperation," the SEC has emphasized the importance of a public company's cooperation in an SEC investigation. The SEC website highlights the Enforcement Cooperation Program, and the benefits of cooperation.[12] The SEC has been willing to agree to cease-and-desist orders, deferred prosecution agreements, non-prosecution agreements, and even "full passes" if the respondent substantially cooperated with the investigation.

The Seaboard Report set forth a non-exclusive list of criteria for the staff to consider "in determining whether, and how much, to credit self-policing, self-reporting, remediation and cooperation" while maintaining "broad discretion to evaluate every case individually, on its own particular facts and circumstances."[13] In addition, in January 2010, as part of a broad effort to further encourage cooperation by individuals and companies, the SEC updated the Enforcement Manual to address how to measure and reward cooperation by individuals and public companies.[14] The Enforcement Manual now identifies a "non-exclusive" list of tools for "facilitating and rewarding cooperation," including proffer agreements, cooperation agreements, deferred prosecution agreements, non-prosecution agreements, and immunity requests.[15]

A company should remember that cooperation does not preclude counsel from negotiating with the staff regarding its requests for documents and testimony or from vigorously advocating for the company. At the same time, counsel must approach negotiations carefully and strategically. Counsel's credibility plays a major factor in the staff's perception of the client during an investigation, and the staff may make an adverse inference against the client if the staff believes counsel is employing dilatory tactics.

Attorney-Client Privilege and Attorney Work-Product Considerations

Companies need not waive the attorney-client privilege, work-product protection, or other privileges in order to receive cooperation credit. Deciding to share privileged materials with the SEC or otherwise waiving the privilege is a significant decision with serious potential consequences. Voluntary disclosure to an independent third party that lacks a common legal interest generally waives the attorney-client privilege, even if the third party agrees not to disclose the communications to anyone else.[16] Most courts have held that a company's disclosure of privileged materials to the SEC waives the attorney-client privilege.[17] And if the attorney-client privilege is waived to the SEC, that waiver generally would include a waiver as to other third parties, including potential civil litigants or the Department of Justice (DOJ). A waiver with respect to specific documents or information also likely would extend to all other communications related to the same subject matter as the disclosed communications.[18] Similarly, disclosure of materials protected by work-product protections to the SEC also likely would constitute a waiver of that protection.[19] However, if a court found that work-product protections were waived, it likely would limit the waiver to the specific documents disclosed and not a broader waiver of all work-product related to that subject matter.

Keeping a Company's Independent Auditors Informed

Appropriately informing a company's independent auditors of the investigation, its progress, and key facts is one of the most important action items for a company in an SEC investigation. Keeping the auditors informed and up-to-date will help facilitate the investigation and ensure, to the extent practicable, that the company is able to continue to issue audited financial statements. To the extent a

company also is conducting an internal investigation, auditors often make substantive suggestions regarding the scope of document collection, search terms, investigative interviews, and fact-finding.

Working with the auditors, however, raises privilege and work-product questions that require a careful balancing of the need to keep the auditors informed while maintaining a company's privileges. Just as with disclosure to the SEC, courts typically have held that disclosure of attorney-client privileged information by a company to its independent auditors constitutes waiver of the privilege.[20] However, courts generally have held that sharing work-product with auditors does not waive work-product protections because the auditors are neither the company's adversaries nor a conduit to the company's adversaries.[21]

Considering the Impact of Parallel Civil Litigation and Other Government Investigations

Decisions about sharing privileged information or work-product should take into account the risk of parallel litigation and other regulatory investigations. When disclosure of an investigation, or the conduct that triggered the investigation (*e.g.*, a financial restatement), causes a stock drop, shareholder class action litigation will almost surely follow. Such cases can generate significant potential damages. Less serious, but even more common, are shareholder derivative suits. These suits, purportedly brought in the name of the corporation, do not require any stock drop. Instead, the plaintiffs' lawyers contend a company should sue its own officers or directors for causing the alleged misconduct that triggered an SEC investigation.

A company must be aware that waivers of privilege and work-product protections in one context generally are waivers as to all contexts. What may help in one forum can have serious adverse consequences in another. For example, detailed written presentations or PowerPoint slides provided to the SEC on the facts of a case may win SEC cooperation credit and could shorten the time of the SEC investigation. But the same presentation—if produced in collateral civil litigation—could provide plaintiffs' lawyers with a road map to the worst facts and raise the settlement value of the civil litigation.

Remediation

When a company learns of potentially problematic conduct, the company should take immediate steps to ensure that no improper or illegal conduct is ongoing and to remedy any mistakes in financial statements. The SEC considers appropriate remediation to be a key element of cooperation, and prompt and meaningful remediation can impact both whether there is an enforcement action and the scope of the sanctions. Any remediation plan should be robust and demonstrate to the SEC the company's desire to fix any problems that occurred.[22]

Resolving the Investigation

Favorable resolutions come in many forms. Closing an investigation quickly without any charges, and with minimal disruption to a company's business, is the most desirable outcome—and that does occur. Even if an investigation is extended, an SEC staff decision to close the investigation without action is still a good outcome. If, following an investigation and Wells process, the Enforcement staff is determined to move forward with an enforcement recommendation, a company can still negotiate the violations charged and the relief obtained in a way that may be more favorable than a litigated outcome.

The Wells Process and Settlement Negotiations

The process by which the Enforcement staff ends an investigation is a flexible one. If the staff tentatively concludes that it will recommend to the SEC an enforcement action against a particular party, the staff makes a Wells call—formal notice of the staff's intended recommendation—and provides the party with an opportunity to respond in writing.[23] After receiving a Wells call, counsel typically meets with the Enforcement staff to learn the staff's position and the possible enforcement recommendation. At this point, a company is entitled

to make a Wells submission to the SEC, stating its position and presenting arguments why the SEC Commissioners should reject the staff's recommendation for enforcement.[24]

Informally, however, a party that thinks the Enforcement staff does not fully appreciate the strength of its position, or a party that believes that a Wells call is inevitable but settlement is possible, need not, and generally should not, wait for a Wells call before contacting the staff to discuss the relative strengths of their positions and settlement. And, in many cases, the staff may make inquiries regarding the possibility of settlement before making a formal Wells call.

If the staff proceeds with recommending an enforcement action after the Wells notice and a company's Wells submission, the staff submits a memorandum to the SEC setting forth its recommendation along with the Wells submission. The SEC then decides whether to institute an enforcement action based on this recommendation.

Settlement vs. Litigation

Public companies often opt to settle rather than litigate SEC cases involving allegations that the company misstated their financial condition for a number of reasons beyond the costs of litigation, including adverse findings that could becoming binding in collateral litigation, the opportunity to settle without an admission of wrongdoing, and an ability to influence how the misconduct is described by the SEC. By contrast, individuals tend to have a different calculus and litigate more frequently against the SEC.

Types of Enforcement Actions

The SEC is authorized to bring two basic types of enforcement actions:

1. Civil injunctive actions in federal district court
2. Administrative proceedings before the SEC's own administrative law judges

Civil injunctive action. When filing an enforcement action in federal district court, the SEC generally will seek civil monetary penalties, an injunction against future violations of the federal securities laws, and other equitable remedies. A case begins with the SEC filing a complaint, which sets forth the SEC's allegations. In a settled enforcement action, along with a complaint, parties also will file the defendant's consent to the entry of the final judgment (including any sanctions and undertakings), and the final judgment to be approved by a judge. The final judgment will enjoin the defendant permanently from future violations and impose the agreed-upon sanctions. In a settled action, there are no findings of fact or conclusions of law in the final judgment. If a defendant chooses to litigate with the SEC, the defendant will submit an answer to the complaint and the case will proceed in litigation.

Administrative proceeding. Instead of filing an action in federal district court, the SEC may decide to bring an administrative proceeding—a decision that is within the SEC's discretion. A settled administrative proceeding typically is resolved by the entry of a cease and desist order—similar to a federal court injunction—requiring a respondent to cease and desist from violations of the federal securities laws. A settled order also will include the SEC's findings of fact, conclusions of law, and sanctions imposed.

Parallel Criminal Investigations

The SEC does not have the authority to bring criminal actions. However, the SEC can refer a matter to the DOJ for criminal prosecution, and parallel civil and criminal investigations are common, particularly if they implicate the anti-fraud statutes or the Foreign Corrupt Practices Act. Additionally, information that a company produced to the SEC can (and will) be shared with the DOJ. Therefore, a company should be mindful of that fact and factor the possibility of a criminal investigation into the myriad strategic decisions it must make during an SEC investigation.

Monetary Sanctions

Over the past 15 years, the SEC increasingly has sought significant monetary sanctions. Monetary sanctions are composed of three distinct segments: civil penalties, disgorgement, and prejudgment interest.

Civil Penalties. The SEC has the authority and discretion to tailor remedies to the seriousness of the

violations. A three-tier structure of increasing gravity governs the size of civil monetary penalties that a court may impose for non-insider trading violations. The tier structure penalties are as follows:

- First Tier penalties are assigned to any violations.
- Second Tier penalties are reserved for violations involving "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement."
- Third Tier penalties are reserved for violations involving "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement" and that "directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain" to the violator.[25]

Generally, the securities laws set forth two alternative methods for calculating the maximum penalty. The first method, which is applicable in both administrative and civil actions, permits a "per violation" calculation, the amount of which increases by tier based on the seriousness of the violation. The second method, which is applicable only in civil actions, allows for the imposition of a penalty equal to the "gross amount of pecuniary gain" to the defendant as a result of the violation(s).

The penalty amounts available still permit the SEC significant flexibility in tailoring a sanction. First, the SEC usually can find as many violations as it needs to—for example, the SEC can charge each allegedly misstated entry in the books and records of a company as a separate violation. Second, if there is a sufficiently large pecuniary gain, the per violation amounts become irrelevant in civil actions. The statutes are not particularly limiting in practice, and the SEC is often subject to public clamor and pressure to impose high penalties for violations of federal securities laws.

Disgorgement and Prejudgment Interest. The SEC routinely seeks disgorgement of ill-gotten gains plus prejudgment interest from the date of the violation. The case law on disgorgement generally states that disgorgement need only be a reasonable approximation of a defendant's ill-gotten gains, and that once the SEC makes a prima facie showing that the proposed amount is such an approximation, a defendant bears the burden of demonstrating that the amount is not appropriate.[26] In cases involving false financial statements or false SEC filings, courts have ordered defendants to disgorge any profits resulting from the inadequacy of disclosures made.[27] Such a measure is necessarily complicated, and rebutting the SEC's assertion may require the engagement of forensic experts.[28]

Courts may award prejudgment interest on disgorgement on a discretionary basis. The time frame for imposing prejudgment interest usually begins with the date of the unlawful gain and ends at the entry of judgment.[29] Prejudgment interest may significantly increase the amount the SEC recovers, particularly because there may be years between the time that the conduct occurred that gave rise to the alleged violation of the securities laws and the time a court enters a judgment.

Potential Admissions Required for a Settlement

Historically, in SEC settlements, parties would neither admit nor deny the SEC's allegations, findings, or conclusions. In recent years, however, the SEC has twice amended its longstanding policy permitting a company to settle without admitting or denying the allegations in the complaint. First, in early 2012, the SEC announced that it would eliminate the "neither admit nor deny" language in cases where there already had been admissions or adjudications of fact in criminal cases.[30] Second, in late June 2013, then-Chair White announced that the SEC would require admissions in cases of egregious conduct or widespread investor harm.[31] The new policy acknowledged that "most" cases would continue to be settled without requiring admissions, but advised that in certain cases

> heightened accountability or acceptance of responsibility through the defendant's admission of misconduct may be appropriate, even if it does not allow us to achieve a prompt resolution.[32]

At this writing, the SEC has since required admissions in more than 20 cases.[33]

Collateral Consequences of an SEC Settlement

SEC resolutions can trigger a variety of collateral consequences. Each case is unique and the nature and extent of any collateral consequences will depend on the particular facts and resolution. Some of the potential collateral consequences public companies may face are set forth below.

Impact on Other Litigation

As noted above, historically, public companies settling with the SEC were able to resolve matters without admitting or denying the SEC's allegations, findings, or conclusions. Accordingly, SEC settlements without any admission had no preclusive effect, meaning that the fact of a settlement does not preclude litigating the underlying facts in another proceeding like a securities class action.[34] Some recent cases, however, have explored whether any part of the settlement is admissible in subsequent litigation.[35] To the extent a company is required to make an admission to settle with the SEC, however, that admission would be admissible and could have preclusive effect in other litigation. This means that the company would be unable to argue a contrary position, thereby impacting the ability to prevail and the settlement value of any other litigation.

Public Company Disclosure Obligations

The disclosures a settlement requires will turn in part on the violations charged. The resolution itself is public, but the entry of an injunction or administrative order against a public company may trigger other disclosure obligations within the company's SEC filings, particularly under Regulation S-K. In any event, a company should consider carefully the appropriate and accurate public disclosure of the settlement.

Ineligibility to File Automatic Shelf Registration Statements

A company that is a Well-Known Seasoned Issuer (WKSI) has the ability to file shelf registration statements that are automatically and immediately effective without staff review.[36] Under Rule 405 of the Securities Act, a WKSI cannot be an "ineligible issuer." An ineligible issuer includes an issuer who has (or whose subsidiaries have) within the three years prior to the applicable determination date been the subject of a judicial or administrative decree or order (including a settled claim or order) involving allegations or violations of, or prohibiting future violations of, the anti-fraud provisions of the federal securities laws.[37] An issuer can apply for an exemption from ineligible issuer status by obtaining a waiver "upon a showing of good cause, that it is not necessary under the circumstances that the issuer be considered an ineligible issuer."[38]

Disqualification from Certain Offerings

Rule 506 of Regulation D permits a company to raise an unlimited amount of capital if the company sells the securities only to accredited investors and 35 additional purchasers who qualify as sophisticated investors.[39] Dodd-Frank required the SEC to adopt disqualification regulations applicable to offerings and sales of securities under Rule 506.[40] Under the rule, an issuer cannot rely on Rule 506 if certain individuals or entities (including directors and officers who participate in the offering) have been subject to a disqualifying event such as SEC enforcement orders or court judgments. Again, a company may apply to obtain an exemption from this disqualification[41] or a waiver.[42]

Loss of Safe Harbor for Forward Looking Statements

Section 27A of the Securities Act and Section 21E of the Exchange Act provide issuers with safe harbors from private actions alleging that certain forward-looking statements were materially untrue or incomplete.[43] An issuer who—in the three years prior to the forward-looking statement—was

> the subject of a judicial or administrative decree or order arising out of a government action that . . . prohibits future violations

> of the anti-fraud provisions of the securities laws . . . [or] determines that the issuer violated the anti-fraud provisions of the securities laws

cannot take advantage of the safe harbor provisions.[44] However, a disqualified issuer may apply to the SEC for exemption.[45]

Conclusion

SEC investigations can be complex, costly, and time-consuming. But understanding the process and pitfalls can help public company executives and in-house counsel navigate the process, while avoiding unnecessary distraction from business operations. Understanding the process, risks, and strategic issues a company will face can help avoid missteps and move the investigation toward resolution as quickly as possible with the least disruption to the company, its executives, and employees.

Notes

1. Dodd-Frank added two key provisions to the Exchange Act. The new Section 21F of the Exchange Act establishes a whistleblower program that offers financial incentives for a person to voluntarily provide non-public information to the SEC, which results in an enforcement action. Specifically, any resulting enforcement action that results in monetary sanctions in excess of U.S.$1 million entitles the whistleblower to an award of between 10-30% of the aggregate monies received by any U.S. regulator. In addition, Section 21F establishes an anti-retaliation provision, which establishes a private cause of action for a whistleblower to sue his or her employer in federal court for any form of harassment caused by the employee's whistleblowing activity. The SEC itself can also take legal action against retaliating employers. By the end of Fiscal Year 2016, the SEC had paid more than U.S.$111 million to 34 whistleblowers since whistleblower rules went into effect in August 2011, with more than U.S.$57 million paid in FY 2016 alone. See SEC, 2016 Annual Report to Congress on Dodd-Frank Whistleblower Program 10 (2016), *https://www.sec.gov/whistleblower/reportspubs/annual-reports/owb-annual- report-2016.pdf*. In 2016, the SEC also brought charges under Rule 21F-17(a) against multiple companies for including language in confidentiality agreements that impeded whistleblowers from reporting to the SEC. For example, in BlueLinx Holdings, Inc., the SEC asserted that separation agreement clauses that required employees to waive the right to any monetary recovery in connection with any legal complaint "raised impediments to participation by its employees in the SEC's whistleblower program." The company paid U.S.$265,000 in penalties and was required to modify its separation agreements so as to not restrict whistleblower incentives. *See* BlueLinx Holdings, Inc., Exchange Act Release No. 78528 (Aug. 10, 2016), *https://www.sec.gov/litigation/admin/2016/34-78528.pdf*. Accordingly, public companies should be careful to ensure that separation agreements comply with Dodd-Frank so as not to create potential problems with the SEC.
2. SEC, 2017 Annual Report to Congress on Dodd-Frank Whistleblower Program 1 (2017), *https://www.sec.gov/files/sec-2017-annual-report- whistleblower-program.pdf*; SEC, 2016 Annual Report to Congress on Dodd-Frank Whistleblower Program 10 (2016), *https://www.sec.gov/whistleblower/reportspubs/annual-reports/owb-annual-report-2016.pdf*.
3. The Enforcement Manual is available at *https://www.sec.gov/divisions/enforce/enforcementmanual.pdf*.
4. Section 21(b) of the Exchange Act (and similar provisions in other federal securities statutes) authorizes the SEC to conduct investigations of possible violations of the federal securities laws. The SEC issues formal orders of investigation that authorize specific enforcement staff to exercise the SEC's authority to subpoena documents and witnesses. Prior to 2009, a formal order of investigation had to be authorized by the SEC itself. In 2009, the SEC's Rules of Practice were amended to delegate authority to the Director of the Division of Enforcement. *See* Exchange Act Release No. 60448 (Aug. 11, 2009), *https://www.sec.gov/rules/ final/2009/34-60448.pdf*; Exchange Act Release 62690 (Aug. 16, 2010), *https://www.sec.gov/rules/final/2010/34-62690.pdf*.
5. In 2016, a federal district court in the Southern District of New York dismissed a shareholder suit alleging that

defendants had violated securities laws by failing to disclose receipt of a Wells notice. In re Lions Gate Entm't Corp. Sec. Litig., 165 F. Supp. 3d 1 (S.D.N.Y. 2016). Among other conclusions, the court held that that receipt of a Wells notice, without additional factors, does not trigger a duty to disclose under Section 10(b) of the Exchange Act and Rule 10b-5 because the SEC may ultimately choose not to initiate an action against the investigation target and so the Wells notice itself is not an indication that material litigation is substantially likely to occur. *Id*. at 12–13. The court found further that the fact of the investigation was not per se material and that the plaintiffs had failed to allege how knowledge of a preliminary SEC investigation for which there was no settlement in place at the time of the Class Period would have significantly altered the total mix of information available to an investor. Id. at 14.

6. *See* 18 U.S.C. § 1350; 17 C.F.R. §§ 240.13a-14, 15d-14.
7. Regulation FD sets forth the SEC rules governing selective disclosure by companies of material nonpublic information. The SEC adopted Regulation FD to prevent material nonpublic information from being given selectively to market professionals such as broker-dealers, investment advisers and managers, and investment companies, who could use such information to their own or their clients' advantage. Regulation FD applies to communications on behalf of the issuer with market professionals and with security holders who may foreseeably trade on the basis of the disclosed information. *See* 17 C.F.R. pt. 243.
8. *See* 18 U.S.C. § 1519, Destruction, alteration, or falsification of records in Federal investigations and bankruptcy; 18 U.S.C. § 1520, Destruction of corporate audit records.
9. *See* Upjohn Co. v. United States, 449 U.S. 383 (1981). An *Upjohn* instruction should make clear to the witness that counsel represents the company and not the employee individually; conversations with the employee may be protected by the attorney-client privilege if counsel seeks information to provide legal advice to the company; the privilege, however, belongs to the company exclusively; and the company may decide to waive the privilege and disclose the communications with the employee to third parties, including the government.
10. Enforcement Manual § 4.1.3.
11. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and SEC Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44969, (Oct. 23, 2001), *http://www.sec.gov/litigation/ investreport/34-44969.htm* (hereinafter Seaboard Report).
12. *https://www.sec.gov/spotlight/enforcement-cooperation-initiative.shtml*.
13. Seaboard Report.
14. The SEC's statement announcing the initiative identified four general considerations to use in assessing cooperation by individuals: (1) the assistance provided by the cooperator; (1) the importance of the underlying matter; (3) societal interest in holding the individual accountable for his or her misconduct; and (4) the appropriateness of cooperation based on the risk profile of the individual. *See* SEC Press Release, SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations (Jan. 13, 2010), *https://www.sec.gov/news/press/2010/2010-6.htm*; *see also* Robert S. Khuzami, Director, Division of Enforcement, Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement (Aug. 5, 2009), *https://www.sec.gov/news/speech/2009/ spch080509rk.htm*.
15. Enforcement Manual § 6.2.
16. Westinghouse Elec. Corp. v. Republic of Phil., 951 F.2d. 1414, 1427 (3d Cir. 1991).
17. Although recognized by the Eighth Circuit, the First, Third, Fourth, Sixth, Ninth, Tenth, D.C., and Federal Circuits have rejected the selective waiver doctrine. *See* In re Pac. Pictures Corp., 679 F.3d 1121, 1129 (9th Cir. 2012); In re Qwest Commc'ns Int'l, Inc., 450 F.3d 1179, 1197 (10th Cir. 2006); Burden-Meeks v. Welch, 319 F.3d 897, 899 (7th Cir. 2003); In re Columbia/HCA Healthcare Corp. Billing Practices Litig., 293 F.3d 289, 295 (6th Cir. 2002); United States v. Mass. Inst. of Tech., 129 F.3d 681, 686 (1st Cir. 1997); Genentech, Inc. v. United States Int'l Trade Comm'n, 122 F.3d 1409, 1416–18 (Fed. Cir. 1997); Westinghouse Elec. Corp., 951 F.2d at 1425; In re Martin Marietta Corp., 856 F.2d 619, 623–24 (4th Cir. 1988); Permian Corp. v. United States, 665 F.2d 1214, 1221 (D.C. Cir. 1981); Diversified Indus., Inc. v. Meredith, 572 F.2d 596 (8th Cir. 1978) (en banc). The Second Circuit does not have a per se rule rejecting selective waiver, but has recognized it only in limited cases. See In re Steinhardt Partners, L.P., 9 F.3d 230, 235–36 (2d Cir. 1993).

18. *See, e.g.*, SEC v. Microtune, Inc., 258 F.R.D. 310, 317 (N.D. Tex. 2009) ("When a party waives the attorney-client privilege, it waives the privilege as to all communications that pertain to the same subject matter of the waived communication."); see also Nguyen v. Excel Corp., 197 F.3d 200, 208 (5th Cir. 1999) ("[D]isclosure of any significant portion of a confidential communication waives the privilege as to the whole.").
19. Disclosure of materials protected by work-product does not automatically waive work-product protections. Instead, waiver occurs when the documents are either made available to an adversary or to a third party that could serve as a conduit to an adversary. Put differently, waiver results if the work-product is treated in a manner that substantially increases the likelihood that an adversary will come into possession of the material. *See* Mass. Inst. of Tech, 129 F.3d at 687 (stating that "work product protection is provided against 'adversaries,' so only disclosing material in a way inconsistent with keeping it from an adversary waives work product protection"). The SEC is usually considered an adversary thus waiving work-product protections. *See, e.g.*, In re Initial Pub. Offering Sec. Litig., 249 F.R.D. 457, 466 (S.D.N.Y. 2008) (finding work-product protection was waived when defendant provided materials to the SEC in response to an SEC inquiry); SEC v. Brady, 238 F.R.D. 429, 444 (N.D. Tex. 2006) (finding waiver of work-product protections where defendant disclosed privileged information and documents to the SEC, under a confidentiality agreement, in response to an informal SEC investigation).
20. *See, e.g.*, United States v. Deloitte LLP, 610 F.3d 129, 139–40 (D.C. Cir. 2010) (although voluntary disclosure to auditors waives attorney- client privilege, it does not necessarily waive work-product protection); Microtune, 258 F.R.D. at 317 (disclosure to outside auditors waives attorney-client privilege); Brady, 238 F.R.D. at 439–40 ("disclosure of privileged information directly to a client's independent auditor . . . destroys confidentiality" and therefore constitutes a waiver).
21. *See, e.g.*, Deloitte LLP, 610 F.3d at 139–40 (holding disclosure of work-product protected documents to independent auditors did not waive privilege and noting "[t]o the best of our knowledge, no circuit has addressed whether disclosing work-product to an independent auditor constitutes waiver. Among the district courts that have addressed this issue, most have found no waiver"); Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc., 237 F.R.D. 176, 183 (N.D. Ill. 2006) (disclosure of protected materials to auditors did not constitute waiver as "[d]isclosing documents to an auditor does not substantially increase the opportunity for potential adversaries to obtain the information"). *But see* Medinol v. Bos. Sci. Corp., 214 F.R.D. 113, 116–17 (S.D.N.Y. 2002) (work-product protection waived by disclosure to independent auditor as auditor and company "did not share 'common interests' in litigation").
22. Taking steps to bolster controls and remedy any problems that occurred should not be viewed as an admission of liability. Although unlike the Federal Rules of Evidence, in the context of SEC investigations, there is no rule that prohibits the staff from considering the remediation when assessing whether there was misconduct, where mistakes or misconduct has occurred, it is almost always preferable to remediate promptly and comprehensively.
23. *See* Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations, Securities Act Release No. 5310, Exchange Act Release No. 9796, Investment Company Act Release No. 7390 (Sept. 27, 1972).
24. *See* 17 C.F.R. § 202.5(c). The Rules state further that:

    > Submissions by interested persons should be forwarded to the appropriate Division Director or Regional Director with a copy to the staff members conducting the investigation and should be clearly referenced to the specific investigation to which they relate. In the event a recommendation for the commencement of an enforcement proceeding is presented by the staff, any submissions by interested persons will be forwarded to the Commission in conjunction with the staff memorandum.

    Id
25. 15 U.S.C. §§ 77h-1(g), 77t(d), 78u-2(b).
26. *See* SEC v. Razmilovic, 738 F.3d 14, 31–32 (2d Cir. 2013); SEC v. Platforms Wireless Int'l Corp., 617 F.3d 1072, 1096 (9th

Cir. 2010); SEC v. First City Fin. Corp., 890 F.2d 1215, 1230–32 (D.C. Cir. 1989).

27. *See, e.g.,* SEC v. Sierra Brokerage Servs. Inc., 608 F. Supp. 2d 923, 969–70 (S.D. Ohio 2009); SEC v. Bilzerian, 814 F. Supp. 116, 123 (D.D.C. 1993).
28. The SEC historically took the position that disgorgement was an equitable remedy not subject to the five-year statute of limitations. However, in Kokesh v. SEC, 137 S. Ct. 1635 (2017), the Supreme Court held that disgorgement is a "penalty" and is subject to the five-year statute of limitations in 28 U.S.C. § 2462.
29. SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1477 (2d Cir. 1996).
30. Public Statement, Robert Khuzami, Director, SEC Division of Enforcement, Public Statement by SEC Staff: Recent Policy Change (Jan. 7, 2012), *http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1365171489600*.
31. White, Deploying the Full Enforcement Arsenal, *supra* n.66.
32. Alison Frankel, Should Defendants Fear New SEC Policy on Admissions in Settlements?, Reuters, June 19, 2013, *http://blogs.reuters.com/alison-frankel/2013/06/19/should-defendants-fear-new-sec-policy-on-admissions-in-settlements/*.
33. *See, e.g.*, Credit Suisse AG, Securities Act Release No. 10229, Exchange Act Release No. 79044 (Oct. 5, 2016); Citigroup Glob. Mkts., Inc., Exchange Act Release No. 78291 (July 12, 2016); Merrill Lynch, Pierce, Fenner & Smith Inc., Exchange Act Release No. 78141 (June 23, 2016); In re BDO U.S.A, LLP, Exchange Act Release No. 75862 (Sept. 9, 2015); OZ Mgmt., LP, Exchange Act Release No. 75445 (July 14, 2015); Wedbush Sec. Inc., Exchange Act Release No. 73652 (Nov. 20, 2014); Lions Gate Entm't Corp., Exchange Act Release No. 71717 (Mar. 13, 2014); JPMorgan Chase & Co., Exchange Act Release No. 70458 (Sept. 19, 2013).
34. *See, e.g.,* United States v. Brekke, 97 F.3d 1043, 1049 (8th Cir. 1996); Lipsky v. Commonwealth United Corp., 551 F.2d 887, 893–94 (2d Cir. 1976); In re Cenco, Inc. Sec. Litig., 529 F. Supp. 411, 415–16 (N.D. Ill. 1982).
35. The analysis is contingent on various factors, including the type of settlement and how a party might attempt to make use of the settlement, or certain aspects thereof, in a subsequent proceeding. Two competing federal rules of evidence are in play: Rule 408, which generally prohibits the admission of settlement information for purposes of establishing liability; and Rule 803(8)(C), which allows the admission of public records of public agencies setting forth factual findings resulting from a lawful investigation. *Compare* Option Res. Grp. v. Chambers Dev. Co., 967 F. Supp. 846, 849 (W.D. Pa. 1996) (finding that the SEC's factual findings, including its opinions and conclusions, contained in the settled administrative orders were admissible under Rule 803(8)(C)), *with* Carpenters Health & Welfare Fund v. Coca-Cola Co., No. 1:00-CV-2838-WBH, 2008 U.S. Dist. LEXIS 112503, at *19–20 (N.D. Ga. Apr. 23, 2008) (finding that SEC cease and desist order against the defendant was not admissible under Rules 408 and 803(c)), and SEC v. Pentagon Capital Mgmt. PLC, No. 08 Civ. 3324, 2010 U.S. Dist. LEXIS 25092, at *2–4 (S.D.N.Y. Mar. 11, 2010) (finding that factual findings contained in SEC settled orders relating to third-parties were admissible under Rule 803(c)).
36. 17 C.F.R. § 230.405.
37. *Id.*
38. *Id.*
39. *See* 17 C.F.R. § 230.506(b).
40. *See* Disqualification of Felons and Other "Bad Actors" From Rule 506 Offerings, 78 Fed. Reg. 44,730, (July 24, 2013); 17 C.F.R. § 230.506.
41. *See* 17 C.F.R. § 230.262; 17 C.F.R. § 230.506. In addition, Rule 602 of Regulation E also allows public companies to seek a waiver upon a showing of good cause that waiver is not necessary; however, the SEC has not delegated this authority, requiring public companies to appeal directly to the SEC for a Regulation E waiver. 17 C.F.R. § 230.602.
42. *See* 17 C.F.R. § 230.262; 17 C.F.R. §§ 230.505, 230.506.
43. 15 U.S.C. §§ 77z-2, 78u-5.
44. *See* 15 U.S.C. §§ 77z-2(b)(1)(A)(ii), 78u-5(b)(1)(A)(ii).
45. 15 U.S.C. §§ 77z-2(g), 78u-5(g).

INSIDER TRADING

Evaluating Insider Trading Compliance Programs in Light of Recent Cybersecurity Events and SEC Guidance

Recent SEC cybersecurity guidance to public companies crystallizes the need for companies to review the operation of their insider trading compliance programs. Among other things, companies should consider their risk profile and update their list of examples of material non-public information.

By Dixie L. Johnson, Phyllis B. Sumner, Dick Walker, and Michael R. Smith

In light of the continuing drumbeat of high profile data breaches and the recent guidance from the Securities and Exchange Commission (SEC) to public companies in response[1] (SEC Cybersecurity Guidance), many public companies will find it timely to review the operation of their insider trading compliance programs. The SEC Cybersecurity Guidance serves as a call to action for various stakeholders in public companies—for boards, to evaluate their oversight of cybersecurity risks, and for management, to evaluate the approach to disclosure of cybersecurity risks and incidents, disclosure controls and procedures, and insider trading compliance programs. Just last month, the SEC brought a first-of-its kind enforcement action alleging that a company failed to disclose a cybersecurity breach quickly enough.[2] It is clear the SEC will be monitoring cybersecurity disclosure issues closely in the coming quarters. Accordingly, public companies may wish to consider the steps discussed below when evaluating their insider trading compliance programs.

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Purposes of an Effective Insider Trading Compliance Program

While there is no specific statute or regulation that requires a public company that is not a broker-dealer or investment adviser to maintain an insider trading compliance policy, following the insider trading scandals of the 1980s and the enactment of the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), such policies have been universally adopted. Under ITSFEA, controlling persons may be subject to treble damages for "reckless disregard" of the fact that subordinates may engage in violations, and for the failure to take appropriate steps to prevent such conduct. The failure to maintain an effective insider trading compliance program arguably could be evidence of "reckless disregard" under the statute. Under the federal sentencing guidelines, companies can reduce their "culpability score" for employees' insider trading by having an effective compliance program in place. Finally, the U.S. Department of Justice has indicated that the operation of effective compliance programs will impact its decision to prosecute firms for the actions of their employees.

The terms of insider trading policies vary considerably, however, and the manner in which companies administer their programs varies even more. Accordingly, before going into the specifics of how a program might be updated in response to recent events and the SEC Cybersecurity Guidance, it is useful to consider the purposes that these programs aim to serve. Attention to these "first principles" will inform many of the decisions that should be considered in implementing and updating a company's insider trading policies and procedures.

Insider trading compliance programs serve three main purposes. First, protecting the company and other control persons. The last thing any public company and its officers and directors need is an insider trading investigation. At a minimum, these investigations require companies to produce extensive corporate records demonstrating what information was available, to whom and when. Arguments also could arise that corporate officers, and perhaps the company itself, are liable as "control persons" for illegal employee trading. The establishment, maintenance and enforcement of an effective insider trading compliance program should make it less likely that a company's insiders will engage in illegal activity. It also should mitigate exposure for the company and the distractions and expense of an investigation, in the event there is a bad actor.

The company's culture may come into play in designing and operating its insider trading compliance program.

Second, protecting the company's workforce. Insider trading compliance programs also protect the company's directors, officers and other employees from becoming embroiled in the costly and distracting legal and reputational nightmare of defending against allegations of "insider trading." An officer seeking to sell some shares as part of her financial planning wants comfort that, if she does so, her actions will not become the subject of scrutiny. Consider, for example, the appearance of improper trading if her sale is followed by the company announcing disappointing news and a decline in the share price. As another example, if a company's policies and reminders encourage an officer, director or employee to protect material non-public information (MNPI) from family members, a costly and embarrassing investigation triggered by a family member's trading could be avoided.

Third, protecting the company's reputation. Allegations of insider trading against an employee, officer or director may cause significant reputational harm to a public company. Defending against this reputational damage may be expensive for the company and distracting for its workforce.

Alignment on Program Philosophy

Public companies face many choices in designing their insider trading compliance programs. These choices should be informed by balancing the risks that the company and its officers face from insider trading by company personnel against the costs of imposing an overly-restrictive policy. A highly restrictive policy may reduce the risk of the company and its managers facing an insider trading investigation, but there are costs to such an approach. At the extreme, the company's ability to use its equity securities in incentive compensation programs may be compromised if employees believe that they will not be able to sell those securities to meet their financial needs. In more pragmatic terms, an overly-restrictive program may be difficult to administer on a day-to-day basis, and may result in a pattern of non-compliance.

The company's culture may come into play in designing and operating its insider trading compliance program. Some companies tend to impose more restrictions on any activities that could subject the company to legal liabilities, with the added benefit of helping employees avoid difficult situations. Other companies take a more "hands-off" approach, restricting the activities of employees only when dictated by compelling needs of the company.

Whenever the company considers changes in its insider trading compliance program, it is important to ensure that the board and management are aligned on the purposes and philosophy embodied in the program.

Best Practices for Updating Insider Trading Compliance Programs

Before considering the appropriateness of updates to a company's insider trading compliance policy to address cybersecurity matters, it is useful to review some key operational elements employed by most policies. Most insider trading compliance policies:

- Prohibit trading or tipping by directors, officers and other employees (along with their respective family and household members) in possession of MNPI;
- Impose "window" restrictions around quarterly earnings announcements, so that certain individuals may trade only during limited periods of time each quarter;
- Require directors and senior officers privy to sensitive information to "pre-clear" their transactions;
- Provide that various types of purchases and sales by insiders will be exempt from these restrictions; and
- Allow the company to impose special trading blackouts in appropriate circumstances (*e.g.*, a team working on a material acquisition or that has become aware of a material event).

With those key elements in mind, the following points should be addressed.

Consider whether cybersecurity incidents should be included among examples of events that may be material. Insider trading compliance policies uniformly prohibit trading while an employee, officer or director is in possession of any MNPI about the company. To assist individuals in their understanding of what constitutes MNPI, policies typically include a list illustrating the types of information that are likely to be considered "material." Some of these examples are applicable to all public companies (*e.g.*, the company's quarterly results varying significantly from previous guidance or an impending change in senior management), while other examples should be tailored to risks specific to the company and its industry.

In view of the SEC Cybersecurity Guidance, we recommend that all public companies consider their risk profile, including with respect to cybersecurity, and update their list of examples of MNPI to reflect their current situation. Rather than simply listing "a material cybersecurity incident," consider whether the examples listed in your policy appropriately address the broader set of similar events your business might encounter. In addition to the company's technology infrastructure, consider risks to its facilities or fleet. Consider other types of events that could disrupt the company's operations. The following language, for example, would cover cybersecurity incidents, as well as a broader range of events:

> a significant disruption in the company's operations or loss, potential loss, breach or unauthorized access of its property or assets, including its facilities and information technology infrastructure.

Companies should consider whether this type of list of examples of MNPI will be useful for its workforce, and any such list must be carefully tailored to include the types of information that are most important to the company. A policy that includes this type of list should state clearly that the examples are provided solely for illustration purposes and that they are not a complete list of types of events that might be material. Policies often remind employees that they have the responsibility for being certain that they do not have MNPI when they enter into transactions and that they should consult supervisors or compliance personnel with any questions.

Confirm that the Company has an effective mechanism for imposing special blackouts. As described above, most insider trading compliance policies include provisions under which the company reserves the right to impose a trading blackout at any time, on any group of employees or officers (referred to as a "special blackout"). In the SEC Cybersecurity Guidance, the SEC focuses on the period when a company is investigating the underlying facts and

assessing the materiality of a significant cybersecurity incident, prior to the time that it publicly discloses the incident. The SEC emphasizes that companies should consider whether and when it may be appropriate to implement a special blackout in this period.

In view of this SEC guidance, public companies should ensure that their insider trading compliance policies include appropriate provisions permitting them to impose special blackouts. Beyond including such a measure in the policy, each company should consider how it would identify the employees who should be covered and how it would communicate with them, in an urgent situation. It also may be useful to consider, in advance, the types of transactions that might be exempt from a special blackout.

Consider whether other updates of your insider trading compliance policy might be appropriate. As companies experience changes in the way they do business, the composition of their workforces and their channels of public communication, it is useful for them to review and refresh their insider trading compliance policies. As you consider amendments to your policy relating to cybersecurity matters, the following are a few subjects that may also be worthy of consideration:

Windows. Is the timing for opening and closing the quarterly window in connection with earnings still consistent with the timing of financial information becoming available internally? For example, has the company implemented a new internal reporting system that provides better visibility into its quarterly results earlier in the quarter? Has the list of insiders who have regular access to financial information changed?

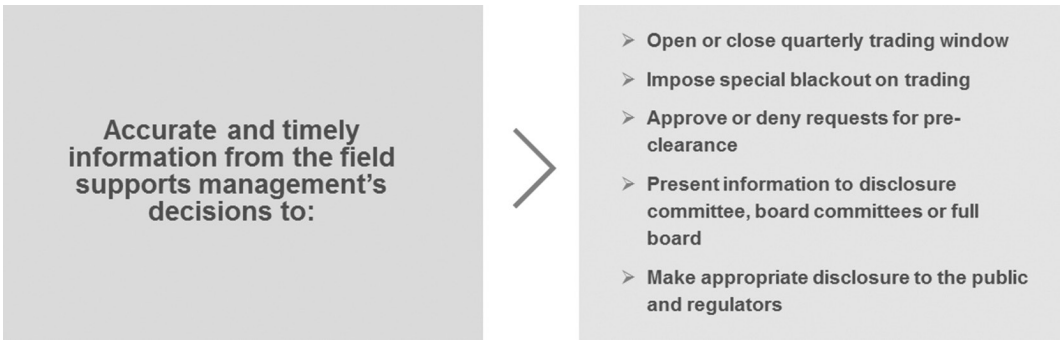
Trading groups. Are you comfortable with how employees, officers and directors are categorized between the group subject to pre-clearance and windows, the group subject to windows but no pre-clearance and the group restricted only when in possession of MNPI? For example, have you added personnel to your legal, finance, accounting, IR or IT functions that are privy to information that historically had only been available to officers who are subject to pre-clearance?

Pre-clearance. Does your policy reflect actual practice for obtaining pre-clearance and is responsibility for pre-clearance in the right hands? For example, should the company consider a committee approach to pre-clearance instead of designating one individual? What documentation and recordkeeping requirements are imposed for pre-clearance requests?

New means of communications, security ownership or financial instruments. Have there been developments in channels of communications or types of security ownership and financial instruments that should be expressly referenced in the policy? For example, does the policy adequately address the interplay between consumer engagement through the internet and social media channels, on the one hand, and unauthorized disclosure of MNPI and "tipping," on the other hand?

Relationships with third parties. Insider trading compliance policies typically touch other companies in two respects. First, company employees should be prohibited from trading on the basis of MNPI relating to other public companies that they obtain during the course of their work for the company. Second, policies often contain provisions calling on company employees to arrange for agreements with third party vendors, consultants and contractors, prohibiting these third parties from trading in company securities or disclosing MNPI. In view of new approaches to collaboration and the increased sharing of information with people outside of the company, the company may wish to consider its coverage of such third parties.

Recurring questions. Whenever a company updates its policy, it should consider the types of recurring questions asked by employees, officers and directors. Addressing these issues in the policy should provide clarity for the workforce, improve consistency and reduce the burden of administering the program.



Review and Update Processes and Procedures

Drafting a robust insider trading compliance policy is the easy part. The more significant challenge is ensuring that the company's processes and procedures relating to the flow of information and the administration of the policy are both effective and practical. With no "one size fits all" approach, it is important to work together with internal stakeholders and outside advisors to develop and implement customized processes and procedures that work for your company.

Information Flow

It is critical that a company have effective disclosure controls for material events, including relating to cyber and data privacy matters. Companies must design reliable processes through which information will flow "from the field" to officers responsible for public disclosure and insider trading compliance, as well as processes through which headquarters personnel may pull information from the field. Among other things, proper flows of information enable the company to impose "special blackouts" when appropriate, as described above.

Coordination between Public Disclosure and Insider Trading Compliance Functions

Given the increased focus on the accuracy and completeness of public disclosure related to cybersecurity, and the impact of information about cybersecurity on insiders' securities transactions, it is critically important to have effective coordination between those responsible for the company's public disclosure and its insider trading compliance program. Although it is appropriate for companies to use different "triggers" for denying pre-clearance of insiders' transactions, imposing special blackouts on groups of employees and making disclosure of an event to the public, decisions on these matters should be made on the basis of consistent information and legal analyses.

Pre-Clearance Officer or Committee

Since there is no "check the box" guide to determining if an event such as a cybersecurity incident is "material" or disclosable, with the availability of information often evolving over time, even with the most systemized insider trading compliance program there will be pressure on people administering the policy to call the "balls and strikes" correctly. Companies should consider whether decisions to open or close windows, to pre-clear transactions or to impose special blackouts should rest with one individual (*e.g.*, a senior legal officer) or instead with a small committee (*e.g.*, a committee composed of legal, finance and compliance officers). We believe there will be a trend toward more companies adopting the committee approach, thereby relieving a single individual from the responsibility (and scrutiny) of such decisions. There is no need for committees to meet in person or even confer by telephone, as electronic messages may allow them to work efficiently.

Basis of Granting Pre-Clearance

Regardless of whether an individual officer or a committee will pass on requests for pre-clearance, it will be useful for the company to provide guidance regarding the standard and degree of conservatism to be employed in making the pre-clearance decision. Should only the existence of currently material information result in a denial, or should clearance also be denied if there is a real concern that information currently known could develop into MNPI? This is another example of a decision on which the board and senior management should be aligned, based on their approach to risk.

Administrative Nuts and Bolts

- Diligent day-to-day attention to the administration of the policy is important for its effectiveness, and operational matters should not be overlooked. Among other things, you should work with advisors to address the following points:
- Establish processes for adding and removing individuals from pre-clearance and window groups, as well as for periodically confirming that the approach to classification is appropriate
- Craft succinct communications for the opening and closing of windows, expected trading calendars, reminders, special blackouts etc.
- Consider whether the company should obtain periodic certifications of compliance from employees, officers and directors, as well as certifications when an insider trades within a window or requests pre-clearance
- Ensure that the company has proper record-keeping for its insider trading compliance program, and consider what the records would show if the company were required to produce its records in an enforcement proceeding
- Consider whether there are metrics that suggest insiders either are or are not complying with the company's policy. Do the numbers of inquiries about the policy or requests for pre-clearance suggest that insiders are complying with the policy?

Awareness and Training

"Tone at the top" is an important component of any area of compliance and can be reinforced with a thoughtful approach to awareness and training. Consider how information is most effectively communicated through all levels of your organization and design procedures to disseminate information regarding your insider trading program and the importance of compliance. This includes considerations such as where the policy is made available, the frequency and content of communications about the policy and training programs on compliance. It is often helpful to view these items through the eyes of your least-sophisticated employee.

Notes

1. SEC Release Nos. 33-10459; 34-82746, Feb. 21, 2018.
2. SEC Release 33-10485 (April 24, 2018).

CORPORATE GOVERNANCE

Obligations of Directors and Managers of Alternative Entities—*Miller v. HCP* and Other 2018 Delaware Decisions

While directors, managers or general partners of "alternative entities" have "default" fiduciary duties pursuant to statute, the entities themselves are created by contract and the fiduciary duties can—and typically are—modified or entirely disclaimed by agreement. A February 2018 Delaware Court of Chancery decision highlights the contrast with corporate law, and the generally limited application of the implied covenant of good faith in the alternative entity context.

By Gail Weinstein, Steven J. Steinman, Randi Lally, and Maxwell Yim

As is well known, in Delaware, in the *corporate* context, the common law has established that directors owe fiduciary duties of due care and loyalty to the corporation and its stockholders—and these duties cannot be disclaimed or modified by agreement. Although directors, managers or general partners of so-called "alternative entities" (*i.e.*, *non*-corporate entities such as limited liability companies, limited partnerships, and the like) have "default" fiduciary duties pursuant to statute, the entities themselves are created by contract and the fiduciary duties can—and typically *are*—modified or entirely disclaimed by agreement.

When an LLC (or other alternative entity) agreement clearly disclaims all statutory fiduciary duties of the directors, the directors' duties are limited to (1) those expressly set forth in the agreement and (2) those that a court deems to arise under the implied covenant of good faith and fair dealing (which adheres to every contract and, by statute, cannot be waived or modified). Generally, the implied covenant of good faith is deemed applicable by the Delaware courts only under quite limited circumstances. The implied covenant has been deemed applicable only if there is (1) a "gap" in the agreement because the parties did not consider an *un*anticipatable event that has arisen *and* (2) evidence as to what the parties would have agreed had they considered the possibility of that event arising.[1] Thus, typically, LLC directors' only obligations are those that are expressly set forth in the LLC agreement.

Alternative entity operating agreements typically expressly confer *very broad authority* on the directors managers or general partners, as the case may be, to operate the entity in their discretion. This broad discretion typically extends to transactions in which the directors, managers or general partners, and/or the controlling member who appointed them, are self-interested. The underlying judicial premise in these cases (often reiterated by the court in its opinions) is that, when an investment is made in a non-corporate entity, the investor is "consciously choosing" to give up the protection of fiduciary duties applicable to corporate directors in exchange for specifically negotiated contractual protections. Thus, the courts have been disinclined to "read in" fiduciary-type obligations that are not clearly stated in the agreement.[2]

With this backdrop, the following key principles should be kept in mind:

- "Good faith" in the context of the implied contractual covenant has been viewed by the court differently than "good faith" as part of the corporate fiduciary duty of loyalty. In the context

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of the implied contractual covenant, the concept has been limited to a requirement that a party not take action to defeat the expectations clearly implied by the explicit terms of an agreement—and it has *not* encompassed the concept applicable in the corporate fiduciary context of acting as a loyal fiduciary to advance the best interests of the stockholders. In recent cases, the court has reiterated that, even if there is a gap in the agreement, the implied covenant "does not establish a free-floating requirement that a party act in some morally commendable sense." Rather, "good faith" in the contractual context "entails faithfulness to the scope, purpose, and terms of the parties' contract"; and "fair dealing" "does not imply equitable behavior… [; rather,] it simply means actions consonant with the terms of the parties' agreement and its purpose." Moreover, the court has written, the implied covenant does not impose "obligations from [the court's] own notions of justice or fairness," but, instead, determines whether, from the contract terms, it can be determined "what the parties themselves would have agreed to had they considered the issue in their original bargaining positions at the time of contracting."[3]

- ***An express standard of "good faith" set forth in an agreement will have whatever meaning is ascribed to it in the agreement.*** Alternative entity agreements frequently include a provision stating that the directors or other managers must "act in good faith." Critically, the meaning of "good faith" in this context will be whatever it is defined as being in the agreement. For example, an agreement may define "good faith" for this purpose as the directors acting in what they *believe* to be the best interests of the LLC (a "subjective good faith" standard, which is satisfied so long as the directors actually had such belief); or it may be defined as the directors acting in what they *reasonably* believe to be the best interests of the LLC (an "objective good faith" standard, which is satisfied if the directors had a reasonable basis for the belief). In many agreements, although there is a general good faith standard, there are safe harbor procedures set forth which, if satisfied, provide a *conclusive presumption* of good faith under certain circumstances (for example, for approval of conflicted transactions).
- ***Risk of ambiguity based on the interrelationship of provisions in an alternative entity agreement.*** Alternative entity agreements often include a disclaimer of fiduciary duties, a general standard of subjective good faith for the directors, exculpation for directors other than for acts taken in bad faith, a conclusive presumption of good faith for actions taken in reliance on experts (such as reliance on a fairness opinion), and safe harbor provisions (providing a conclusive presumption of good faith with respect to self-interested transactions if they have been approved by a conflicts committee). When the court has found an LLC agreement to be unclear or ambiguous, it has most often been as a result of a lack of clarity with respect to the interrelationship among these various provisions relating to the directors' obligations.
- ***Lack of awareness by minority investors in alternative entities.*** In our experience, notwithstanding disclosure to minority investors at the time they invest, they often are surprised—for example, when the board approves a transaction in which the directors (and/or the controller who appointed them) are self-interested—that the directors not have fiduciary duties to the entity or the investors, that the general good faith standard of conduct does not require that the directors act in the best interests of the investors expected, and that the directors have broad authority to approve conflicted transactions.
- ***Importance of drafting.*** As the judicial focus in these cases is on the precise terms of the entity's governing agreement, the most critical factor in seeking to avoid future disputes and litigation uncertainty is to ensure that the agreement includes "state-of-the-art" provisions that reflect

the parties' intent. As reflected in the discussion of recent cases that follows, most of the litigation in this area relates to LLC agreements that do *not* reflect modern forms of LLC or limited partnership agreements. State-of-the-art provisions, which take into account the most recent judicial contractual interpretations, will clearly: (1) disclaim all fiduciary duties; (2) *define* any general "good faith" standard of conduct; (3) not include language in the exculpation or indemnification provisions that can suggest that some fiduciary duties may continue; and (4) provide safe harbor procedures for approval of conflicted transactions (with a well-defined standard for evaluation of the transaction and specified requirements with respect to eligibility for committee members). The specific drafting is critical and small wording differences can lead to very different judicial results. Chief Justice Strine and Vice Chancellor Laster have written that, while LLC agreements "coalesc[e] around particular features and concepts," this "superficial standardization" is "overwhelmed by diversity in implementation," which "limits the efficacy of precedent and creates fertile opportunities for future litigation."

Miller v. HCP

The *Miller* decision,[4] issued by the Court of Chancery in February 2018, highlights the contrast between alternative entity law and corporate law, the typically broad authority of managers of alternative entities, and the generally limited application of the implied covenant of good faith in the alternative entity context.

The plaintiff, a co-founder of Trumpet Search, LLC, claimed that the private equity firm that was Trumpet's controlling member had breached the implied covenant of good faith in connection with a sale of Trumpet. The controller did not have an identity of interest with the other members in the sale because the LLC operating agreement contained "waterfall" provisions that allocated to the controller almost all of the proceeds up to $30 million on a sale of the company (resulting in the controller having no incentive to obtain a price above $30 million). The LLC agreement waived all fiduciary duties of the Trumpet directors and members, and granted "sole discretion" to the board with respect to a sale of the company so long as the sale was to an unaffiliated third party. Within a year after the PE firm's investment and adoption of the LLC agreement, the PE firm championed a sale to an unaffiliated third party (MTS), which had made an offer of $31 million. Trumpet's board "elected not to run an open sales process." Following pressure from the minority of the board not allied with the controller, the controller-allied directors decided to give the non-allied directors five days to solicit other interest, which resulted in MTS increasing its offer to $43 million—which, under the waterfall provisions, resulted in some minority investors receiving a small amount of proceeds from the sale but the plaintiffs still receiving none.

The plaintiff contended that the controller and its allied directors had breached the implied covenant of good faith by approving the sale at $43 million without having conducted an open auction (which, they asserted, would have resulted in a substantially higher sale price and "thereby ensure[d] maximum value for all members"). The court rejected the plaintiff's argument that, under the implied covenant of good faith, the manager had a duty to seek to maximize the price when the company was sold to the unaffiliated third party. The court reasoned that there was no gap in the agreement as to the board's discretion relating to a sale to an unaffiliated third party—to the contrary, sole discretion was expressly granted under the agreement for sales other than to insiders. Moreover, the court stated, even if there had been a gap, it was anticipatable that the board might not conduct an auction in connection with a sale to an unaffiliated third party given that, based on the waterfall provisions in the LLC agreement itself, it was clear that the controller had no incentive to obtain a sale price above $30 million.

The court indicated the following in *Miller*:

- ***The implied covenant of good faith has limited applicability.*** The term "covenant of good faith and fair dealing" is "something of a misnomner," as "fair" in this context, the court wrote, "simply means actions consonant with the terms of the parties' agreement and its purpose"; and, similarly, "good faith" involves "faithfulness to the scope, purpose, and terms of the parties' agreement." The court stated that the implied covenant "applies only in that narrow band of cases where the contract as a whole speaks sufficiently to suggest an obligation and point to a result, but [where there is a gap such that the contract] does not speak directly enough to provide an explicit answer." The court wrote with respect to the Trumpet LLC agreement: "It thus appears that the parties…did consider the conditions under which a contractually permissible sale could take place. They avoided the possibility of a self-dealing transaction but otherwise left to the [controller and its affiliates] the ability to structure a deal favorable to their interests. Viewed in this way, there is no gap in the parties' agreement to which the implied covenant may apply."
- ***Actions constituting actual bad faith conduct could lead to the court invoking the implied covenant.*** The court stated that the defendants' conduct in connection with the sale process was not arbitrary, unreasonable or unanticipated. There were "no allegations of fraud or a kickback from the buyer" and "no indication that the Defendants acted from any perverse or cryptic incentive, other than their own self-interest manifest from the waterfall provision of the [LLC agreement]—there is, for example, no indication that they acted with the purpose of harming then non-affiliated members." The court concluded: "Such actions plausibly would be of the type addressed by the implied covenant."
- ***The results would have been different in the corporate context.*** The court commented that if the case had been decided in the corporate context, the directors would have had a fiduciary duty under *Revlon* to seek to maximize the price of the company on its sale (and the judicial standard of review for the challenged transaction would have been entire fairness).

Other 2018 Delaware Decisions Also Underscore These Principles

The *ETE* decision[5] reflects that the protections of a safe harbor provision for an alternative entity's conflicted transactions may be lost if the board does not comply with the precise terms of the provision. The Court of Chancery ruled that the conflicts committee safe harbor was not available, as the committee had been established initially with three members, two of whom were ineligible to serve under the terms of the limited partnership agreement—and, although only the one eligible member actually served, the committee had never been formally reconstituted. We note that the court may have been influenced in this case by the overall negative factual context, including the inexperience and ineffectiveness of the sole director who served on the committee. The court found that (1) absent the safe harbor protection, the LPA terms required that conflicted transactions be "fair and reasonable" to the partnership and (2) the defendants had not established that the transaction (a private offering of securities primarily to insiders) was fair. The court awarded only nominal damages, however, because the unitholders were not actually harmed (as the value of their units had increased significantly after the challenged transaction due to an improvement in conditions in the energy market).

MHS Capital v. Goggin[6] highlights the importance of careful drafting of an LLC agreement as ambiguity in the interrelationship of the provisions can provide a basis for the court to reject dismissal of breach of contract claims. The Court of Chancery, at the pleading stage, rejected dismissal of the plaintiff's breach of contract claim against the LLC manager, who allegedly had diverted LLC interests and funds to enrich himself and his friends. The LLC was entitled to

receive certain assets it had purchased in a bankruptcy sale but the LLC manager allegedly had (a) directed the bankruptcy court to deliver some of the assets to other companies owned by the manager and his friends and (b) used LLC funds to pay significant fees to an attorney who represented the manager's (and not the LLC's) interests. The manager contended that the breach of contract claims should be dismissed on the basis that the exculpatory clause of the LLC agreement provided that he could not be liable for monetary damages. The court rejected the motion to dismiss, finding that it was unclear under the agreement how the provision setting forth the general standard of care required of the manager ("good faith and ordinary care") was "meant to work with the exculpatory clause, which purports to eliminate all damages."

Eames v. Quantlab[7] reflects the ambiguity that can arise with respect to the interrelationship of various provisions within and among agreements relating to a general partner's duties—as well as the Delaware courts' general predilection for narrow interpretation of the rights of minority investors in non-corporate entities. The Court of Chancery granted the defendants' motion to dismiss the plaintiffs' claims that, under (1) the limited partnership agreement and (2) the LLC agreement governing the general partner, the limited partners had the right to remove and replace the general partner. The limited partnership agreement (LPA) provided that admission of a new general partner required the consent of the limited partnership units and the consent of the existing general partner. The LPA also provided that, absent removal for cause, a general partner could not be removed unless there was at least one remaining general partner. The LLC agreement governing the general partner (GP) provided that each of GP's managers (B and Eames) could act alone to transact business "for the benefit" of GP—but could not, without the consent of the other, take any act that would make it impossible for GP to carry on its or the limited partnership's ordinary business or make a major change in the principal business of either.

The court held that Eames' purported consent on behalf of GP to the appointment of a new general partner was invalid, as the consent of both managers of GP was required because the removal was *not* for GPs benefit and did change GP's business. The court reasoned that adding a general partner caused GP to cease being *the* general partner, and to become instead just *a* general partner, of the limited partnership. The court wrote:

> While certain of the limited partners may now be displeased with their inability to direct [the limited partnership]'s day-to-day business, this arrangement reflects a bargained-for allocation of interests and influence.

Capone v. LDH[8] reflects that, notwithstanding the disclaimer of fiduciary duties in an alternative entity's operating agreement, inclusion of certain types of phrases can be interpreted by the court as suggesting an intention of the parties that the directors have duties beyond those specified in the agreement. The Court of Chancery reasoned that, although the LLC agreement provided that membership units to be purchased from terminated employees would be valued by the LLC board as of a specified date, when new information (which became available after the specified date but before the units were purchased) clearly indicated that the board's valuation had significantly undervalued the units, the board had an *implicit* duty to revise the valuation. The court, at the pleading stage, denied the defendants' motion to dismiss, emphasizing that the valuation provision included the caveat that the valuation was to be produced as specified "unless otherwise determined by the board" (which, according to the court, suggested that the board had discretion that perhaps should have been exercised).

Leaf Invenergy v. Invenergy Wind[9] highlights the importance of expressly memorializing in an alternative entity's agreement, in specific terms, the parties' expectations—in this case, with respect to a liquidated damages remedy for a breach of the agreement. The LLC agreement provided that the company could not engage in a sale of assets without the consent of certain of its members unless those

members would achieve at least a specified agreed rate of return (the "target multiple").

The Court of Chancery found, at the pleading stage, that the agreement had been breached by the LLC board when it sold assets without the consent of one of these members; and that the clear expectation of the LLC and that member had been that, if such a breach occurred, the company would pay the member an amount equal to the target multiple. However, after a trial to determine the proper remedy for the breach, the court awarded the member only nominal damages of $1 because (1) the LLC agreement itself did not contain a provision clearly stating what the damages would be and (2) the member did not suffer harm from the breach (because the asset sale that had been effected without its consent was at an "attractive price" that increased the value of its LLC interest). The court wrote:

> The parties' subjective beliefs about a remedy are not controlling unless they are implemented in a remedial provision in an agreement, such as a liquidated damages clause.

Here, "the parties did not memorialize their subjective beliefs about the expected remedy in a contractual provision.

Morris v. Spectra Energy[10] reflects the potential that the court may find a breach of the implied covenant in the context of a conflicted transaction that is, on its face, "patently unfair and unreasonable." The Court of Chancery found it likely, at the pleading stage, that the general partner of a master limited partnership had breached its express contractual obligation to act in good faith in connection with a sale, by the MLP to the indirect parent of its general partner, of an asset that the purchaser already had publicly committed to contribute to a joint venture at a much higher valuation than it was paying the MLP for the asset. The difference between the two prices was about half a billion dollars. Although the transaction apparently had been approved as specified under the MLP agreement, the court found that the large facial disparity between the alleged value of the asset sold and the price paid for it gave rise to a reasonable inference that the general partner had approved the transaction in bad faith.

The MLP agreement required that the general partner (GP) make determinations "in good faith," which was defined as a subjective belief by GP that the action taken was in the best interests of the MLP. The agreement provided a *rebuttable* presumption of good faith by GP with respect to any conflicted action that was approved by a conflicts committee and provided a *conclusive* presumption of good faith by GP with respect to any action taken in reliance on an expert opinion.

The court identified the threshold issue as whether the *rebuttable* presumption applicable to conflicted transactions or the *conclusive* presumption relating to reliance on expert opinions governed with respect to the transaction. The court acknowledged the general contract interpretation principle that more specific provisions (such as a provision relating to conflicted transactions) override more general provisions (such as an "overarching" good faith standard), and acknowledged Delaware Supreme Court precedent holding that a general *conclusive* presumption of good faith arising from reliance on advisors trumps a specific conflict provision's *rebuttable* presumption of good faith. The court emphasized, however, that the judicial precedents do not represent "totemic statements," as the court's interpretation of an agreement in any case will depend on the "precise language" of the specific agreement and a reading of the agreement as a whole.

In this case, the court ruled, the *rebuttable* presumption applicable to conflicted transactions applied. The court stated that, given the "broad contractual freedoms" afforded to alternative entities and the limited bargaining power of unitholders, ambiguities in the agreement should be resolved in favor of the unitholder. Perhaps most tellingly, the court wrote: "[W]hen sophisticated entities intend to provide a conclusive presumption in a conflicts situation, they know how to draft such a provision." Thus, the court found a pleading stage inference of a breach of GP's contractual obligation of good faith. (The court also ruled that the implied covenant of good faith was not applicable as there was no gap

to be filled in the agreement because GP's conduct was to be evaluated under the good faith standard set forth in the agreement.)

Brinckerhoff v. Enbridge Energy[11] involved the interpretation of a *non*-state-of-the-art limited partnership agreement which did not provide safe harbors for affiliated transactions. The Delaware Supreme Court, overturning the Court of Chancery decision below, interpreted the limited partnership agreement as imposing a "fair and reasonable" standard for self-interested transactions, and thus ruled that the Court of Chancery's dismissal of the plaintiff's claims at the pleading stage was improper.

The master limited partnership had re-purchased from its general partner an asset that it recently had sold to the general partner at a significantly lower price—despite strong evidence that the value of the asset had actually significantly declined since the time of the sale to the general partner. The Court of Chancery, in the decision below, held that the LPA's general good faith standard modified and overrode the separate, more specific provisions such as the "fair and reasonable" standard for affiliated transactions). The court interpreted the general good faith standard as requiring a *subjective* belief by the general partner that an action was in the best interests of the MLP—and as therefore requiring, for the plaintiff to prevail, that the board's actions were taken in bad faith and amounted to the equivalent of "waste."

The Supreme Court overruled the decision below and held that the general good faith standard *operated in the spaces between the LPA's specific provisions*—that is, was applicable only to the extent that there was *not* a more specific applicable provision. Therefore, the Supreme Court ruled, the affiliated repurchase transaction was governed by the provision that imposed the specific obligation that affiliated transactions be objectively fair and reasonable. Moreover, the Supreme Court interpreted the general good faith standard differently—finding that it was more consistent with the overall terms of this particular agreement that it meant a *reasonable* belief that the action taken was in, or not inconsistent with, with best interests of the MLP (rather than the lower standard for good faith used by the Court of Chancery, which would have required that the action was so beyond the bounds of reason as to be inexplicable other than by bad faith and, so, was similar to "waste"). The Supreme Court also held that the board's reliance on a fairness opinion did not result in a conclusive presumption of good faith under the LPA, as the LPA provided that "*reasonable* reliance" was required—and, given the alleged errors of the banker, whether the reliance in this case had been reasonable presented a question of fact requiring discovery.

Importance of the Factual Context

While, as discussed, the Delaware courts extend a high degree of deference to LLC and partnership agreement provisions, importantly, the facts and circumstances can very much affect the judicial result. For example, in *El Paso* (2015)[12], in the context of extremely negative facts relating to the conflict committee's process, the court concluded that the committee did not satisfy the safe harbor requirement of a subjective belief that the transaction at issue was in the best interests of the MLP. The transaction involved a purchase of assets by the MLP from its general partner's parent—at a price significantly higher than the MLP had paid for the same type of assets from the general partner's parent only months earlier and notwithstanding a significant decline in the market for this type of asset. Emphasizing the incomplete, inaccurate, and "manipulative" nature of the information provided to the committee by its financial advisor, as well as the committee's ignoring the fact that information it had relating to the MLP's other recent dropdown transactions, and the committee members apparently not even understanding the terms of the transaction, the court's view appeared to be that the committee did not have a base of information upon which it was even *possible* to form a subjective belief as to whether the transaction was in the MLP's best interests. It is to be noted that, in addition, there were contemporaneous emails among the committee members that indicated that they *actually* believed that the transaction would *not* be in the best interests of the partnership.

Dieckman v. Regency (2016) provides another example. The Delaware Supreme Court ruled that, although the conflicts committee members technically had met the independence requirements of the safe harbor provision, the committee's approval of the transaction at issue was not effective because of "deceptive," "manipulative" and "misleading" conduct by the general partner. As one example, to satisfy the independence requirement for committee members that they not be directors of any affiliates of the general partner, the general partner had one MLP director selected to serve on the committee resign his directorship with one of the general partner's affiliates just before the committee was formed and to rejoin just after the committee process ended.

The court also held that the safe harbor based on approval by the unaffiliated unitholders had not been satisfied because the disclosure that an "independent" conflicts committee had approved the transaction did not reveal the members' conflicts of interest. The court rejected the lower court's determination that the express obligation of the general partner to act "in good faith" did not impose any disclosure obligation beyond the minimal disclosure requirement specifically set forth in the agreement. The court stated that, once the general partner went beyond the minimal disclosure requirements set forth in the partnership agreement and instead issued a comprehensive proxy statement, it had an obligation under the implied covenant of good faith not to mislead the unitholders to "induce" them to approve the transaction. The court focused on the safe harbor process in its entirety and found that the language implicitly required the general partner to act in a manner that would not undermine the (minimal) protections afforded to the unitholders in connection with the safe harbor process. Finally, in one 2018 decision, the Court of Chancery found that the implied covenant of good faith was applicable where, in the court's view, the controller of an LLC was responsible for the gap in an agreement and held that it therefore would be inequitable for the controller to benefit from the gap.

Practice Points

More flexibility than in the corporate context. While Delaware law relating to *corporate* fiduciary duties and exculpation for personal liability has been transformed over the past several years, resulting in even less potential than previously for liability of corporate directors, the alternative entity format still offers even more flexibility for directors *when the governing agreement is properly drafted and followed*. Often, under the governing agreement, directors, managers and general partners have no fiduciary duties to the other investors and have very broad discretion, including with respect to conflicted transactions.

Definition of the scope of the board's discretion. The scope of the board's discretion (including "sole discretion") should be defined as clearly as possible to avoid any ambiguity. A grant of discretion to a board generally will be subject to exercise in good faith unless the agreement clearly specifies a different standard. In *Miller*, where "sole discretion" was granted to the directors, a critical factor in the court's finding that the implied covenant was *not* applicable was that the agreement language, in the court's view, indicated that the parties had the potential for action by the controller that might favor the controller's interests and had addressed it specifically by limiting the board's discretion with respect to a sale *to a controller*, but not limiting the board's discretion with respect to any sale *to an unaffiliated party*. If "sole" discretion is granted, any limitations on that discretion should be stated clearly; and a controller should seek to include a statement that the specified limitations are the only ones intended by the parties.

Limiting the role of the implied covenant of good faith. As noted, the implied covenant adheres to every contract and cannot be waived or modified; however, as discussed, the covenant rarely is invoked by the court to "read in" provisions that the parties did not expressly set forth in the agreement. All reasonably anticipatable events should be considered, and any intended protections for the minority investors should be expressly included. While we have not seen this provision in any agreement, in an effort to

further limit the potential of the implied covenant being invoked, a provision could be included that states that the agreement reflects all of the minority protections intended by the parties, that the parties believe that there are no "gaps" in the agreement, and that, to the extent that any gap may develop, the parties mutually intend that any gap be filled by the directors in their sole discretion and notwithstanding any possible self-interest.

Need to seek to eliminate ambiguity arising from the interrelationship of provisions. Any ambiguity in the drafting of an alternative entity governing agreement can lead not only to future disputes between the parties but also opens the door to possible invocation by the court of the implied covenant of good faith. A frequent source of ambiguity is the interrelationship among the various provisions relating to disclaimer of fiduciary duties, a general good faith standard, exculpation and indemnification provisions, and provisions governing conflicted transactions. State-of-the-art provisions— which clearly and unambiguously reflect the parties' intentions and which take into account the most recent judicial pronouncements on these types of provisions—should be used. The duties of LLC directors will be most clearly circumscribed where the LLC operating agreement expressly disclaims all fiduciary duties; states that any good faith standard is limited to subjective good faith or to good faith only as required under the implied covenant of good faith and fair dealing; excludes from exculpation or indemnification only actions not taken in accordance with the good faith standard set forth in the agreement; and provides clear safe harbors for conflicted transactions, with conclusive presumptions of good faith for reliance on experts or approval by a conflicts committee (with a subjective good faith standard for the committee's determination, and without any qualifications relating to the reliance on experts).

Wide latitude in crafting safe harbors, but compliance with the process is key. While an LLC agreement can provide for very limited obligations of the directors in connection with affiliated transactions, the process established in the agreement must be followed; and the directors will be advantaged to the extent that, notwithstanding the elimination of fiduciary duties by contract, the conflicts committee takes its job seriously and functions well.

Conflict committee members should:

- meet the independence requirements for membership set forth in the LLC agreement;
- know the standard set forth in the LLC agreement for the committee's approval of the transaction;
- ensure that they have the information necessary to make a determination that meets the standard for approval;
- be appropriately engaged in the process of considering the transaction;
- consider retaining independent financial and legal advisors (and, if advisors are retained, consider retaining them before the financial terms of the transaction are "fully baked"); ask questions to ensure that the advice and analyses are understood; consider obtaining a fairness opinion or legal opinion; and remain in control of the committee process;
- consider whether to negotiate the terms of the conflicted transaction with the parent company (unless the determination is clear, some level of negotiation is often advisable as a basis for forming a good faith judgment about the transaction); and
- make a determination that meets the standard for approval (tracking the language set forth in the LLC agreement with respect to the standard of approval), and memorialize their determination in the formal record of the committee's deliberations.

Notwithstanding the definition of independence set forth in the LLC agreement, the more independent (and the more experienced) the members of the conflicts committee are, the more protective the process may be from a legal point of view. If the agreement provides a clear safe harbor process (based on conflicts committee approval or otherwise) and that process is followed—and there is no "deception" in obtaining the conflicts committee approval—then, based on compliance with the safe

harbor, any challenge to the transaction should be dismissed at the pleading stage of litigation.

Attention to specific phrases when drafting. Drafting of an alternative entity governing agreement should take into consideration the most recent judicial pronouncements on these types of agreements, including with respect to the interpretation of specific phrases. For example, we note the following:

- "*Unless the board otherwise determines*": When a specified procedure for making a determination is subject to the caveat "unless the board otherwise determines," that phrase may be interpreted by the court as suggesting some implied fiduciary-type duty of the board.
- *"Sole discretion"*: There is a possibility of the court finding that the implied covenant of good faith applies when a provision authorizes a board to use "sole discretion"—unless it is clear that the parties considered and addressed the potential for self-interested action inherent in an exercise of sole discretion.
- "*Gross negligence" exclusion*: The court possibly could interpret an exclusion from the exculpation or indemnification provision for "gross negligence" as suggesting that the parties may have intended corporate law fiduciary duty concepts to apply (given that gross negligence is the traditional standard for pleading and proving a breach of the fiduciary duty of care under business judgment rule review). Under this interpretation, an LLC manager could be sued for a breach of the duty of care notwithstanding the waiver of fiduciary duties (and, ironically, notwithstanding the fact that in the corporate context the claim would not survive the pleading stage based on an exculpatory provision in the charter). Accordingly, where fiduciary duties are disclaimed, concepts that could suggest that they may persist should be avoided.

Notes

1. However, in a recent case involving an alternative entity, the Delaware Supreme Court expanded the applicability of the implied covenant to a *forseeable* event when the parties failed to express the terms that would apply only because, according to the court, the terms were "too obvious to need expression." The Supreme Court, through the implied covenant, imposed terms that the court determined were "easily implied because the parties must have intended them and have only failed to express them because they are too obvious to need expression." The court stated: "[S]ome aspects of the deal are so obvious to the participants that they never think, or see no need, to address them." *Dieckman v. Regency*, No. 208, 2016 (Del. Jan. 20, 2017).
2. We note that, in an article published in 2014, Chief Justice Strine and Vice Chancellor Laster questioned the validity of this premise. They argued that minority investors in alternative entities typically do *not* actually negotiate terms and they advocated that the Delaware statute be amended to make the duty of loyalty non-waivable. *See The Siren Song of Unlimited Contractual Freedom,* available at https://corpgov.law.harvard.edu/2014/08/22/the-siren-song-of-unlimited-contractual-freedom/.
3. *Miller v. HCP & Company*, C.A. No. 0291-SG (Del. Ch. February 1, 2018). We note, however, that, nonetheless, in the infrequent cases in which the court, in the context of an LLC agreement in which fiduciary duties have been disclaimed, *has* found the implied covenant of good faith to be applicable, the backdrop has been alleged facts that have indicated that the challenged conduct constituted "arbitrary" or "deceitful or manipulative" conduct the purpose of which was "to harm" the other investors or "to deprive them of the fruits of their bargain."
4. *Miller v. HCP & Company*, C.A. No. 0291-VCG (Del. Ch. February 1, 2018).
5. *In re Energy Transfer Equity, L.P. Unitholder Litig.,* C.A. No. 12197-VCG (May 17, 2018).
6. *MHS Capital LLC v. Goggin*, C.A. 0449-VCG (May 10, 2018).
7. *Eames v. Quantlab*, C.A. 0792-VCS (May 1, 2018).
8. *Capone v. LDH Management Holdings LLC*, C.A. 11687-VCG (Apr. 25, 2018).
9. *Leaf Invenergy Company v. Invenergy Wind LLC*, C.A. 11830-VCL (Apr. 19, 2018).
10. *Morris v. Spectra Energy Partners (De) GP, LP*, C.A. 12110-VCG (June 27, 2017).
11. *Brinckerhoff v. Enbridge Energy*, C.A. 11314-VCS (Mar. 20, 2017).
12. *In re El Paso Pipeline Partners L.P. Deriv. Litig.*, C.A. 7141-VCL (Apr. 20, 2015).

IN THE COURTS

Supreme Court Provides One Answer about SEC Administrative Law Judges, but Leaves Many Questions

By Marc Sonnenfeld, Christian Mixter, Susan Resley, and Lyric Chen

On June 21, in *Lucia v. Securities and Exchange Commission*, the U.S. Supreme Court held that administrative law judges of the U.S. Securities and Exchange Commission are not mere federal employees but qualify as "Officers of the United States" under the Appointments Clause of the U.S. Constitution, which requires such officers to be appointed by the president, courts of law, or heads of departments. *Lucia*'s further implications for decisions issued by SEC ALJs (and by ALJs at other federal agencies) remain to be seen.

The SEC—which confidently announced last November that it had "resolved any concerns that administrative proceedings presided over by its ALJs violate the Appointments Clause"[1] by "ratifying" their prior appointments[2]—is baffled about what lies ahead for its administrative process. Immediately after receiving the *Lucia* decision,[3] the Commission issued an order staying all pending administrative proceedings for thirty days or until further order of the Commission.[4]

Background

One of the ways the SEC enforces the federal securities laws is by instituting administrative proceedings against alleged wrongdoers. *Lucia* began with an SEC administrative proceeding against petitioner Raymond Lucia and his investment company, which were known for the retirement savings strategy called "Buckets of Money." The SEC charged Mr. Lucia with violating the Investment Advisers Act of 1940 (Advisers Act) for misleading and deceiving investors and prospective investors through slide-show presentations. By law, the SEC may itself preside over such a proceeding, or may delegate the task to one of its five ALJs, who historically have been selected by SEC staff. In this case, the SEC delegated the matter to ALJ Cameron Elliot.

SEC ALJs supervise discovery, issue and modify subpoenas, decide motions, determine the admissibility of evidence, administer oaths, hear and examine witnesses, and can impose sanctions for contemptuous conduct or violations of procedural requirements.[5] In cases assigned to them, ALJs also issue "initial decisions" that contain factual findings and legal conclusions, as well as the appropriate order, sanction, relief, or denial of relief.[6] The SEC can review the decision upon request or on its own accord. If the SEC declines to review the decision, it issues an order that the ALJ's initial decision has become final, and the decision is then deemed an action of the Commission.[7]

In the proceeding against Mr. Lucia, Judge Elliot presided over nine days of testimony and argument, and issued a decision concluding that Mr. Lucia had violated the Advisers Act and imposing sanctions of civil penalties of $300,000 and a lifetime bar from the investment industry. The SEC then reviewed Judge Elliot's decision and remanded for additional fact-finding. Judge Elliot made additional findings and issued a revised initial decision with the same sanctions. Mr. Lucia appealed the decision to the SEC, arguing that the administrative proceeding was invalid because Judge Elliot had been appointed by SEC staff rather than by the Commissioners.[8]

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The SEC rejected Mr. Lucia's argument, and the DC Circuit Court of Appeals agreed, concluding that SEC ALJs are employees rather than "Officers of the United States" within the meaning of the Appointments Clause.[9] The DC Circuit's decision conflicted with a decision by the U.S. Court of Appeals for the Tenth Circuit in *Bandimere v. SEC*.[10]

Distinguishing Officers and Employees

In reaching its decision, the Supreme Court relied on a framework established by *United States v. Germaine*[11] and *Buckley v. Valeo*,[12] and applied in *Freytag v. Commissioner*.[13] *Germaine* made clear that, to qualify as an officer, an individual must occupy a "continuing" position established by law.[14] *Buckley* held that members of a federal commission were officers if they "exercis[ed] significant authority pursuant to the laws of the United States."[15] In *Freytag*, the Court concluded that "special trial judges" (STJs) of the United States Tax Court are officers rather than employees.[16] There, the Court found significant that STJs serve on an ongoing basis; their duties, salaries, and means of appointment are specified in the Tax Code; and they possessed significant duties and discretion.[17]

The Court noted that ALJs, like STJs, receive a career appointment and hold a continuing office established by law.[18] The ALJs' duties, salary, and means of appointment also are governed by statute.[19] In addition, "ALJs exercise the same 'significant discretion' when carrying out the same 'important functions' as STJs do."[20] Moreover, ALJs have a "more autonomous role" than STJs, because a regular Tax Court judge must always review an STJ's opinion, whereas the SEC can decline to review an ALJ's decision.[21] According to the Court, "[t]hat last-word capacity makes this an *a fortiori* case: if the Tax Court's STJs are officers, as *Freytag* held, then the Commission's ALJ must be too."[22] Based on this reasoning, the Court remanded the case and required that the SEC administrative proceeding against Mr. Lucia be assigned to a different ALJ or the SEC itself for a new hearing.[23]

Implications

Although it set a clear course for Mr. Lucia's case, the Court left behind many questions for the administrative adjudication systems at the SEC and other federal agencies.

First, when the SEC issued its November 2017 order "ratifying" the appointments of its ALJs, it directed the newly ratified ALJs to "review their actions in all open administrative proceedings to determine whether" those same ALJs should "ratify those actions."[24] The *Lucia* Court declined to determine whether agency ratification of ALJ appointments would resolve the constitutional infirmity of those appointments,[25] and also—by forbidding Judge Elliot from rehearing Mr. Lucia's case—suggested that litigants who received a final decision in a pending administrative proceeding may be entitled to have their cases heard by a different ALJ. These questions surrounding the "ratification" process may well explain the SEC's June 21 order staying all pending administrative proceedings.

Second, the Court declined both Mr. Lucia's and the Solicitor General's invitations to consider whether existing restrictions on *removal* of ALJs are consistent with the constitutional principles articulated in *Free Enterprise Fund v. Public Company Accounting Oversight Board*.[26] As Justice Stephen Breyer's separate opinion illustrates well, that thicket remains, irrespective of the Court's decision not to enter it in *Lucia*. [27]

The bigger picture here is that the SEC already may have decided that litigated administrative enforcement proceedings are more trouble than they are worth. As many have noted, the agency has brought almost all of its contested enforcement actions in federal court since the *Lucia/Bandimere* circuit split arose, and largely has confined its administrative docket to settled matters and to the minority of cases involving suspensions and bars of regulated entities and persons that can only be brought administratively.

Notes

1. Art. II, § 2, cl. 2.
2. "SEC Ratifies Appointment of Administrative Law Judges," Press Release No. 2017-215 (Nov. 30, 2017).
3. No. 17-130, slip op. (U.S. June 21, 2018).
4. Order *In re: Pending Administrative Proceedings*, Securities Act Rel. No. 10510 (June 21, 2018).
5. *Id*. (citing 17 CFR § 201.111, 201.180; §§ 200.14(a), 201.230).
6. *Id*. (citing 17 CFR §§ 201.360(a)(1), (b)).
7. *Id*. (citing § 78d-1(c); 17 CFR § 201.360(d)(2)).
8. There was no dispute that the SEC qualified as a Head of Department under the Appointments Clause. Slip Op. 3.
9. *See* 832 F.3d 277, 283-89 (D.C. Cir. 2016). Mr. Lucia petitioned for rehearing en banc, but following oral argument, the en banc court divided evenly, resulting in a per curiam order denying Mr. Lucia's petition for review. *See* 868 F.3d 1021 (D.C. Cir. 2017).
10. 844 F.3d 1168, 1179 (10th Cir. 2016).
11. 99 U.S. 508 (1879).
12. 424 U.S. 1, 126 (1976).
13. 501 U.S. 868 (1991).
14. *Germaine*, 99 U.S. 511.
15. *Buckley*, 424 U.S. at 126, n.162.
16. *Freytag*, 501 U.S. at 881.
17. *Id*.
18. Slip Op. at 8.
19. *Id*.
20. *Id*.
21. *Id*.
22. *Id*.
23. *Id*.
24. "SEC Ratifies Appointment of Administrative Law Judges," Press Release No. 2017-215 (Nov. 30, 2017).
25. Slip Op. at 13 n.6.
26. 561 U.S. 477 (2010). *See* Slip Op. at 4 n.1.
27. *Lucia v. Securities and Exchange Commission*, No. 17-130 (U.S., June 21, 2018) (Breyer, J., concurring in the judgment in part and dissenting in part).

IN THE COURTS

Ninth Circuit Clarifies Delaware Demand Futility Standard in Derivative Case

By Charles S. Duggan, Edmund Polubinski III, Lawrence Portnoy, and Neal A. Potischman

On June 13, 2018, the U.S. Court of Appeals for the Ninth Circuit issued an opinion in *Tindall v. First Solar Inc.*, affirming the district court's dismissal of a derivative action for failure to show demand futility.[1] The court held that Delaware's A*ronson* test for demand futility is limited to cases involving affirmative business decisions made by a board, and does not apply where a shareholder seeks to challenge the board's sign-off regarding a corporation's financial statements or press releases. A plaintiff complaining about such routine matters can avoid making a demand on the corporation's board only by showing compliance with the test announced by the Delaware Supreme Court in *Rales v. Blasband*.[2]

Backgound

In *Tindall*, plaintiffs brought a shareholder derivative action accusing First Solar's directors and officers of breaching their fiduciary duties by "failing to disclose in financial statements and press releases the existence of manufacturing and design defects" allegedly found in the company's solar panels.[3] Plaintiffs did not make a pre-suit demand to the board before bringing their derivative action. Accordingly, they were required to show demand futility (i.e. that it would have been pointless to demand corrective action before filing the litigation).[4]

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The Decision

Applying Delaware law, the Ninth Circuit held that Delaware's *Aronson* test—which requires plaintiffs to allege particularized facts creating a reason to doubt either that (1) "the directors are disinterested and independent" or (2) the "challenged transaction was otherwise the product of a valid exercise of business judgment"—is limited to board *business* decisions, and does not apply to *all* board conduct, including the approval of financial statements.[5] The court concluded that only affirmative business decisions "implicate the business judgment rule" invoked by the second prong of the test.[6] The court held that the conduct at issue in this case—namely, the approval of the company's financial statements and press releases—was not a "business decision" because such an approval "reflect[ed] business judgments already made" rather than "weighing the risks and rewards of future conduct," which is the "type of decision-making process the business judgment rule is designed to protect."[7]

Having concluded that the *Aronson* test for demand futility did not apply, the court concluded that the plaintiff was required to satisfy a competing Delaware standard called the *Rales* test, which Delaware courts apply to claims involving lack of board oversight.[8] In *Rales*, the Delaware Supreme Court concluded that a court must

> examine whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations. Thus, a court must determine whether or not the particularized factual allegations of a derivative stockholder

> complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand. If the derivative plaintiff satisfies this burden, then demand will be excused as futile.[9]

Conclusion

The decision suggests that where a board engages in routine approvals that cannot properly be characterized as affirmative business decisions, a derivative plaintiff cannot establish demand futility unless the plaintiff can show that the board would be unable to assess a shareholder demand in an objective and disinterested fashion.

Notes

1. No. 17-15185 (9th Cir. June 13, 2018).
2. 634 A.2d 927 (Del. 1993).
3. *Tindall* at 3-4.
4. *Id.* at 4-5.
5. *Id.* at 5-6 (discussing *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984)).
6. *Id.* at 6-7 (collecting cases).
7. *Id.* at 7.
8. *Id.* at 7-8.
9. *Rales*, 634 A.2d at 934; see also *In re Yahoo! Inc. Shareholder Derivative Litig.*, 153 F. Supp. 3d 1107, 1119 (N.D. Cal. 2015) (discussing the *Rales* test).

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.

Bryan Cave Leighton Paisner LLP
Washington, DC (202-508-6000)

Virtual Currencies, ICOs and the SEC (June 1, 2018)

A discussion of the SEC's approach to virtual currencies, including its actions with respect to initial coin offerings.

Losing Control: Proposed FINRA Amendment Eliminates Control as an Element for Proving an Excessive Trading Violation (June 18, 2018)

A discussion of a proposed amendment to FINRA Rule 2111 that eliminates the requirement for FINRA to prove the broker exercised "control" over the customer's account to establish excessive trading.

When Directors and Officers Are Sued (June 8, 2018)

A discussion of how exculpation, indemnification and advancement of expenses works and may apply to protect directors and officers personal assets.

Cleary Gottlieb Steen & Hamilton LLP
New York, NY (212-225-2000)

Untangling the Web of Cybersecurity Disclosure Requirements (June 5, 2018)

A discussion of the key U.S. and E.U. legal regimes concerning the legal regimes concerning the disclosure of cybersecurity incidents from the perspective of a U.S. company subject to the disclosure requirements of multiple jurisdictions.

Potential SEC Inquiry: Improper Rounding Up of Earnings Per Share (June 25, 2018)

A discussion of a report that the SEC Division of Enforcement has launched a probe into whether certain issuers may have improperly rounded up their earnings per share to the next higher cent in quarterly reports.

Dorsey & Whitney LLP
Minneapolis, MN (612-340-2600)

New Law Allows for Regulation A Plus Offerings by Reporting Companies (June 12, 2018)

A discussion of the provision of the recently enacted Economic Growth, Regulatory Relief, and Consumer Protection Act (Economic Growth Act) that directs the SEC to amend Regulation A Plus to allow SEC reporting issuers to use it when raising capital.

Can the SEC Eradicate the Distinction between Primary and Secondary Liability? (June 21, 2018)

A discussion of the U.S. Supreme Court consideration of whether the SEC can circumvent *Janus Capital Group, Inc. v. First Derivate Traders* regarding the requirements for pleading and establishing a claim for false statements and/or material omission under Section 10(b) and Rule 10b-5 under the Securities Exchange Act of 1934 by recasting its claim as one for "scheme" liability.

Drinker Biddle Reath LLP
Philadelphia, PA (215-988-2700)

Audit Committees Bridging the GAAP (June 6, 2018)

A discussion of the important oversight role that audit committees can play in bridging the gap

between management and investors when providing non-GAAP financial information.

Eversheds Sutherland LLP
Washington, D.C. (202-383-0100)

"Phase Two" for Private SBCs: SEC Permits Liquidity for Investors through Split-Off Transaction (June 4, 2018)

A discussion of an exemptive order issued by the SEC Division of Investment Management to allow a private business development company (BDC) to split off part of the BDC into a new vehicle that would seek to list its shares.

Fried, Frank, Harris, Shriver & Jacobson LLP
New York, NY (212-859-6600)

SEC Charges 13 Private Fund Advisers for Repeated Failures for File Form 13F (June 1, 2018)

A discussion of SEC announced settlements with thirteen registered investment advisers that failed to file Form PF over multi-year periods.

Court of Chancery Rejects Extending Appraisal Rights Based on the "Underlying Economic Reality" of a Merger Structure (June 5, 2018)

A discussion of a Delaware Court of Chancery decision, *City of North Miami Beach Genl. Employees' Retirement Plan v. Dr Pepper Snapple Group, Inc.*, holding that appraisal rights are not available to the stockholders of Dr Pepper in connection with a transaction structure (involving a reverse triangular merger and a special cash dividend to the target stockholders) which will result in the sale of control of the company.

Supreme Court Clarifies State Court Jurisdiction for Securities Claims and Opens Door to Plaintiff Forum Shopping (Summer 2018)

A discussion of the U.S. Supreme Court's decision in *Cyan, Inc. et al. v. Beaver County Employees Retirement Fund* holding that the Securities Litigation Uniform Standards Act of 1998 did no strip state courts of jurisdiction over class actions alleging violations of the Securities Act of 1933 (Securities Act) where such lawsuits assert claims only under the Securities Act.

Hunton Andrews Kurth LLP
Richmond, VA (804-788-8200)

Advance Notice Bylaws (June 2018)

A discussion of a Washington state court decision, *Blue Lion Opportunity Master Fund, L.P. v. HomeStrreet, Inc.*, enforcing an advance notice bylaw against an activist hedge fund.

Fiduciary Duties of Buy-Side Directors (June 2018)

A discussion of two recent cases showing pitfalls where a majority of the buyer's board of directors is conflicted or there is a controlling stockholder on both sides of the transaction, in which case the courts will not apply the business judgment rule unless certain procedural safeguards are in place.

Political and Social Issues in the Boardroom: Examples from the Gun Industry (June 2018)

A discussion of the intensifying boardroom environment of dealing with political and social issues using gun violence as a recent example.

K&L Gates LLP
Pittsburgh, PA (412-355-6500)

SEC Proposes Permanent Solution to Loan Issues for Investment Companies (June 6, 2018)

A discussion of SEC proposed amendments

Click Here for Your Fund Report: SEC Endorses We-Delivery and Asks for Comments (June 11, 2018)

A discussion of SEC proposed amendments to part of the SEC auditor independence rule, Rule

2-01(c)(1)(ii)(A), otherwise known as the "Loan Rule," that are designed to refocus the analysis when the auditor has a lending relationship with certain shareholders and persons associated with an audit client.

Congress Acts to Expand Capital Formation Rules While Rolling Back Dodd-Frank Regulations (June 19, 2018)

A discussion of provisions of the Economic Growth Act aimed at encouraging capital formation, including: (1) a new exemption from regulation as an investment company for a newly created category of "qualifying venture capital funds;" (2) an amendment to SEC Rule 701 increasing the dollar threshold above which issuers must begin delivering financial and other prescribed information to equity plan participants; and (3) expanding the range of eligible issuers that may rely on Regulation A Plus for capital raising activities.

Kelley Drye & Warren LLP
New York, NY (212-808-7800)

Second Circuit Extends Application of U.S. Securities Laws to Foreign Trades Matched on U.S.-Based Electronic Trading Platform (June 18, 2018)

A discussion of a U.S. Court of Appeals for the Second Circuit decision, *Myun-Uk Choi v. Tower Research Capital LLC,* holding that the U.S. securities laws apply to foreign trades "matched" on U.S.-based trading platforms.

Latham & Watkins LLP
Los Angeles, CA (202-637-2200)

Spotify Case Study: Structuring and Executing a Direct Listing (June 21, 2018)

A discussion of the Spotify transaction, including why Spotify chose to pursue a direct listing, the path to a direct listing, and the challenges encountered along the way.

McGuire Woods LLP
Chicago, IL (312-849-8100)

SEC Updates Compliance and Disclosure Interpretations of Proxy Rules, Schedule 14A/14C (May 30, 2018)

A discussion of a consolidated set of Compliance and Disclosure Interpretations issued by the SEC Division of Corporation Finance of the proxy rules and Schedules 14A/14C.

Nixon Peabody LLP
Rochester, NY (585-263-1000)

No Second or Third Bite at the Apple: The Supreme Court Holds that Equitable Tolling Does Not Apply to Successive Class Actions (June 12, 2018)

A discussion of a U.S. Supreme Court decision, *China Agritech, Inc v. Resh*, holding that the equitable tolling doctrine it had announced over three decades earlier does not apply to successive class actions.

Ropes & Gray LLP
Boston, MA (617-951-7000)

Separately Managed Accounts: SEC Resolves One "Inadvertent Custody" Ambiguity (June 13, 2018)

A discussion of the SEC Division of Investment Management supplementing its "Staff Responses to Questions About the Custody Rule" to clarify that when an adviser does not have a copy of a client's custody agreement and does not know, or have reason to know, whether that agreement would give the adviser inadvertent custody, the Division would not recommend enforcement action under Rule 206(4)-2 of the Advisers Act.

Shearman & Sterling
New York, N.Y. (212-848-4000)

Preparing for the Consolidated FINRA Registration Rules and Restructured Examination Requirements (June 25, 2018)

A discussion of FINRA rule changes announced in Regulatory Notice 17-30 that go into effect on October 1, 2018, including: (1) consolidation of FINRA registration rules; () technical changes to permissible registration categories; and (3) restructuring of the representative-level qualification examinations.

Sullivan & Cromwell LLP
New York, NY (212-588-4000)

SEC Corporation Finance Director Lays Out the Staff's Analysis in Assessing Whether Digital Assets Constitute Securities (June 18, 2018)

A discussion of a speech by the Director of the SEC Division of Corporation Finance in which he lays out the analysis applied by the staff in assessing whether a digital asset constitutes a security.

Wachtell, Lipton, Rosen & Katz
New York, NY (212-403-1000)

SEC Commissioner Questions Insider Sales into Stock Buybacks (June 12, 2018)

A discussion of a speech by SEC Commissioner Jackson calling for the Commission to review its rules regarding share repurchases in order to limit corporate insiders from selling shares granted to them as part of performance-related equity grants following a corporate buyback announcement.

T. Rowe Price: Perspectives on T. Rowe's Public Stance on Shareholder Activism (June 12, 2018)

A discussion of the announcement by T. Rowe Price of its policy views and investment philosophy on shareholder activism from the perspective of a mutual fund family dedicated to active, rather than passive, management.

ESG and Sustainability: The Board's Role (June 27, 2018)

An overview of how boards of directors and senior management teams may wish to approach sustainability, corporate social responsibility and other ESG matters.

Wilson, Sonsini Goodrich & Rosati LLP
Palo Alto, CA (650-493-9300)

New York Court Finds Failure to Meet *MFW* Standard in Controlling Stockholder Merger (May 31, 2018)

A discussion of a New York Supreme Court decision, *In re Handy &Harman Ltd. Stockholder Litigation*, in which the controlling stockholder of a Delaware corporation failed to obtain judicial deference under the so-called *MFW* framework for its merger with the corporation.