CLEARY GOTTLIEB

Selected Issues for Boards of Directors in 2019

January 16, 2019

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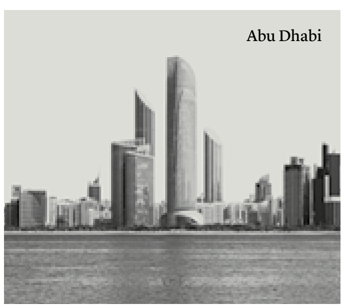

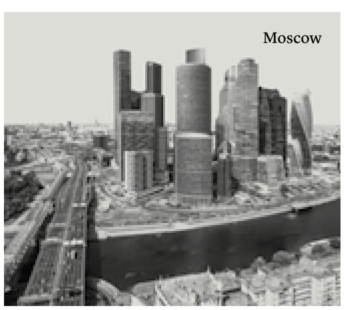

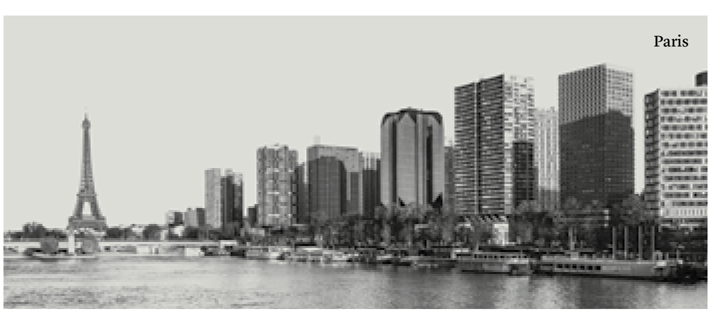

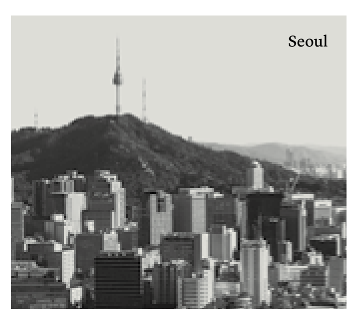

As 2019 begins, companies continue to face global uncertainty, marked by volatility in the capital markets and global instability. And while change is inevitable, what has been particularly challenging as we enter this new year is the frenzied pace of change, from societal expectations for how companies should operate, to new regulatory requirements, to the evolving global standards for conducting business.

As companies navigate how to adapt, they are being held to increasingly higher standards in executing a coherent, thoughtful and profitable long-term strategy in this ever-evolving landscape. This memorandum identifies the issues across a number of different areas on which boards of directors, together with management, should be most focused.

Talent Management

Diversity Considerations

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Gender diversity has been at the forefront of social and governance issues for corporate boards in recent years. Focus on this topic continued to intensify in 2018 and is likely to be a significant issue in the 2019 proxy season and beyond. Stakeholders of all types—from large institutional investors to employees to some state governments—have been expressing views on gender issues such as board gender diversity as well as pay equity and the #MeToo movement, with the result that many companies feel pressure to act and react to these matters on expedited timelines—sometimes with significant top-down enterprise changes. The following is a review of the most significant of these developments.

Institutional Investors

Some of the largest institutional shareholders, including BlackRock, State Street Global Advisors, Vanguard and others, have continued to emphasize the importance of board diversity. With some perceived lack of responsiveness, particularly at small- and mid-cap companies, these investors have now begun to express that view with votes, generally through votes against the chair or entire nominating and governance committee. Institutional investors have been vocal that these voting trends will continue as they become increasingly intolerant of companies that continue to fail to make sufficient progress.

Pension Funds

The New York City Comptroller Scott Stringer's Boardroom Accountability Project 2.0 (buoyed by its success with proxy access, known as version 1.0 of the Project) sent letters to the boards of 151 companies in 2018, calling on them to disclose the skills, race, and gender of board members and to discuss their process for adding and replacing board members. In addition to board gender diversity, the NYC Comptroller has also been focused on gender pay equity at companies.

Other pension funds are also focused on these issues and have begun to reflect that view in their voting. In particular, CalPERS publicized that it voted against 438 directors at 141 companies based on a failure to respond to CalPERS efforts to encourage increased diversity. Those efforts included two large-scale letter writing campaigns that resulted in 504 companies adding at least one diverse director to the board.

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Other Shareholders

Other, smaller shareholders, have also been focused on one or more aspects of diversity. For example, Arjuna Capital, a sustainable investor, has focused on gender pay equity proposals and has engaged with companies, principally in technology and banking, to release information about gender pay equity. After the 2018 proxy season, during which a number of companies voluntarily released information, Arjuna Capital released its first Gender Pay Scorecard analyzing equal pay issues at companies that had provided disclosure.

Proxy Advisory Firms

In 2019, Glass Lewis will begin recommending voting against nominating committee chairs of Russell 3000 companies without female directors (and may extend this to other nominating committee members in certain circumstances) unless the company has disclosed a significant rationale or a plan to address the lack of female directors. ISS stated it will similarly begin recommending voting against the nominating committee chairs in the Russell 3000 or S&P 1500 starting in February 2020. ISS noted a few mitigating factors it will consider, but emphasized that a lack of gender diversity should be temporary and limited to "exceptional circumstances."

State Governments

On September 30, 2018, Governor Jerry Brown of California signed into law a novel bill that made California the first state to require publicly held corporations headquartered in the state to have at least one female director by the end of 2019, or face modest financial penalties. Thereafter, California-headquartered companies will be required to have additional women directors by December 31, 2021, as follows:

Number of Total Directors	Number of Women Directors
6 or greater	At least 3
5	At least 2
4 or fewer	At least 1

California's new law is the culmination of a push that began in 2013, when it became the first state to pass a non-binding resolution to encourage corporations to increase female representation on boards. Illinois, Massachusetts, Colorado and Pennsylvania followed suit and passed similar non-binding resolutions, and a bill similar to California's new law is currently being debated in New Jersey.

Employees

With increased social and traditional media attention, employees are also increasingly vocal about gender issues that affect them and their employers. Companies have faced demands from employees to provide explanations for opposition statements to diversity-related shareholder proposals and pressure regarding failure to make pro-employee changes.

As companies prepare for the upcoming proxy season and related engagement with shareholders and others, we offer the following concepts for the board to consider in developing a strategy:

— *No company is immune from the push for increased board diversity*. A company without any diverse board members (*e.g.*, many small- and mid-cap companies) can expect increasing pressure from investors and others. However, a board with some diverse board representation is likely to experience some pressure to continue to increase the number of diverse board members. Studies have often identified at least three directors as a "critical mass" threshold for seeing the benefits of diversity in the boardroom.

— *This is not a one-time fix*. Refreshment plans should not aim only to increase diversity in the short term but focus on diversity as a long term and lasting goal.

— *A lack of diversity in the industry will not be an acceptable excuse for a lack of board diversity*. In the past, certain industries have seemed to be insulated from the issue; that is unlikely to be the case going forward.

— *Carefully consider company statements and actions from a variety of perspectives*. What may be acceptable to the investor community may be problematic for employees, customers, suppliers, or other stakeholders.

— *Be proactive*. Expectations in this area continue to evolve, and a company that thinks broadly about these issues and implements changes proactively is more likely to avoid embarrassing and costly missteps.

— *Consider diversity from a holistic perspective*. Simply achieving diversity on the board will not suffice. Emerging as a likely area of future focus is the composition of key board committees and leadership roles. Diversity within senior management is also expected to be a likely area of upcoming attention. And while gender is a particular focus at the moment, other aspects of diversity are likely to become the next priorities.

Human Capital Management Moves to the Front Lines

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Over the past year, as evidenced by the significant media attention focused on the #MeToo movement, gender inequality concerns, pay disparities and various employment practices, human capital management has culminated into a significant environmental, social and governance ("ESG") topic on which investors, employees and other stakeholders expect companies and boards to be focused and make progress. And, in a December 2018 Roundtable of the Investor Advisory Committee, the Securities and Exchange Commission ("SEC") considered, together with many of these stakeholders representing different points of view, whether human capital management issues should be the subject of mandatory disclosure.

In part, the rise of attention to human capital management reflects a sea change in our society due to the shift from an economy that thrived on making things to an economy where the biggest growth area, regardless of industry, is technology, which relies in large part on skilled employees. The ability to effectively attract and retain employees is critical to many companies and the risk of poor execution can have significant reputational, financial and other costs.

The increasing attention to human capital management has been rapid. To illustrate how quickly human capital management issues have moved to the forefront of governance agendas, consider the progression in BlackRock's Larry Fink annual letter to CEOs. The 2016 letter mentioned ESG issues broadly, noting that such issues range from "climate change to diversity to board effectiveness." The 2017 letter highlighted employee development and their long-term financial well-being as some of BlackRock's engagement priorities due to how critical they are to a company's long-term success. The 2017 letter also focused on the importance of internal training and education of employees to fill the skills gap, and the need to "increase the earnings potential of the workers who drive returns" as a way of remaining competitive in the changing economy. In 2018, the letter was titled "A Sense of Purpose," and closed with questions for company reflection that covered, among other topics, the company's efforts for achieving a diverse workforce, its progress on providing training and retraining opportunities for employees, and the path for preparing employees for retirement using behavioral finance and other tools that indicate BlackRock's increasingly sharper focus on the issue.

Human capital management has become a board-level issue linked to risk oversight and long-term strategic planning to ensure that the business model is sustainable from a workforce perspective.

The definition of human capital management is slightly amorphous and what is considered a human capital management issue is likely to shift over time. In general, human capital management can refer to effective employee policies, such as business codes of conduct, whistleblower policies, equal employment opportunity policies, health and safety guidelines, and training and development programs to encourage employee engagement and wellness. Human capital management also deals with the issues of culture that have been in the news as high-profile companies weather scandals that call into question company culture. Traditional compensation and employee retention issues are also often combined with human capital management, such as statistics on promotion and compensation, gender pay equity and the ability to participate in an employee stock purchase program.

Part of the difficulty in defining human capital management is due to the fact that it varies significantly between industries, and even between competitors of similar size in similar industries. For instance, the issues for a car-share company with a business model that relies on worker participation in the gig economy is different than the human capital management considerations for sizeable long-standing car manufacturing companies.

Many of the considerations for human capital management were previously thought to be under the purview of the HR department. But, as these issues escalate in importance, it is becoming clear that this is not an area that should be viewed solely as a management responsibility. Rather, human capital management has become a board-level issue linked to risk oversight and long-term strategic planning to ensure that the business model is sustainable from a workforce perspective.

Indeed, given the significant reputational consequences that mismanagement of these issues can attract, including negative publicity, adverse impact on employee morale and attrition, and other stakeholder backlash, all facets of the board are implicated in some manner. From a strategic perspective, the full board should be focused on these issues. However, as they distill into individual risk issues, it may be appropriate for the audit or risk oversight committee to be heavily involved. In addition, the compensation committee will need to ensure that compensation plans for executives and full-company compensation programs appropriately reflect human capital management considerations. The nominating and governance committee also must focus on these concerns, particularly as shareholder attention in this area increases, bringing with it a spike in the number of shareholder proposals on a wide variety of related topics. In December 2018, the New York City Comptroller underscored the need for board-level attention when he brought a number of shareholder proposals focused on employment practices, stating "when big corporations force their workers to sign away basic rights, investors have to fight back."

Boards should therefore be asking themselves how to best oversee these concerns. Even for boards that have been overseeing these issues for some time, the increased attention indicates that it may be appropriate for boards to review their current approach. Boards should also be analyzing the information flow; what may have been considered too granular for a board may now be appropriate, given the increased level of board involvement. In addition, boards may want access to new information that may need to be developed internally or hired externally to help companies navigate the shifting landscape.

What has become clear is that boards and companies that do not consider these issues and adapt how they view human capital management will be the subject of intense scrutiny. As these efforts and this focus intensifies, companies that have begun to address these issues internally will find that they are in a better position to engage with their stakeholders and avoid reputational backlash.

Among the Many Risks Boards Manage, Don't Forget CEO Risk

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Business risks are everywhere and boards rightly place responsibility for anticipating and managing many of those risks on their CEOs and management teams. In turn, a number of incidents in 2018 highlighted the potential risk individual CEOs can pose to their own companies' reputations and drew attention to the board's obligation to anticipate and manage that risk. The nature of the risk assessment and the appropriate mitigating actions will vary depending on the CEO's role, public profile and relationships with other board members.

Considerations in Evaluating the Risk Level Presented by a CEO

Baseline Risk

As the top-level of management, the CEO is the spokesperson for the company's business and in many cases, on a range of other issues affecting modern companies—labor and human rights, trade and immigration policy, gender diversity and others. Any ill-considered commentary can alienate employees, customers, suppliers and shareholders.

This baseline risk necessitates a minimum level of board oversight to ensure alignment between the board-developed strategy and the effectiveness of the public execution of that strategy. As a result, most boards communicate to their CEOs basic expectations and policies, formally or informally, to guard against, for example, inadvertent off-script comments announcing material developments prematurely or inaccurately.

Areas of Incremental Risk

Incremental risk above the baseline, and a red flag for the board, exists when the CEO has a pattern of public commentary that surprises the board, possibly indicating a lack of internal collaboration, discipline or overall care in crafting messages to stakeholders. At this level of risk, the board may decide additional hands-on oversight is warranted, which could include pre-vetting of the CEO's communications when they relate to the company or are made through company-approved communication channels.

When a CEO is unusually prominent, high profile or becomes synonymous with the company's brand, the risk level increases. Shareholders and regulators may have difficulty separating the CEO's personal speech and actions from company views and commentary. When faced with this situation, the board should evaluate expanding any pre-vetting measures to include non-company related public events and communication channels.

The potential for the CEO to exert influence over directors is another circumstance in which the risk is incrementally elevated, such as when a CEO is also the chairperson or has outside relationships with board members. However, the burdens on the director and the board are very different in these two situations. On the one hand, with a combined CEO and chair role, the potential conflict is an easily identifiable governance issue and many solutions have already become widespread best practices. For example, ensuring there is a strong lead independent director who leads meaningfully probing executive sessions and keeps an open line of communication with the CEO are often sufficient for a board to feel comfortable that it has exercised appropriate oversight.

On the other hand, when the CEO has an outside relationship, whether personal, professional or otherwise, with one or more board members or there is a culture of board deference to management, the metrics by which to judge the severity of the issues and formulate responses are subjective. These are situations in which the relationships are not sufficient to cause a director to be non-independent under applicable SEC or stock exchange regulations, but are sufficient to create an appearance, or worse, of bias or inadequate oversight of the CEO. In these instances, individual directors must assess the governance issues based on their independent judgment, frequently using incomplete information about the nature and closeness of the relationships.

To add complexity to the oversight dynamic, the directors without personal relationships with the CEO (the "non-aligned directors") may find themselves at odds with the other directors, creating a fraught inter-board dynamic. It is not an enviable task[1], and the inclination to remain silent and not "rock the boat" will be alluring to the non-aligned directors, but they must use their good judgment to identify the personal relationships that rise to the level of undermining the board's independent oversight role and then convince the aligned directors to act accordingly to correct the problem.

Too little regulation, and the board risks an ungovernable and overly risky CEO who can cause legal and regulatory harm, but may unleash significant creative energy. Too much oversight, and the board may view themselves as having discharged their oversight duties, but the CEO may become an uninspired leader, which will decrease long-term shareholder value.

In addition to some of the previously mentioned risk mitigation strategies, a board in this situation may decide oversight is more properly placed in a subset of non-aligned directors working as an ad hoc committee. Even if those directors who have outside relationships with the CEO would in fact be able to discharge their oversight with no bias, such a committee of non-aligned directors will eliminate the appearance of bias and enhance the board's credibility. Boards should be mindful that these relationships are usually scrutinized with the benefit of hindsight, where appearances are given a great deal of weight.[2]

Risk of Overcorrection and Overregulation

While there are opportunities to identify and harness the risk a CEO may pose, sensible and balanced implementation requires an appreciation of the facts on the ground. Boards must be mindful that the method of CEO regulation must be calibrated to maximize long-term shareholder value in fulfillment of the directors' fiduciary duties. Balancing risk to maximize

1 Line drawing of this type is subjective and sometimes difficult to rationalize. In *In re MFW S'holders Litig*, the Chancery Court of Delaware drew a distinction between friendships in which parties served as each others' maids of honor, had been college roommates, or shared a beach house with their families from those where the parties occasionally have dinner over the years, attend the same parties and call themselves 'friends'.

2 CEOs themselves can benefit from eliminating bias, whether actual or perceived, stemming from outside relationships that frequently appear to the outsider as a governance weakness and can attract activist investors. A multi-year FTI consulting study indicates that more than one-third of CEOs turn over within 12 months of activist engagement, and if the activist obtains board seats, more than half of CEOs are replaced within two years.

shareholder value is a familiar topic to boards, but it is interesting to juxtapose the risk of oversight of a person—the CEO—with shareholder value. Too little regulation, and the board risks an ungovernable and overly risky CEO who can cause legal and regulatory harm, but may unleash significant creative energy. Too much oversight, and the board may view themselves as having discharged their oversight duties, but the CEO may become an uninspired leader, which will decrease long-term shareholder value.

As boards evaluate their practices, as well as CEO performance, their risk appetites and the risk profile of the company for the coming year, there is no prescription or set of procedures that will fit each company. However, directors should be thinking critically and creatively about the board's relationship with the CEO in his or her many roles—as a director, member of management, executor of strategy, and company spokesperson.

Opportunities and Challenges for Compensation Committees

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2019 presents both an opportunity and a challenge to board compensation committees to consider rethinking their approach to performance-based executive compensation.

Since 1992, public company shareholders have been asked to vote every five years on the "material terms of the performance goal under which compensation is to be paid" to the company's top executives in order to preserve corporate tax deductions under Section 162(m) of the Internal Revenue Code. Under Section 162(m), the "performance goal" included the business criteria on which the goal was based and the maximum amount of compensation that could be paid to an executive if the goal was attained. In addition, the compensation could be paid solely on the basis of the attainment of pre-established, objective performance goals with no exercise of positive discretion by the compensation committee. These requirements for "qualified performance-based compensation" tied in nicely with, and helped to frame, the increased focus over the last 25 years on executive compensation generally, and "pay for performance" specifically, by shareholders, proxy advisory firms and the SEC.

The removal of the "qualified performance-based compensation" exception in 2018 from the compensation deduction limits of Section 162(m) knocked out the statutory parameters within which public companies have historically structured their incentive compensation programs and largely eliminated the need for shareholder approval of the plan parameters set by companies (other than approval of the overall number of shares to be issued pursuant to equity plans pursuant to stock exchange listing conditions).

This tax law change frees compensation committees from strict reliance on objective criteria with pre-established goals in the design and implementation of their executive incentive compensation. Subjective performance measures may be employed more widely and greater discretion may be exercised in translating performance results into compensation decisions, all without the threat of negative tax consequences. However, freedom means choice. One initial decision, especially if a company is bringing a plan to shareholders for approval in 2019, is whether to discard all Section 162(m)-related provisions from incentive compensation plans as no longer applicable or leave certain of them in place.

Predictably, shareholders have expressed their own views about performance-based compensation, notwithstanding the tax law change. As expressed by ISS in its recently updated U.S. Equity Compensation Plan FAQs (the "FAQs"), "Section 162(m)'s requirements for qualifying performance-based compensation included items that are recognized by investors as good or best practices. If a plan contains provisions representing good governance practices, even if no longer required under the revised [Section 162(m)], their removal may be viewed as a negative change in a plan amendment evaluation. For example, the removal of individual award limits would be viewed as a negative change." In addition to ISS' possible reaction, large institutional shareholders who are accustomed to voting independently of ISS' recommendations on plan features such as individual award limits could also react negatively to their removal without shareholder approval.

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The concept of compensation committees using discretion in compensation decisions, unfettered by Section 162(m) concerns, also troubles ISS as stated in its recently updated FAQs: "While the tax deduction for performance pay afforded under 162(m) provided an added benefit, it was seldom a primary reason behind investors' expectation for performance-based programs. Shifts away from performance-based compensation to discretionary or fixed pay elements will be viewed negatively." Interestingly, in the same FAQs, ISS also added the following statement, which suggests that the tax law change may result in some softening of the mandate on compensation committees to stick strictly to objective, formulaic approaches: "While recognizing that investors prefer emphasis on objective and transparent metrics, ISS does not endorse or prefer the use of TSR or any specific metric in executive incentive programs. ISS believes that the board and compensation committee are generally best qualified to determine the incentive plan metrics that will encourage executive decision-making that promotes long-term shareholder value creation."

When deciding whether to continue adhering to incentive plan structures driven primarily by objective GAAP/non-GAAP measures or to take advantage of the potential for increased flexibility, compensation committees should also consider other trends in the corporate governance realm. Interest in corporate sustainability, especially the impacts of companies on, and the impacts on companies of, ESG issues has steadily been increasing over recent years. Groups such as the Global Reporting Initiative, the Task Force on Climate-related Financial Disclosures and the Sustainability Accounting Standards Board ("SASB") have promulgated standards and recommendations for company disclosure of ESG risks and sustainability policies and practices. Many companies now routinely post sustainability reports on their websites.

2018 was a big year for the sustainability movement. Early in 2018, ISS unveiled its E&S QualityScore representing its measurement of the quality of corporate disclosures on environmental and social issues, including sustainability governance. In late 2018, Glass Lewis stated that it would begin to integrate guidance on material ESG topics from SASB's recently published standards into its research and voting reports. Shareholder proposals relating to social and environmental issues were the topic of approximately 43% of all shareholder proposals submitted in 2018.

While the idea of including ESG metrics in executive compensation plans has been around for years (and adopted around the edges by some companies), given the current climate, compensation committees that have not begun to contemplate the use of sustainability metrics in executive compensation may wish to start. Of the approximately 55 shareholder proposals on executive compensation in the Russell 3000 in 2018, 20 requested companies to include social or environmental performance metrics in their executive compensation plans. Recently, Royal Dutch Shell and certain of its institutional investors released a joint statement regarding the company's long-term goal of reducing its carbon footprint, including a plan to incorporate carbon emissions measures tied to that goal into the company's executive compensation program.

SASB uses the term "sustainability" to refer to "corporate activities that maintain or enhance the ability of the company to create value over the long term. Sustainability accounting reflects the governance and management of a company's environmental and social impacts arising from production of goods and services, as well as its governance and management of the environmental and social capitals necessary to create long-term value." Performance-based compensation designed to incentivize the creation of long-term value is the cornerstone of every company's executive compensation program. Although the use of sustainability metrics in executive compensation will present challenges, any compensation committee contemplating its historical incentive compensation framework should consider the inclusion of pertinent ESG measures.

SEC Proxy Developments in 2018

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In 2018, the SEC continued to take small steps towards refining the shareholder proposal and proxy processes, although the guidance remains a bit muddled and imprecise. In addition to publishing Staff Legal Bulletin No. 14J ("SLB 14J") and two new Compliance and Disclosure Interpretations ("C&DIs") regarding Notices of Exempt Solicitation, the SEC also hosted a proxy roundtable featuring a variety of viewpoints this past fall.

SLB 14J and Proxy Proposals

In October 2018, the Staff of the Division of Corporation Finance (the "Staff") released SLB 14J as a follow-up to Staff Legal Bulletin No. 14I ("SLB 14I") released in the fall of 2017. SLB 14J provides additional guidance on the use of board analysis in no-action letter requests, discusses how the Staff views micromanagement arguments and addresses the exclusion of certain executive compensation proposals.

— *Board Analysis*. The "economic relevance" and "ordinary business" exceptions under Exchange Act Rules 14a-8(i)(5) and (7), respectively, allow companies to exclude certain shareholder proposals from their proxy statements. In SLB 14I, the Staff indicated that companies should include the board's analysis in requests for no-action relief on the basis of the "economic relevance" or "ordinary business" exceptions. In subsequent speeches, the Staff provided informal guidance that it would like such analyses to include a discussion of any shareholder engagement by directors and whether shareholders expressed interest in or concern about the issues raised by the shareholder proposal. Despite hopes for expanded grants of no-action relief, throughout the 2018 proxy season, the Staff granted relatively little no-action relief for companies, even when board-level analysis was included. In recently released SLB 14J, the Staff emphasized the importance of substantive board analyses versus those that lacked specificity. The Staff also provided a non-exhaustive list of substantive factors for companies to consider in their board analysis.

— *Micromanagement*. When considering whether a proposal should be excluded under the "ordinary business" exception on the basis of micromanagement, the Staff weighs two considerations: (i) the subject matter of the proposal and (ii) whether the proposal, if passed, would micromanage the company. To assess the degree to which a proposal attempts to micromanage a company, the Staff considers whether the proposal probes complex matters and involves intricate details. Although the initial expectation was that such considerations would be focused on proposals that seek to commission a study or report, there is hope based on a recent Staff no-action relief that the Staff will grant no-action relief more broadly on the basis of micromanagement. Most recently, the Staff granted no-action relief to a company on the basis of micromanagement because the shareholder's proposal would have required shareholder approval for each new share repurchase program and stock buyback.

— *Executive and Director Compensation*. The Staff also clarified when it will grant no-action relief for proposals that relate to executive and director compensation. The Staff changed its prior position that micromanagement arguments generally do not apply to proposals regarding senior executive and director compensation, noting that proposals relating to senior executive and/or director compensation should not be treated differently from other ordinary business proposals and therefore may be excluded under the "ordinary business" exception on the basis of micromanagement.

Notices of Exempt Solicitation

Under Exchange Act Rule 14a-6(g), any person who engages in an exempt shareholder solicitation and beneficially owns over $5 million of the subject class of securities must file a Notice of Exempt Solicitation with the SEC. The shareholder filing the notice must also attach the required solicitation materials. Historically, Notices of Exempt Solicitation were filed by shareholders on the company EDGAR page and did not include information that clearly identified the filing party, which created

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some confusion for investors. Additionally, the 2018 proxy season saw an increase in the voluntary submission of such notices, perhaps most notably by frequent shareholder proponent John Chevedden.

The Staff published two C&DIs to provide guidance on the voluntary use of these notices. The guidance clarified that a shareholder may voluntarily submit a Notice of Exempt Solicitation, even if the holder does not satisfy the minimum share ownership requirement that would require the filing. However, the Staff also clarified that any voluntary filing must provide clear identifying information about the shareholder and state that the filing is voluntary, on the cover page. When submitting a Notice of Exempt Solicitation on EDGAR, even voluntarily, all of the information required by Rule 14a-103 must be presented before the written solicitation materials.

Proxy Voting Reform

On November 15, 2018, the SEC hosted a proxy roundtable, which brought together panelists from issuers, registrars, proxy advisory firms, shareholders, Congress, and law firms. While there was no rulemaking, these panels provided important viewpoints on issues that are ripe for SEC reform.

The first panel addressed proxy voting mechanics and technology, which, as all panelists agreed, is the area that has the greatest systemic issues and the most room for improvement. Some of the areas for improvement discussed were voting confirmation and accuracy, universal proxy and technology. Regarding voting confirmation and accuracy, many of the panelists agreed that there needs to be an end-to-end vote confirmation system, but developing such a system is difficult because the intermediaries involved in the proxy process do not have the proper incentives to participate. Many of the panelists noted that a universal proxy card may eliminate some election problems and mitigate shareholder confusion. There was no consensus regarding technology, however, particularly the use of blockchain. Additionally, while technology is important in the voting process, it was not seen by panelists as the only method of solving voting issues.

The other panels discussed shareholder proposals and proxy advisory firms. Regarding shareholder proposals, all panelists agreed that because the SEC regulates shareholder proposals through Rule 14a-8, it cannot pull back on its oversight. However, the panelists disagreed on whether any changes should be made to the resubmission and voting thresholds. The panel addressing proxy advisory firms discussed the incentives of such firms and how they handle conflicts of interest, but many of the panelists believe these firms adequately disclose conflicts, and we do not expect any new reform in this area.

In light of these recent developments, we recommend that companies and boards continue to meaningfully engage with their shareholders on the governance of the company, and provide substantive, thoughtful and specific analysis in requests for no-action relief to exclude shareholder proposals.

Considerations for Director Engagement, Cooperation and Settlement With Activists and Other Concerned Investors

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At some point during any effort by an investor, whether a brand name activist or a dissatisfied institutional investor, to influence the company, the shareholder will likely ask to meet with the full board or at least some of the non-management directors. Rejection of these requests frustrates these investors and increases the risks of a more public and aggressive campaign. Although we often advise that the initial meeting with difficult investors be only with management, we have increasingly found that granting an investor's request to present to the board or meet with some non-management directors actually turns out to be a harmless way for the investor, including potentially nasty activists, to communicate without creating disruption. Thus, we will typically advise that the company, including in many cases non-management directors, "take the meeting" with the activists or other investors, subject to appropriate preparation and a number of "Dos and Don'ts" to assure compliance with Regulation FD and to avoid permitting these interactions to turn into negotiating sessions, forums for the company to make any kinds of commitments, or opportunities for the representatives of the company to make statements that they will later regret, for example, when published by an activist in an open letter. As we have detailed in a popular recent post[3], the downsides of a weak session by a director with an investor are much more significant than the upside of a successful session.

We have found that the directors who do best at these meetings with activists and other investors are those who have engaged in the board room regularly with management about what the investor relations ("IR") function of the company is hearing. These directors understand not only the strategic plan of the company, but also what aspects of the strategic plan are best and least understood and most and least popular among institutional investors. In addition, they understand where the company stands on growth prospects, performance, and ESG matters relative to its peers and other companies that are in the portfolio of its largest institutional investors. Too often, the briefing on IR

3 https://www.clearymawatch.com/2018/05/avoid-bungling-off-cycle-engagements-stockholders/

Although we often advise that the initial meeting with difficult investors be only with management, we have increasingly found that granting an investor's request to present to the board or meet with some non-management directors actually turns out to be a harmless way for the investor, including potentially nasty activists, to communicate without creating disruption.

for the board is that "everybody loves us" and there is an absence of either benchmarking against other companies or candor about the focus of questions and the lingering misunderstandings about and challenges to existing strategy. We often work with management and the board to interpret the significance of the feedback received by IR and to outline proactive steps to improve disclosure, enhance investor engagement and take steps internally at the company in response. The board exercise of digesting what IR has been hearing and then figuring out next steps is the best way to prepare boards for future direct interaction with activists and other engaged investors.

Another aspect of activism and shareholder engagement for which directors need to be prepared are cooperation and settlement agreements where the company makes concessions to an activist or other investor in exchange for soft or contractual assurances of support. The concessions in these agreements often directly impact the board. Commonly, settlements require boards to agree to add and/or subtract directors, form special committees, hire consultants or other advisors, and/or adhere to age or tenure limitations. We have found that companies are able to negotiate these agreements most efficiently and with the least degree of lingering resentment by directors when the board is briefed about what a settlement agreement would look like either on a "clear day" or at the first signs of an activist campaign, as opposed to hearing only machismo about how the activist is ignorant and the company will crush any opposition. Sometimes a fight is the right way to go, but we have found, and the statistics bear out, that directors overwhelmingly choose settlement at the end of the day and that a board that is sophisticated about how settlements work will be likely to obtain a superior settlement and minimize disruption.

Global Crisis Management: Reflections on 2018 and Thinking Ahead, From the Board's Perspective

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Fueled by a steady stream of corporate scandals leading up to and coming out of the financial crisis, in 2018, the focus for senior management and boards of directors at a number of major global firms was on crisis management.

High-profile examples are many, as are examples of companies' responses to a crisis itself becoming a story: from the entertainment industry's reaction to the Harvey Weinstein revelations and the continuous bumbling of corporate responses to #MeToo allegations to delays in reactions to and disclosure of personal data breaches at a long list of companies ranging from retailers to airlines, 2018 illustrated that it is not just the event, but often the response to the event, that matters most. Recent prominent post-mortems of how companies respond to crises, however, also provide useful guidance for directors and management on how to prepare to ultimately face a crisis.

For boards of directors, ensuring that the company is ready to respond to a crisis requires an ongoing and robust commitment to understanding the challenges the company faces, ensuring that the company has in place adequate procedures for surfacing potential issues of concern before they develop into crises, and challenging management on crisis response plans before a crisis emerges. Boards should ensure that management is practicing for crisis response, including running tabletop exercises on topics of major concern to the company. Those exercises should include drafting press statements and testing such statements by professionals.

One important area of focus for all companies should be the plan to respond to whistleblower complaints. Whistleblower complaints, both internal and to regulators, continue to be a primary driver of enforcement action. Because whistleblower complaints can be and often are made confidentially, they can lead to a company finding itself in a full-blown crisis with little warning. Whistleblower complaints to the SEC have continued a multi-year climb from 334 in 2011 to more than 5,200 in 2018. Notably, while accounting-related complaints continue to be prominent, the most significant category of SEC whistleblower complaints in

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2018 was "Other."[4] Having in place clear and effective policies and practices to respond to whistleblower complaints and, importantly, avoiding the appearance of retaliation against whistleblowers should be at the top of every board's crisis management agenda.

Credible and substantiated allegations of sexual harassment against the powerful and the prominent catapulted the #MeToo movement into the board room. Activist shareholders and plaintiffs' lawyers have increasingly targeted boards and board members for failing to adequately respond to "red flags" concerning misconduct of senior executives and misuse of corporate funds to pay victim settlements and alleged harassers. In February 2018, the Delaware Chancery Court approved a $90 million settlement with the board and certain officers of 21st Century Fox, to be paid by the company's D&O insurance, resolving such claims related to conduct by Roger Ailes and Bill O'Reilly.[5] A similar matter is pending against the board of Wynn Resorts for the alleged conduct of its former CEO.

For boards, the important lesson of the last year is to anticipate management issues, and challenge management on its plans to address harassment allegations if they arise. For example, is the board sufficiently apprised of the terms of employment for senior executives and the options that exist for suspending or removing them? Has the company thought broadly, globally and pro-actively about policies and procedures regarding workplace harassment? Is the board informed about the prevalence of harassment at the company? Does corporate culture support and encourage internal reporting, and is management trusted to respond to allegations of harassment?

Cybersecurity has continued to be the instigator of crises in 2018, as in past years. The continued fallout from Yahoo!'s handling of data breaches between 2014 and 2016 illustrates how the response to a crisis—in this case, the largest corporate data breach to date—can spawn exposure on multiple fronts. In April, Altaba, the Yahoo! successor, paid $35 million to the SEC to settle allegations of failing to provide adequate disclosures of its 2014 personal data breach in its financial disclosures. That resolution followed an earlier $80 million settlement of a shareholder derivative lawsuit[6] against Yahoo!'s CEO, Chief Information Officer, and General Counsel arising from allegedly inadequate disclosures of data breaches in 2014, 2015, and 2016.[7] Finally, in October, Altaba announced it had reached a further at least $50 million settlement with a class of users whose data had been stolen (this settlement remains subject to court approval).[8] Of these, only the recent class action settlement arises directly from the underlying issue. Inadequate responses and incomplete disclosures were the basis for almost 70% of the company's liability to this point.

More generally, cybersecurity crises move fast, and the damage can be done in the early days. All 50 states now have laws in place requiring notification in the event of data breaches, and the SEC's 2018 guidance on cybersecurity, released in February, both encourages timely and complete disclosure of data breaches and restates the importance of ensuring that company insiders do not

4 SEC Whistleblower Program, 2018 Annual Report to Congress, https://www.sec.gov/files/sec-2018-annual-report-whistleblower-program.pdf.

5 Fox's Unusual $90M Scandal Deal Gets Chancery's OK, https://www.law360.com/articles/1011154/fox-s-unusual-90m-scandal-deal-gets-chancery-s-ok.

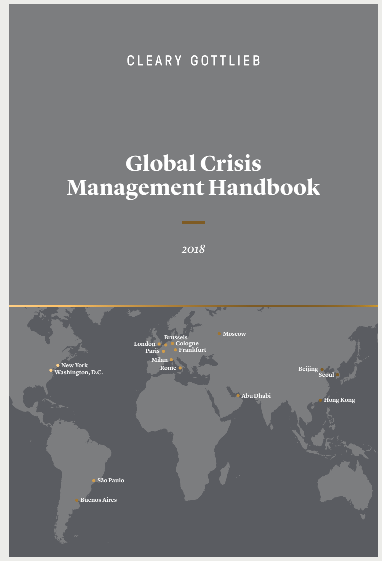
6 https://www.sec.gov/litigation/admin/2018/33-10485.pdf

7 In re Yahoo! Inc. Securities Litigation, No. 17 Civ. 373 (LHK) (N.D. Cal.).

8 In re Yahoo! Customer Data Security Breach Litigation, No. 16 Md. 2752 (LHK) (N.D. Cal.).

trade on information concerning data breaches prior to public disclosure.[9] Similar guidance has been adopted by authorities in other jurisdictions.[10] And, critically, other stakeholders, such as customers, investors, clients and the media, expect real-time information regarding cyber-breaches. All companies should have contingency plans in place for data breaches, and those plans should include means for ensuring that disclosure of information to the public and to regulators is complete, timely and accurate.

While avoiding corporate crises remains a prime objective of boards and management, the nature of the issues that will face companies in 2019 remains uncertain. The lessons that can be drawn from the past, however, are that the companies that successfully weather corporate crises are those that respond with accurate and timely information, with decisive action, particularly where senior executives are implicated, with transparency to regulators and authorities, and with understanding of the impact that the issue may have on clients, customers and other stakeholders.



In 2018, Cleary Gottlieb published the first edition of our ***Global Crisis Management Handbook****, a go-to guide for the legal and practical implications that frequently arise in a large-scale corporate crisis or other cross-border investigation. The Handbook is designed to be a useful, practical desk reference, and contains helpful checklists keyed to particular phases of crisis management and incident response, cross-referenced to substantive and up-to-date guidance written by Cleary Gottlieb lawyers around the world.*[11]

[11] The Handbook is available to download at https://www.clearygottlieb.com/news-and-insights/publication-listing/introducing-the-global-crisis-management-handbook-v2

[9] Commission Statement and Guidance on Public Company Cybersecurity Disclosures, https://www.sec.gov/rules/interp/2018/33-10459.pdf.

[10] *See, e.g.*, https://www.clearygottlieb.com/news-and-insights/publication-listing/hong-kong-sfc-and-hkma-issue-new-guidelines-for-reducing-and-mitigating-hacking-risks.

Regulation of New Technologies

The Evolving State of Cybersecurity

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Companies continue to face significant, even existential, risks from cybersecurity attacks. Several significant developments during 2018 have underscored the potentially escalating costs of cybersecurity incidents, as well as the risks from poor management of the ensuing crisis after an attack has been identified.

New data breach notification obligations continue to be implemented, including under the European Union's General Data Protection Regulation ("GDPR"), which went into effect in May 2018. Enforcement actions related to cybersecurity incidents and vulnerabilities also saw an uptick in 2018, which may portend further such activity in 2019, and there continues to be significant litigation risk associated with cyberattacks.

As a result, boards should continue to exercise vigorous oversight over preparation for such attacks, and ensure that companies are dedicating sufficient resources to mitigating cybersecurity threats and to crisis preparation.

Developing Law and Guidance With Respect to Data Breach Disclosure:

— *State Laws*: Companies in the United States facing a data breach continue to face a patchwork of notification requirements at the state level. For the first time, as of March 2018, all 50 states (as well as the District of Columbia and several U.S. territories) now have data breach notification laws on their books.[12] However, the laws vary, including when and how data subjects and law enforcement must be notified of a data breach, presenting challenges for a company's compliance with all state laws using the same notification process.

— *SEC Guidance*: At the federal level, the SEC issued interpretive guidance in February 2018[13], updating the 2011 guidance from the SEC's Division of Corporation Finance. The new guidance emphasizes the SEC's view that companies must make appropriate disclosures relating to cybersecurity risks or incidents that are material to investors. In particular, the SEC has made clear that a company cannot simply refer to cybersecurity risks in the abstract in its risk factors when it has previously been the victim of an attack. It must also take steps to prevent trading by corporate insiders who know about a potentially material issue until investors have been appropriately informed.[14] In October 2018, the SEC also issued a separate investigative report[15] urging companies to account for cyber-threats when implementing internal accounting controls.

— *GDPR and Its Progeny*: Under the GDPR, personal data breaches have strict notification requirements that may involve notification to data protection supervisory authorities *and* to data subjects.[16] In many cases, notifications must be made within 72 hours, with potential fines of up to 2% of a group's global annual turnover for the preceding fiscal year, or €10 million (whichever is higher), for failure to comply with notification requirements under the GDPR. Moreover, the breach itself may implicate a breach of the GDPR's underlying principles (including the principle of integrity and confidentiality) for which a fine of up to 4% of a group's global annual turnover for the preceding fiscal year, or €20 million (whichever is higher), can be imposed. GDPR-inspired laws are now being passed across the world, including in Brazil and in California. For example, Brazil's new data protection law (the Lei Geral de Protecão de Dados Pessoais, or "LGDP") was recently passed and is scheduled to go into effect in 2020. Among significant new data protection rules and transfer limitations similar to the GDPR, the LGDP imposes data breach notification requirements, and significant penalties of up to 2% of turnover in Brazil, limited to 50 million Brazilian reals (approximately US$13.5) million per violation.

Selected Enforcement Activity in 2018

— *State AG/FTC Enforcement*. Uber Technologies Inc. was sued by the Attorneys General of all 50 states and the District of Columbia, and in September 2018, a record-breaking $148 million settlement was announced, in connection with Uber's failure to disclose a 2016 data breach.[17] In October 2018, the U.S. Federal Trade Commission ("FTC") expanded its 2017 settlement with Uber regarding a 2014 data breach to include additional violations arising from Uber's 2016 data breach. The FTC settlement imposes notification, reporting, and records retention obligations on Uber, and any failure by Uber to notify the FTC of future data security incidents could lead to civil penalties. The Uber settlements underscore the fact that, in managing the fallout

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12 https://www.clearycyberwatch.com/2018/04/50-states-now-data-breach-notification-laws/

13 https://www.clearygottlieb.com/-/media/files/alert-memos-2018/sec-issues-interpretive-release-on-cybersecurity-disclosure.pdf

14 https://www.clearycyberwatch.com/wp-content/uploads/sites/458/2018/02/2018_02_28-SEC-Issues-Interpretive-Release-on-Cybersecurity-Disclosure.pdf; https://www.sec.gov/rules/interp/2018/33-10459.pdf;

15 https://www.clearyenforcementwatch.com/2018/10/sec-investigative-report-urges-public-companies-guard-cyber-threats-implementing-internal-accounting-controls/

16 https://www.clearycyberwatch.com/2018/01/notification-data-breaches-gdpr-10-frequently-asked-questions/

17 https://www.clearycyberwatch.com/2018/10/sec-state-ags-announce-settlements-vfa-uber-data-breaches/

from a data breach, companies must be scrupulous in meeting their disclosure obligations, even if they believe the threat of harm has been eliminated.

— *SEC Enforcement*. In April 2018, Altaba (formerly known as Yahoo!) entered into a $35 million settlement agreement with the SEC, resolving allegations that Yahoo! violated federal securities laws in connection with the disclosure of the 2014 cybersecurity incident involving its user database.[18] The case represents the first time a public company has been charged by the SEC for failing to adequately disclose a cyber-breach. Altaba's settlement with the SEC, coming on the heels of its agreement to pay $80 million to civil class action plaintiffs alleging similar disclosure violations, underscores the increasing potential legal exposure for companies based on failing to properly disclose cybersecurity risks and incidents.

— *GDPR Enforcement*. To date, enforcement action under the GDPR for a personal data breach has been limited to one case in Germany against Knuddels GmbH & Co KG.[19] The size of this fine was relatively low (€20,000), with the German regulator taking into account the efficiency with which the data controller mitigated the damage and informed data subjects (as well as the high level of cooperation shown in connection with the supervisory authority's investigation). While other regulators have yet to address a personal data breach under the GDPR, the UK's Information Commissioner's Office ("ICO") has not been shy about imposing the maximum penalty under the former data protection regime. This year, the ICO levied the maximum fine (£500,000) against Equifax Inc. for its 2017 data breach which implicated the personal data of U.K. persons, and fined Uber £385,000 for failing to protect customers' personal information relating to the 2016 cyberattack described above.[20] Additionally, Uber was fined €600,000 by the Dutch supervisory authority (the *Autoriteit Persoonsgegevens*) and €400,000 from the French supervisory authority (the *Commission nationale de l'informatique et des libertés*), in connection with the same breach.[21]

Civil Litigation

In addition to the growing risk of enforcement actions, the cost of data breaches from a civil litigation perspective continues to increase. In 2018, for example, Anthem agreed to pay $115 million to settle consumer class actions relating to its 2015 breach, which affected almost 80 million users. Yahoo!, in connection with the data breach mentioned above, agreed to pay consumers $85 million and provide two years of free credit monitoring for the 200 million users affected by its breaches (in addition to the $80 million Yahoo! agreed to pay shareholders[22] based on the alleged securities disclosure violations).

Notwithstanding these large settlements, companies continue to fight claims, particularly on the basis of lack of Article III standing—that the plaintiffs whose data has been compromised cannot identify any harm from the breach. Courts remain split on what is required to establish standing for pleading purposes, and whether actual harm must be alleged, or whether alleging a substantial risk of future harm is sufficient. For example, in a 2018 case stemming from a breach of Zappos.com, the Ninth Circuit reaffirmed its position[23] on one side of a circuit split by finding standing to bring suit based on a "substantial risk" of identity theft or fraud resulting from a data breach, even in the absence of allegations that the risk actually materialized. The Fourth Circuit took a stricter approach in *Hutton v. National Board of Examiners in Optometry, Inc.*,[24] holding that alleged costs for mitigating measures to safeguard against future identity theft was a sufficient injury to establish standing while declining to adopt the lower "substantial risk" standard. It remains to be seen whether, in 2019,

18 https://www.clearycyberwatch.com/2018/04/yahoos-successor-settles-first-ever-case-involving-sec-charges-failing-disclose-cybersecurity-incident/

19 https://www.clearycyberwatch.com/2018/12/first-german-fine-issued-gdpr/

20 https://ico.org.uk/action-weve-taken/enforcement/uber/

21 https://autoriteitpersoonsgegevens.nl/en/news/dutch-dpa-fine-data-breach-uber

22 https://www.clearycyberwatch.com/2018/03/yahoo-enters-proposed-settlement-data-breach-securities-class-action/

23 https://www.clearycyberwatch.com/2018/03/ninth-circuit-reverses-dismissal-lack-standing-data-breach-case/

24 https://www.clearycyberwatch.com/2018/07/fourth-circuit-eight-circuit-address-injury-data-breach-cases/

Given the increasing levels of enforcement activity and civil litigation risk, not to mention the reputational harm that comes from suffering a data breach, companies are well-advised to prepare for the worst in advance by, among other things, ensuring that they have an incident response plan in place and testing that plan, assessing what disclosures and notifications will be required in advance of a breach, and identifying counsel and forensic firms that can be "on call" in the event of an attack.

the U.S. Supreme Court will get involved to resolve the issue.

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Boards of directors, likewise, should exercise oversight over the preparations for an attack, and they should keep in mind that regulators and plaintiffs in civil actions will certainly investigate whether a company has devoted sufficient resources to prevention and preparation if there ever is a data breach. Boards should even consider participating in a tabletop exercise, or wargame, to make sure that they understand their role in managing a cyber-related crisis. This preparation, by the board and management, will pay significant dividends in helping the company move quickly and effectively to address an intrusion or other cybersecurity incident.

Key Data Protection Considerations

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In 2019, companies will need to continue to dedicate resources to identifying and managing compliance obligations related to data protection.

The European Union's General Data Protection Regulation ("GDPR") Six Months In

Key Challenges for Companies

— *Applicability*. Multinational organizations continue to grapple with the extra-territorial reach of the GDPR, which even in the absence of an EU establishment applies to data processing that involves the offering of goods or services to EU residents or the monitoring of their behavior in the European Union. Guidance on the territorial applicability of the GDPR has recently been published by the European Data Protection Board[25]; a careful, business-minded analysis (taking into account this guidance) must be undertaken to ensure that the extraterritorial applicability of the GDPR is identified.

— *Ongoing Compliance Obligations*. Organizations face numerous ongoing compliance obligations, including employee training, the incorporation of data protection into systems and procedures (by design and by default), and the undertaking of data protection impact assessments in connection with new processing activities.

[25] https://edpb.europa.eu/our-work-tools/public-consultations/2018/guidelines-32018-territorial-scope-gdpr-article-3_en

Enforcement Action So Far

— The United Kingdom's Information Commissioner's Office ("ICO") issued its first GDPR enforcement notice against Canada-based AggregateIQ on July 6, 2018 (this order was later varied and replaced by the ICO's enforcement notice of October 24, 2018). The ICO did not impose an administrative fine, but instead ordered AggregateIQ to delete the personal data of UK data subjects from its systems, or otherwise face an administrative fine, up to the statutory maximum. The French supervisory authority, *la Commission nationale de l'informatique et des libertés* ("CNIL") issued public formal notices against two marketing platform providers on June 25, 2018, for failing to obtain valid consent for the use of location data for profiling and targeted advertising and gave the companies three months to change their practices to comply with the GDPR (closing one matter after the company changed its practices). Portugal's supervisory authority, *Comissão Nacional de Protecção de Dados* (the "CNPD"), issued its first administrative fine under the GDPR (of €400,000) against a hospital for failing to implement appropriate technical and organizational measures which allowed an excessive number of hospital staff to have access to patient records.

Organizations face numerous ongoing compliance obligations, including employee training, the incorporation of data protection into systems and procedures (by design and by default), and the undertaking of data protection impact assessments in connection with new processing activities.

New Developments in Data Protection Laws

— *CCPA*. On June 28, 2018, California Governor Jerry Brown signed the California Consumer Privacy Act of 2018 ("CCPA") into law. Certain provisions of the CCPA have since been amended, and the law may be subject to further amendment prior to becoming operative on January 1, 2020, but notable features of the draft statute are likely to remain intact, including a broad definition of personal data, expanded rights of California consumers to access, and prohibit the sale of, their personal information, obligations on businesses to comply with such requests and penalties for non-compliance.

— *Biometric Laws*. Three states, Washington, Illinois and Texas, have laws that require consent in order to use biometric data for commercial purposes. The Illinois Biometric Information Privacy Act ("BIPA") provides consumers with a private right of action to sue for alleged violations. In April, a federal judge granted class certification to a group of Facebook users to proceed with a multi-billion dollar class-action suit against Facebook for violating BIPA in its use of facial-recognition software. Companies that utilize biometric data in order to identify individuals, especially those that operate online, should reassess their processing activities as the landscape of BIPA litigation evolves.

— *European Union/Japan Reciprocal Adequacy Decision*. On July 17, 2018, the European Union and Japan agreed to recognize each other's data protection systems as equivalent, allowing businesses to transfer personal data between the European Economic Area ("EEA") and Japan without further safeguards. The European Commission has so far recognized 12 other countries as adequate, but this is the first time that the European Union has agreed to a reciprocal adequacy arrangement.

— *New Data Protection Regimes*. New omnibus data protection laws were introduced in Brazil and Bahrain in 2018. Brazil's data protection law (the *Lei Geral de Proteção de Dados Pessoais*), which mirrors many of the GDPR's concepts, was approved in 2018 and will come into effect in early 2020. The Bahrain Personal Data Protection Law, passed in 2018, will come into effect in August 1, 2019. This law criminalizes many acts including the processing of sensitive personal data in a manner that contravenes the law's specific requirements.

— *Data Localization*. A growing number of countries, most notably Russia and China, have been placing restrictions on transfers and exchanges of data beyond territorial boundaries, and requiring that data be hosted on local servers. The requirement of data localization will need to be considered alongside the principle of "storage limitation" under the GDPR (namely, that companies should not store personal data longer than is necessary for the purpose for which such data was gathered).

Adequacy of Security

— *NYDFS Enforcement*. In June 2018, Equifax agreed to implement stronger data security measures under a consent order with the New York State Department of Financial Services and seven other state banking regulators.[26] The order does not impose any fines or monetary penalties, but requires Equifax and, notably, its board of directors to take certain corrective actions with respect to Equifax's data security programs and to improve Equifax's oversight of information security.

— *GDPR Principles*. Underpinning the GDPR are seven core "Principles," including integrity and confidentiality of personal data (also known as the "security" principle). Member state supervisory authorities have been quick to provide guidance on the implementation of this principle. As companies continue to audit their data security procedures in 2019, this guidance should be borne in mind. In particular, consideration of such guidance may help companies to comply with the principle of "accountability" under the GDPR.

— *FTC Requirements*. In a ruling issued on June 6, 2018, the Eleventh Circuit vacated an FTC cease-and-desist order against LabMD, Inc. as unenforceable because it found that the order commanded an overhaul of the company's data security program without providing a reasonably definite standard by which a court could determine compliance.[27] In light of this, in 2019, we may see the FTC focus on imposing more particularized data security requirements in response to alleged violations of the FTC Act.

Vendor Management

Vendor management and liability have become increasingly important in the United States, the European Union and Brazil.

— *FTC Approach*. An FTC settlement with BLU Products, Inc., a Florida-based mobile device manufacturer, highlights the need for companies to oversee their service providers with respect to both collection of personal information and data security practices. BLU's mobile devices came pre-installed with software from a service provider BLU had contracted with to issue security and operating system updates to BLU's devices. The settlement resolved allegations that the service provider, through its software, collected consumer data that was not necessary for the relevant services. In addition, the software contained commonly known security vulnerabilities. Both practices were in violation of BLU's privacy policy and the FTC Act. Importantly, in conjunction with this settlement, the FTC staff released guidance for companies concerned with the privacy and security risks that arise from sharing data with third-party service providers, urging them to "[k]eep a watchful eye on . . . service providers." Specifically, the guidance encouraged companies to (i) conduct adequate due diligence on service providers in order to understand how their services work, what data they will be able to access, and what needs to be done to conform their conduct to

[26] https://www.clearyenforcementwatch.com/2018/07/state-regulators-reach-settlement-equifax-connection-massive-data-breach/

[27] https://www.clearycyberwatch.com/2018/06/eleventh-circuit-vacates-ftc-order-mandating-implementation-cybersecurity-program/

the companies' privacy promises; (ii) clearly set out security and privacy expectations in contracts; and (iii) build in procedures to enable ongoing monitoring of compliance with those agreements.[28]

— *GDPR Vendor Management Requirements*. The GDPR introduces strict requirements in connection with the engagement of third-party service providers that are "data processors." Article 28 of the GDPR prescribes the inclusion of a number of clauses into the service agreement and requires that data controllers only use data processors that can implement appropriate technical and organizational measures that ensure the protection of the rights of the data subject. This is a high bar that requires diligence on the part of the data controller and efforts from both parties to ensure the agreement between them complies with the GDPR's requirements.

— *Brazil*. The Brazilian National Monetary Council issued Resolution No. 4,658, which establishes new cybersecurity requirements for financial institutions, and notably covers third-party service providers that contract with such institutions, including those located outside of Brazil.[29]

Areas We Are Watching

While 2018 was an active year for data protection developments, there is more in store. These are some of the areas boards should be paying close attention to in 2019:

— *Potential Federal Privacy Law*. In 2019, we can expect to hear more about the possibility of a comprehensive federal privacy law in the United States. Over the course of 2018, several federal privacy bills were introduced in Congress. In September 2018, the Senate Committee on Commerce, Science, and Transportation held a hearing to discuss how a federal privacy law might be crafted, and in November 2018, the FTC stated that it "strongly supports" efforts for federal privacy legislation.

— *New Technologies*. In September 2018, the SEC's Enforcement Division Co-Director, Stephanie Avakian, gave a speech in which she addressed the Division's approach to dealing with cryptocurrencies.[30] The Division's guidance will likely come in the form of enforcement actions and other public statements rather than formal rulemaking. Distributed ledger technology, such as Blockchain, is also likely to come under scrutiny from data protection regulators; the CNIL has confirmed that when distributed ledger technology includes personal data, the GDPR is applicable and has published guidance that suggests that use of these technologies will have to involve great care if the principles of the GDPR are to be complied with.[31]

— *Brexit Third-Country Status*. In January, 2018, the European Commission issued a Notice to Stakeholders in connection with Brexit noting that following the UK's withdrawal, it will become a "third country" for the purpose of data transfers. This means that, unless the European Commission issues an "adequacy decision," recognizing that the United Kingdom's data protection regime provides for equivalent protection for personal data, personal data will no longer be freely transferable to the United Kingdom. On November 14, 2018, the United Kingdom and European Commission approved a draft withdrawal agreement that maintains the status quo with respect to data protection matters until December 31, 2020 (*i.e.*, if the withdrawal agreement is approved by the UK Parliament, then the GDPR will continue to apply in the United Kingdom during the transition period). However, whether or not the United Kingdom will be deemed "adequate" following the end of this period remains uncertain.

28 https://www.clearycyberwatch.com/2018/05/ftc-settlement-signals-importance-service-provider-oversight/

29 https://www.clearycyberwatch.com/2018/05/brazil-issues-new-cybersecurity-regulation-regulated-financial-institutions/

30 https://www.clearycyberwatch.com/2018/09/sec-enforcement-division-co-director-provides-insight-commissions-approach-icos-cryptocurrencies/

31 https://www.cnil.fr/en/blockchain-and-gdpr-solutions-responsible-use-blockchain-context-personal-data

— *Mechanisms for Transferring Personal Data Out of the EEA*

- *Privacy Shield.* The Privacy Shield is the set of safeguards and compliance measures negotiated between the United States and the European Union to allow the transfer of personal data between the EEA and certified U.S. entities. On the United States side, the FTC enforces compliance with the Privacy Shield. Four companies agreed to settle with the FTC in September 2018 over allegedly falsely claimed certifications (three of these companies had simply let their certifications lapse). The FTC reiterated that "[c]ompanies need to know that if they fail to honor their Privacy Shield commitments, or falsely claim participation in the Privacy Shield framework, we will hold them accountable." On the European Union side, the Privacy Shield is under annual review by the European Commission and in June 2018, the European Parliament called for suspension of the Privacy Shield on the basis that it did not believe that the United States was compliant with its obligations. The European Parliament advised that unless the United States could be compliant by September 1, 2018, the Privacy Shield should be suspended. The European Commission did not take this course and instead undertook its second annual review of the Privacy Shield in October 2018. In its report published on December 19, 2018 the European Commission concluded that the United States does ensure an adequate level of protection for personal data transferred under the Privacy Shield, noting that the U.S. Department of Commerce has strengthened the certification process and the FTC has taken a more proactive approach to enforcement.

- *Standard Contractual Clauses.* In April 2018, following a complaint to the Irish High Court by the Irish Data Protection Commission in connection with the data processing activities of Facebook (which include the transferring of personal data of E.U. data subjects to the United States), the Irish High Court referred a number of questions to the Court of Justice for the European Union, including questions in connection with the adequacy of Standard Contractual Clauses and the Privacy Shield. This reference was challenged by Facebook and the Irish Supreme Court has agreed to hear Facebook's appeal. In the event that the Court of Justice for the European Union is required to give its opinion on the adequacy of Standard Contractual Clauses and the Privacy Shield, these mechanisms may be invalidated causing chaos for international data flows.

— *India*. A government committee in India has released a draft Personal Data Protection Bill, 2018, which is currently making its way through the legislative process. The bill is modeled after the GDPR, but also introduces data localization requirements.

Developments in Auditing and Accounting

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In 2019 the board of directors, and especially the audit committee, at nearly every company will face a few continuing issues from the world of accounting and auditing that have had a lot of attention in recent years. But there are also a handful of sleeper issues that are emerging more slowly and whose impact is not yet clear.

The Marquee Items for 2019

"Critical Audit Matters"

In 2017 the Public Company Accounting Oversight Board ("PCAOB") amended its standards for audit reports, and the most important of these changes will require the auditor to report on Critical Audit Matters ("CAMs"). For a large accelerated filer with a December fiscal year, the disclosure will first appear in the 2019 10-K in early 2020, but for companies with fiscal years ending earlier in the second half, the first 10-Ks with CAMs will appear in late 2019.

Auditors will have to identify matters that are communicated or required to be communicated to the audit committee and that (i) relate to accounts or disclosures that are material to the consolidated financial statements and (ii) involve especially challenging, subjective, or complex auditor judgments.

CAM reporting will require close coordination between the auditor, management and the audit committee, and it may well require management to develop new disclosures that are consistent with what the auditor will disclose in its report. To frontload this coordination audit firms have been pushing companies to conduct "dry runs" to identify CAMs now and tune up the related disclosures in the 2018 10-K.

New Accounting Standards

For several years now, the preparation of financial statements has been complicated by the adoption and implementation of major new accounting standards—especially ASC 606 on revenue recognition and ASC 842 on lease accounting.

The implementation cycle is long, and each phase of the cycle involves the board of directors in a different way. Before effectiveness, when the company is learning how to apply the standard, the audit committee should

Speeches by the Staff and Commissioners, and a sharp drop in comment letters, may have suggested it was safe to go back in the water. Then in the last week of December, the SEC announced an enforcement action against the alarm company ADT for failing to give equal prominence to GAAP measures in its earnings releases.

be encouraging early consideration and disclosure of its likely impact; the SEC has been insisting that this element of oversight is an important governance issue. This is where the leasing standard currently stands, and this year disclosures on its impact will need to become increasingly specific. The leasing standard will have a dramatic impact on some balance sheets and may also have covenant implications for some companies.

After effectiveness—this is where revenue recognition stands in 2019—the audit committee might consider asking how management's application of the new standard compares with other companies, and whether SEC comment letters to other companies have implications for decisions management made in applying it.

Non-GAAP Financial Measures

During the course of 2018, the SEC's intense campaign to rein in company use of non-GAAP measures started to look like old news. Speeches by the Staff and Commissioners, and a sharp drop in comment letters, may have suggested it was safe to go back in the water. Then in the last week of December, the SEC announced an enforcement action against the alarm company ADT for failing to give equal prominence to GAAP measures in its earnings releases. This would be a good time for the audit committee to make sure the company is complying with the non-GAAP rules, particularly in earnings releases.

Emerging Areas to Watch in 2019

Meanwhile, there are some less obvious issues gathering steam that may affect boards and audit committees in the medium term. In the background of all these developments is the increasing pressure on auditing firms from enforcement proceedings, PCAOB inspections, litigation costs, and other regulatory attention. (In May 2018 a parliamentary commission in the United Kingdom even called for rules to break up the Big Four auditing firms.) All this can contribute to a more adversarial atmosphere between the independent auditor and the company and its audit committee.

PCAOB Supervision of Non-U.S. Audit Firms

Many of the major enforcement cases against auditors involve non-U.S. member firms of international auditing networks. In 2017 and 2018, there were major PCAOB or SEC cases involving auditors in Brazil, China, Hong Kong, Korea, Mexico, Malaysia, South Africa, Spain and Turkey. These cases highlight a delicate aspect of how audits are conducted: the principal auditor of a multinational enterprise relies on work done by multiple separate firms (whether or not under the same brand) in different countries.

The cases also highlight a very challenging feature of the PCAOB's mission, which is to regulate audit activity wherever it occurs, if the parent reports to the SEC. Now the best-publicized example of that challenge is back in the news, because the SEC and the PCAOB went public in December 2018 with their complaints that the PCAOB is unable to conduct adequate inspections of Chinese audit firms. Apparently the *modus vivendi* worked out in 2016 is no longer satisfactory.

For companies with extensive operations outside the United States, this is an area the audit committee should be watching closely.

Changing Priorities at the PCAOB

The PCAOB has been regulating auditors since 2002, and in 2018 it had a kind of midlife crisis: the Board turned over completely in December 2017, important senior staff were replaced in 2018, and the new Board led by former Senate staffer William Duhnke published a new strategic plan in November 2018. Some of the projects under way at the new PCAOB would be significant if they ultimately lead to new regulation. These include a project on how the auditor should address instances of illegality (referred to as non-compliance with laws and regulations, or NOCLAR); and a project on how auditors are involved in disclosures other than the financial statements, including earnings releases and the use of non-GAAP financial measures.

Shareholder Opposition to Auditor Ratification

In 2018, attention focused on the General Electric shareholders meeting where, after the proxy advisory firms recommended against ratifying KPMG as auditor, ratification won only 65% of the vote. GE was coming off major accounting problems (and approximately $143 million in audit fees) in 2017. There were a handful of other companies where ratification received significantly lower votes than before, and at one UK company a majority opposed ratification. The interesting questions for 2019 will be what happens in “year two” at a company like GE, how the proxy advisory firms approach ratification (Glass Lewis has already revised its guidelines), and whether opposition spreads to other companies.

Increasing Attention to Audit Committee Disclosures

Several signs point to growing focus on how audit committees perform their oversight of the financial reporting process and the auditors, and how companies disclose that performance. Among these were an April 2018 report by IOSCO (an international organization of securities market regulators from multiple countries, often under SEC leadership) on good practices for audit committees, and a November 2018 report from the Center for Audit Quality recommending better disclosure of audit committee practices.

Effective Compliance Programs in 2019

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In 2018, the U.S. Department of Justice ("DOJ") announced several significant policy changes that will have a meaningful impact on corporate fraud and anticorruption investigations. Collectively, these policies underscore the continuing effort by the DOJ to create incentives for companies to self-identify and report misconduct, including by providing greater transparency about the benefits of doing so. One of the principal takeaways from these developments is that companies should prioritize implementing and maintaining effective compliance programs, which will not only help identify internal bad actors and malfeasance, but will also best position companies to voluntarily disclose misconduct, remediate any issues, and maximize the benefits of amnesty and leniency programs if they choose to do so.

Expansion of FCPA Corporate Enforcement Policy

As we previously reported,[32] in late 2017, the DOJ announced the Foreign Corrupt Practices Act ("FCPA") Corporate Enforcement Policy (the "Enforcement Policy"[33]), which built upon its FCPA Pilot Program in effect since April 2016. Under the Enforcement Policy, absent "aggravating circumstances," there is a presumption that the DOJ will decline to prosecute a company that:

— voluntarily self-discloses wrongdoing before "an imminent threat" that the government will learn of the matter;

32 https://www.clearygottlieb.com/news-and-insights/publication-listing/the-new-doj-fcpa-corporate-enforcement-policy-highlights-the-continued-importance

33 https://www.clearyenforcementwatch.com/2018/01/new-doj-fcpa-corporate-enforcement-policy-highlights-continued-importance-anti-corruption-compliance/#_ftn1

— provides "full cooperation," including by proactively producing documents and other information, providing evidence with respect to the culpability of individuals, and making available witnesses located in the United States and abroad to the DOJ; and

— engages in "timely and appropriate" remediation, including the disgorgement of any profits from the wrongdoing.

In this context, "aggravating circumstances" can include pervasive wrongdoing at the company, the involvement of senior management, obtaining a significant profit from the misconduct, or recidivism. Companies that meet all three criteria but do *not* qualify for a declination due to aggravating circumstances are promised a reduction of up to 50% off the bottom end of the U.S. Sentencing Guidelines fine range. Companies that do not meet the self-reporting criteria, but fully cooperate and remediate in a timely and appropriate manner, are eligible for up to a 25% reduction off the bottom of the U.S. Sentencing Guidelines fine range.

In March 2018, the DOJ expanded[34] the application of the Enforcement Policy, announcing that the policy would serve as nonbinding guidance in *all* DOJ Criminal Division matters, including corporate fraud investigations outside of the FCPA context.[35] The expanded application of the Enforcement Policy therefore broadens the types of misconduct for which companies have incentives to self-disclose and cooperate. On July 25, 2018, the DOJ announced a further expansion of the Enforcement Policy in the context of M&A transactions. Specifically, the DOJ will now "apply the principles contained in the Enforcement Policy to successor companies that uncover wrongdoing in connection with mergers and acquisitions and thereafter disclose that wrongdoing and provide cooperation, consistent with the terms of the Policy."

This expansion reaffirms the importance of diligence in M&A transactions, remediation if wrongdoing is identified, and ensuring that an acquired company has appropriate compliance programs and controls in place to prevent and detect misconduct.

Cooperation Obligations with Respect to Individuals

In addition to providing greater transparency regarding the benefits of cooperation credit and self-reporting, the DOJ also provided greater clarity about its expectations regarding its previously-expressed requirement that companies provide relevant information about individuals involved in any misconduct as part of its cooperation obligations.

Previously, under the DOJ's 2015 "Yates Memo," in order for companies to receive full cooperation credit, they had to provide information about all individuals involved in culpable activity. This led to complaints that certain prosecutors were unreasonably interpreting this requirement to require companies to provide evidence on every individual potentially involved in misconduct no matter how limited the connection, which, in cases involving widespread or long-running fraud or corruption, could arguably amount to hundreds of individuals.

On November 29, 2018, Deputy Attorney General Rod Rosenstein announced[36] a policy change to address this concern. Companies seeking cooperation credit are now only required to identify every individual who was "*substantially*" involved in or responsible for the criminal conduct. According to Rosenstein, "the most important aspect of our policy is that a company must identify all wrongdoing by senior officials, including members of senior management or the board of directors, if it wants to earn any credit for cooperating in a civil case." The announced policy change also provides DOJ's civil lawyers, when bringing civil enforcement actions, new discretion in determining who is pursued and how companies are rewarded for cooperating in civil cases.

[34] https://www.clearygottlieb.com/news-and-insights/publication-listing/doj-announces-expansion-of-approach-encouraging-self-reporting-and-cooperation

[35] https://www.clearyenforcementwatch.com/2018/03/doj-announces-expansion-approach-encouraging-self-reporting-cooperation/

[36] https://www.justice.gov/opa/speech/deputy-attorney-general-rod-j-rosenstein-delivers-remarks-american-conference-institute-0

Anti-"Piling On" Policy

The changes to corporate enforcement policies in 2018 have been coupled with an effort to reduce the burdens on companies facing overlapping investigations involving multiple jurisdictions and U.S. agencies.[37] On May 9, 2018, the DOJ announced a new policy, the Policy on Coordination of Corporate Resolution Penalties,[38] designed to promote coordination and limit the imposition of multiple penalties on a company for the same conduct, commonly known as "piling on."

The policy encourages federal prosecutors to consider the potential imposition of penalties on companies by different regulators and authorities in the United States and abroad for the same underlying misconduct. The new policy is also intended to encourage cross-border and intra-agency cooperation on investigations, as well as the global resolution of investigations of corporate wrongdoing. In practice, this results in the DOJ calculating the total criminal penalty against a company under the U.S. Sentencing Guidelines fine range, and then crediting payments to other agencies or authorities.

During 2018 we have seen several examples of crediting by the DOJ of payments made to other agencies, including: (i) the DOJ's agreement to credit Société Générale's[39] payment to the French *Parquet National Financier* for 50% of the DOJ's total criminal penalty; (ii) the DOJ's agreement to credit Petrobras' payments to the *Ministerio Público Federal* in Brazil and the U.S. SEC for 90% of the DOJ's criminal penalty; and (iii) the DOJ's decision to decline to prosecute Guralp Systems[40] because of the company's commitment to accept responsibility for its conduct through a resolution with the United Kingdom's Serious Fraud Office.

The changes to DOJ policy throughout 2018 reinforce the DOJ's efforts to encourage companies to self-report, cooperate and resolve criminal investigations, both by providing companies with greater transparency regarding the benefits of their cooperation, and by offering the possibility of a coordinated, global resolution that minimizes a company's financial exposure to multiple authorities.

The changes to DOJ policy throughout 2018 reinforce the DOJ's efforts to encourage companies to self-report, cooperate and resolve criminal investigations, both by providing companies with greater transparency regarding the benefits of their cooperation, and by offering the possibility of a coordinated, global resolution that minimizes a company's financial exposure to multiple authorities. These changes further highlight the benefits of adopting and improving compliance programs, not only to deter misconduct, but also to help identify and remediate possible wrongdoing at the earliest possible point in time, which, in turn, will provide a company with the maximum ability to take advantage of the benefits of self-reporting and remediation.

Boards of directors should, in turn, continue to exercise oversight over the compliance function, ensuring that it is independent, is provided with sufficient resources to operate, and complies with best practices. Such oversight will also pay dividends in setting the appropriate tone at the top and emphasizing the company's ethical and compliance culture—thereby, hopefully, preventing misconduct from occurring in the first place.

[37] Acknowledging the significant burden that monitors place on corporations, on October 11, 2018, the DOJ announced new guidance on the Selection of Monitors in Criminal Division Matters, which is intended to, among other things, ensure that the scope of any monitorship is "appropriately tailored to avoid unnecessary burdens to the business's operations." The new anti-"piling on" and corporate monitor policies demonstrate the DOJ's increasing consideration for the impact that criminal penalties can have on companies.

[38] https://www.justice.gov/opa/speech/file/1061186/download

[39] https://www.justice.gov/opa/press-release/file/1068521/download

[40] https://www.justice.gov/criminal-fraud/page/file/1088621/download

The Aftershocks of Tax Reform


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2018 saw the aftermath of the U.S. tax reform legislation that was hastily enacted at the end of 2017. Taxpayers processed the law's extreme changes to the U.S. tax system and the many questions and uncertainties in the statutory language, and the government worked on guidance to resolve and clarify these uncertainties. Outside of the United States, governments got creative in dealing with nexus issues relating to the digital economy and modern tax structures. These developments will have significant implications for companies and may create new risks in the coming year.

— *U.S. tax reform advances to the regulatory phase.* The U.S. Treasury Department and the Internal Revenue Service ("IRS") have been hard at work issuing guidance and new tax return forms to clarify and implement the U.S. tax reform law enacted at the end of 2017. Taxpayers and tax advisors have been clamoring for the guidance because of the significant financial impact of the new legislation and the number of ambiguities and uncertainties resulting from the statutory text. While hundreds of pages of proposed regulations have come out in 2018 (and many more are expected in 2019), the process has been complicated by the recent emphasis on ensuring compliance with the Administrative Procedures Act and a new set of procedures requiring Office of Management and Budget review of all proposed regulations prior to release. The certainty that most taxpayers want also takes a backseat to procedural rules as the proposed regulations go through a public comment period after which they can be revised and finalized.

— *European Union questions fairness of U.S. tax reform.* The European Union has asked the Organisation for Economic Co-operation and Development's forum on harmful tax practices to review the U.S. tax reform legislation. The European Union is also reportedly considering filing a complaint with the

World Trade Organization and possibly adding the United States to the E.U. "blacklist" of tax haven jurisdictions. These developments are not unexpected; several E.U. finance ministers sent a letter before the U.S. tax reform legislation was enacted warning that the law would violate tax treaties and World Trade Organization rules. If the E.U. efforts are successful, the United States could be forced to repeal certain aspects of the tax reform legislation or face sanctions from the European Union.

— *Expansion of economic nexus and permanent establishment assertions by governments*. The European Union, the United Kingdom and Italy have enacted new laws meant to expand the tax net to capture digital companies. Additionally, France and Italy have taken an expansive view of nexus under audit, asserting that local affiliates or service providers constitute "permanent establishments" and therefore subject foreign companies to local tax. Google and Valueclick were audited on this theory in France, where both taxpayers ultimately prevailed in the courts, and Apple, Amazon and Google all settled similar audits in Italy. Several European jurisdictions have also resorted to criminal investigations or "dawn raids" of companies that are perceived as not paying their fair share of taxes, including Microsoft and McDonald's (in France), Apple and Amazon (in Italy), and Google (in both France and Italy). Companies operating in Europe should be prepared to deal with these strategies.

— *The European Commission's "State aid" litigation continues*. The European Commission ordered Luxembourg in June 2018 to collect $140 million from Engie, the latest in a series of European Commission decisions requiring corporate taxpayers to pay enormous sums to the foreign tax authority which had previously issued a favorable ruling to that taxpayer. Other examples include Fiat (ordered to return €20 to €30 million to Luxembourg), Starbucks (ordered to return €20 to €30 million to the Netherlands), Apple (ordered to return more than €13 billion to Ireland) and Amazon (ordered to return nearly €250 million to Luxembourg). The taxpayers are contesting these judgments, and there is likely to be years of litigation before we have a conclusive determination of whether the European Commission's expansive interpretation of "State aid" is correct. In the meantime, investigations can be expected to continue. Multinationals that have received private rulings from any European tax authority should review those rulings and assess whether they are at risk and what steps they might take to reduce or mitigate their risks.

In 2018, taxpayers processed the law's extreme changes to the U.S. tax system and the many questions and uncertainties in the statutory language, and the government worked on guidance to resolve and clarify these uncertainties.

— *Litigation over the validity of tax rules*. Taxpayers are continuing to defend against IRS tax deficiency claims with assertions that the underlying Treasury Regulations are invalid. The asserted grounds for invalidity are usually that the Treasury Regulations are inconsistent with the statutory text or that the process by which the Treasury Regulations were promulgated was flawed. The case that is attracting the greatest interest (*Altera v. Commissioner*) involves both of these grounds, and has far-reaching implications, in part because the substantive issue in the case is relevant to many U.S. corporations. The substantive issue is whether affiliated entities that jointly develop intangible property are required to share the cost of issuing stock options to the employees involved in that development. The resolution of the substantive issue will have a significant impact, as will the resolution of the issues involving Treasury's regulatory authority.

Challenges to the validity of tax rules continue to be complicated by the Declaratory Judgment

Act and the Anti-Injunction Act, which prohibit pre-enforcement challenges to tax rules—meaning that taxpayers may challenge tax rules only after taking positions contrary to the rules and then having the IRS assert that additional taxes are due (or refusing to issue a refund of taxes paid). In 2018 taxpayers continued to try to convince courts that *certain* pre-enforcement challenges are permissible, with very limited success. Some see this process as inefficient and unfair, but the policy behind these laws is based upon the importance of tax collections to the operation of the government and the risk of pre-enforcement challenges imperiling the collection of properly due taxes. We anticipate seeing additional litigation over the validity of Treasury Regulations for many years to come, including, eventually litigation over the Treasury Regulations being promulgated now to implement the 2017 tax reform legislation.

— *Significant use of insurance in M&A deals*. There has been an increase in the use of insurance in the M&A market, rather than traditional indemnification from sellers, to address buyer exposures. Insurance covering breaches of representations and warranties (which include tax representations and warranties) is widespread, with more insurers entering the market and more competitive pricing. Additionally, insurers have recently been willing to expand these policies to cover pre-closing taxes generally. Claims under these policies tend to be subject to limitations that traditional seller indemnification would not, including express carve-outs for known exposures and also for certain substantive issues like transfer pricing risks. Insurance coverage in a transaction changes the deal dynamics and could complicate the diligence process. Additionally, in certain situations (and typically for a higher premium) a buyer or seller can separately purchase insurance against specific tax issues of the target that have been identified in diligence, or the tax treatment of the transaction itself. The portfolio of products offered by insurance companies continues to expand. Companies engaging in M&A activity should consider using insurance (and expect that counterparties may use it) and take into account the cost and the impact on pricing and process.

Looking Ahead at Mergers & Acquisitions in 2019

Risks to the Buyer of Fiduciary Duty Breaches by the Target in the M&A Sale Process

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Attention to accretive M&A as a solution to investor pressure when growth slows has led to pressure on merger parties to “cut corners” on process that puts at risk compliance with fiduciary duties. It is critical for acquirors to take steps to assure that the boards of their targets have been complying with their duties.

Buyers in M&A transactions often overlook (or feel powerless to address) this risk that the target’s board may have breached its fiduciary duties in connection with a transaction. A buyer’s failure to account for breaches of fiduciary duties by the target’s board can lead to deal execution risk and/or post-closing liability for the buyer once it has acquired the target (together with its attendant liabilities). When considering the potential for a target board’s breach of fiduciary duties, buyers cannot rely on the typical due diligence process or customary sets of representations and warranties to determine whether such breaches have occurred. However, the buyer can take steps to minimize the risks associated with such breaches.

Conduct by the Target’s Directors and Management

— *Conflicts within the Capital Structure*. In the event the target has multiple types or classes of outstanding equity, the buyer needs to be focused on the potential for conflicts that will trigger breaches of duty. For example, when members of the target’s board hold, or are affiliated with holders of, preferred stock with a preferred return or put rights, these members may be incentivized to vote in favor of a transaction in which the preferred shareholders receive a healthy payout while common shareholders are left receiving little, or nothing, in the way of merger consideration. Alternatively, in the case of a company with high-vote and low-vote stock, special consideration will need to be given to the process employed by the board of directors when the high-vote and low-vote stock receive different consideration. A court reviewing these types of transactions may apply a higher level of scrutiny to the transaction terms if it determines that board members approving the transaction were not disinterested.

Buyers in M&A transactions often overlook (or feel powerless to address) this risk that the target's board may have breached its fiduciary duties in connection with a transaction.

Buyers should consider:

- Requiring the target to obtain the approval of the shareholders who are not associated with interested directors;
- Requesting that the board ask the target financial advisor to provide a fairness opinion in respect of each class of stock;
- Asking the target if it has considered running the process with a committee of independent directors; and/or
- In the context of a private deal, requiring indemnification for claims arising in connection with a breach of fiduciary duty.

— *Management Conflicts*. Although buyers may view a good relationship with a CEO or other senior officers of the target as a benefit during deal negotiations, buyers should be wary of the potential for officers of a company to "get out ahead of" their board during deal negotiations. Buyers should consider taking the following steps to ensure that pre-closing discussions with a senior officer do not become an unwanted point of focus in a shareholder lawsuit:

- Confirm that the insider is not "in front of" his or her board by addressing buyer's written communications to the full board and getting feedback from the target's financial advisor and outside counsel about the board's role; and
- Agree on material transaction terms before negotiating or having substantive conversations about the terms of any post-closing relationship with officers or directors of the target.

Conduct by the Target's Financial Advisors

A target's financial advisor's failure to disclose its relationships (or potential relationships) with the buyer can also lead to claims of breach of fiduciary duty by the target board. Courts have allowed shareholders to claim breach of fiduciary duty when the target's board allegedly failed to act in an informed manner when the board was unaware of its financial advisor's potential conflicts, especially those involving the target financial advisors' investments in, relationships with, and promises to and from the buyer and its affiliates. Though target boards have generally been able to avail themselves of exculpation under 102(b)(7) in the case of such claims, such claims have nonetheless exposed financial advisors to aiding and abetting claims by shareholders, which, post-closing, can result in reputational harm to the buyer as well as potential claims against the target (now as the buyer's subsidiary) by the financial advisor for indemnification.

Buyers should be mindful of their current and potential interactions and take stock of their past interactions with the target's financial advisor. Buyers should take steps to ensure that the target and its counsel are aware of any potential conflicts of interest on the part of the target's financial advisor that arise from connections with the buyer and that these conflicts have been disclosed to the board.

Cleansing

Finally, to the extent buyers become aware (in advance of target shareholder approval of the transaction) of any potential grounds for breach of fiduciary duty claims against the target board, they should require that these claims be included in the merger proxy statement, so that the breaches may be cleansed by a fully-informed shareholder vote.

The Challenge of Internal Forecasts for Directors in the M&A Context

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Uncertainties about the near- and long-term future of companies at which boards are considering strategic alternatives will result in significant impediments to the ability of management teams to produce internal forecasts upon which boards may rely in good faith to support their duty of care when choosing a strategic alternative.

Often a company considering selling itself or pursuing another strategic alternative does not have an "off-the-shelf" set of long-term projections that has been vetted by management and the board in a meaningful way to support the decision to enter into a change-in-control transaction. In addition, a board does not always decide to initiate a sales process with the benefit of advance planning. In today's era of investor activism, a company will often find itself considering a sales process on short notice—triggered by a quarter or two of weak earnings, the emergence of an activist in the stock and/or significant changes in management. In the same way, consideration of non-control transactions, such as a PIPE transaction, can often morph into a sales process.

Once a change-in-control transaction is on the table, however, the target board needs to have conviction that the company's financial projections are the board's best estimate of future performance, not only to support its decision to sell the company or stick with the status quo but also to justify that decision to shareholders, plaintiffs and the courts.

It's easier said than done, but here are some common scenarios that we frequently see boards encounter, and our recommendations for how directors should deal with the concomitant issues that often arise:

The Company Has Multiple Sets of Projections

It is not uncommon for a public company to have multiple sets of projections for future performance at any one time. These are often used for different purposes and different audiences: budgeting to instill fiscal discipline on managers, setting aspirational goals to incentivize and compensate management, and providing short-term or annual guidance to the Street or creditors. Often, these forecasts are prepared by different teams and may be derived from different sources and different data. But their mere existence may complicate directors' selection of a particular set of projections as the best estimate of the company's future performance, and give rise to 20-20 hindsight by plaintiffs and courts later questioning whether the board acted in good faith in selecting the set of projections ultimately used.

As a result, before getting too far into a sales process, evaluation of strategic alternatives or 'quiet' market check, the target board should take stock of the company's various sets of projections. In this context, the board and its advisors should not be using a set of projections that depict what the company 'should' be doing but cannot achieve or are so easy to achieve that they will lead to an understatement of the value of the company. The projections should represent the board's best estimate of the company's future performance.

To ensure that's the case, we have found it useful for target directors to consider, in consultation with management:

— What sets of projections has management previously prepared? For what purpose? What are the key differences between them?

— Do these projections reflect current developments? Are they outdated or have they become stale?

— What are the underlying assumptions? Are the assumptions reasonable and do they reflect both historical and current performance, as well as actual and anticipated developments?

- For instance, does the revenue growth trend in line with the company's historical growth?

- Do profit margins reflect the company's actual profitability or wishful thinking on the part of the board and/or management?

- Have recent changes in tax laws or the regulatory environment in which the company operates been appropriately reflected?

- Have there been significant customer wins or losses that need to be woven in?

— If the directors had to place a bet, which set of projections best reflect future performance?

In our experience, by answering these questions, directors can typically quickly dispense with projections that fail to reflect facts on the ground and zero in on the most realistic set of projections or alternatively come up with a clear set of instructions to management to derive improved projections.

The Target Board Determines that the Projections Previously Circulated to Bidders and their Lenders No Longer Represent the Board's Best View of Future Performance

It sometimes happens that discussions with bidders, sales processes and the route to a transaction occur in a meandering way. Even if the company has approached a transaction in a deliberate manner, sometimes the facts change, businesses succeed or fail, or the board simply spends more time considering a particular set of projections that may have already been provided to bidders and their lenders, and in that way realizes that those projections are no longer the most accurate prediction of future performance and that the more accurate forecast is materially lower.

Reducing the company's internal forecasts in the middle of a sale process triggers two issues. First, a need arises to come clean to the bidders and their lenders as soon as possible. Second, a sense of internal awkwardness may set in if bids are already on the table and the board is at risk of appearing to have lowered its forecast to make it easier to find that the bids on the table are in the best interests of the shareholders and within the range of financial fairness. Despite these two issues, boards still need to prioritize assuring that the current best estimates are used. Decisions and fairness opinions that are based upon a stale set of projections will not help the directors demonstrate satisfaction of their duty of care.

Once a change-in-control transaction is on the table, however, the target board needs to have conviction that the company's financial projections are the board's best estimate of future performance, not only to support its decision to sell the company or stick with the status quo but also to justify that decision to shareholders, plaintiffs and the courts.

In these circumstances, it is worth directors taking a brief pause, to sit down with management and the company's financial advisor to revisit the assumptions underlying the prior projections in order to come up with a more realistic set of projections. Care should be taken to document these deliberations in the board minutes:

— Why was the prior set of projections unrealistic?

— What assumptions need to be revisited? Why? What makes the new assumptions more realistic?

— Do these changes relate to new facts or developments?

— Do they result from looking at the company's business in a different way or result from new strategic plans?

Although it is now common practice for a target to disclose all the sets of projections that have been provided to the bidders and/or the financial advisor(s) in order to get the benefits under Delaware law of a fully informed shareholder vote, the potential awkwardness of revisiting the projections ‘midstream’ can be managed by describing in the disclosure when the new projections were created, the reasons therefor and the significant differences in the assumptions underlying them.

At the end of the day, it’s more important for the board to get it right and believe in the numbers.

Major Legislative, Regulatory or Other Changes Have Occurred or Become Increasingly Likely

Another common scenario arises where a new legislative or regulatory change is just on the horizon. In the fall of 2017, we helped lots of companies and their financial advisors work through the potential ramifications of tax reform, in all the various forms proposed. Similarly, Medicare and Medicaid sometimes act unilaterally to change reimbursement rates. Analogous situations exist where new entrants in the market or the potential loss of a customer may drastically affect a company’s prospects.

Under these circumstances, we will advise in most circumstances that the company undertake the necessary work so that the board may confirm whether the projections continue to reflect the board’s best estimate of future performance. Projections should never be based on speculative changes or hypotheticals. But if a significant change has indeed occurred or is imminent, the projections should be revised to address it to the extent practicable. In addition, as potential or hypothetical changes become more likely to happen, it is advisable for boards to prepare for the impact of these changes by requesting, in addition to the forecasts reflecting the current state of play, a set of sensitivity analyses that show the potential effects that these changes may have on future performance.

A target board’s consideration of the company’s financial projections will continue to receive significant scrutiny by shareholders, plaintiffs and courts in evaluating the directors’ satisfaction of their fiduciary duties and, accordingly, whether a company is simply conducting an annual evaluation of its strategic alternatives, doing a quiet market check or conducting a robust sales process, it is worthwhile for target boards to spend the time to ensure that, when the day comes to approve a transaction, the board is comfortable that its projections reflect the best estimate of the company’s future performance. It may involve a bit of art and science, but by following these guidelines, target boards can avoid missteps that others have made.

Antitrust Enforcement in the United States, Europe and China

Antitrust in the United States

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Antitrust enforcement under the Trump administration remains alive and well, with several areas getting particular attention from the U.S. agencies in 2018. State attorneys general are also increasingly active in antitrust enforcement through merger challenges and behavioral investigations.

Vertical Issues

In late 2017, the DOJ challenged AT&T’s proposed acquisition of Time Warner Inc., arguing that the combined company would have an incentive to leverage Time Warner’s content to extract higher carriage rates from distributors and that as one of the only vertically-integrated companies, along with Comcast, AT&T would have an incentive to deny content to other providers. Judge Richard Leon of the U.S. District Court for the District of Columbia found in favor of the defendants in June 2018, finding that AT&T would have little to no incentive to withhold content. The DOJ has appealed the district court’s decision.

Showing an ongoing commitment to investigating vertical issues, the DOJ announced in October 2018 that it had begun updating the 1984 Non-Horizontal

Merger Guidelines and expects to issue new guidelines in the next year. Noah Phillips at the FTC also noted in November 2018 that both the Antitrust Modernization Commission and the American Bar Association had repeatedly called for updates to the Non-Horizontal Merger Guidelines as they did not reflect the agencies' current practices.

Merger Clearance Timing

The antitrust agencies can take several months, sometimes more than a year, to review mergers, particularly international mega-deals. Recent examples of lengthy merger reviews include Bayer AG's acquisition of Monsanto, which took nearly two years and was cleared only with $9 billion worth of divestitures, and Linde AG's merger with Praxair Inc., which took 16 months and was cleared by the FTC when the parties agreed to various divestitures.

In September 2018, Assistant Attorney General Makan Delrahim acknowledged that the length of merger reviews "is a problem" and that the DOJ would endeavor to resolve "most" merger investigations within six months of notification if the parties provide necessary documents and data early in the process.

Behavioral Investigations

The antitrust agencies continue to investigate potentially unlawful conduct. We have seen some shift away from criminal price-fixing investigations and towards investigations into other conduct, including "no-poach" agreements.

— *Conduct-Related Investigations Arising from Merger Review.* Complying with merger Second Requests requires companies to produce hundreds of thousands or millions of documents. Increasingly, these productions have triggered conduct investigations separate from the underlying merger investigation, including in the "no-poach" context described below.

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— *Increased Enforcement Against "No-Poach" Agreements.* We are aware of a number of instances in which the DOJ has investigated potential "no-poach" agreements in which companies agree not to recruit employees from each other. For example, in April 2018 the DOJ settled a lawsuit with Knorr-Bremse AG and Westinghouse Air Brake Technologies Corporation (Wabtec), two of the largest rail equipment suppliers in the world, alleging that the two companies had agreed not to compete in recruiting each other's employees for a number of years. Assistant Attorney General Delrahim noted that the "complaint is part of a broader investigation by the Antitrust Division into naked agreements not to compete for employees." Elsewhere, Assistant Attorney General Delrahim has stated that the DOJ has multiple active criminal no-poach investigations, particularly in the healthcare industry.

There have also been active investigations into no-poach agreements at the state level. Washington state, for example, has investigated several fast food chains whose franchise agreements contained no-poach provisions that prevented employees from moving from one restaurant in the restaurant group to another. A number of restaurants, including Applebee's, Panera, and IHOP, agreed to remove these provisions from their franchise agreements.

Antitrust in Europe

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> **The European Commission has not only challenged cases in which the merging parties were existing competitors, but has shown an increased willingness to challenge cases based on less conventional concerns.**

In Europe during 2018, European Commissioner Margrethe Vestager continued to actively enforce merger control and antitrust rules in the lead-up to the end of her mandate in late 2019.

More Burdensome Merger Control Review

The European Commission has placed an increasing burden on merging parties in recent years, especially in complex cases. Extended "Phase 2" reviews now routinely lead to extensive requests for internal documents.

Notable examples include the 800,000 documents produced in ArcelorMittal/Ilva, one-million documents produced in Qualcomm/NXP Semiconductors, and almost three-million documents produced in Bayer/Monsanto. The size of these productions increasingly resembles those that take place during Second Requests in the United States, yet merging parties are typically allowed a small number of working days to compile, review for privilege, and produce the responsive materials.

There is a similar trend in the size of datasets requested by the European Commission's economists, and the number and complexity of questions put to third parties (and indeed the number of parties contacted).

Increasingly Challenging and Prospective Merger Control Review

These administrative challenges have been paralleled by an increasingly robust enforcement environment. The European Commission has not only challenged cases in which the merging parties were existing competitors (*e.g.*, Praxair/Linde, ArcelorMittal/Ilva, and Thales/Gemalto), but has shown an increased willingness to challenge cases based on less conventional concerns, with a revival of interest in conglomerate issues (*e.g.*, Qualcomm/NXP Semiconductors) and concerns that mergers would stifle innovation, even in as-yet unidentified product markets (*e.g.*, Dow/DuPont, a 2017 case, and Bayer/Monsanto). This focus on prospective competition and innovation has been reinforced by recent public commentary by Commissioner Vestager and the hierarchy of DG Competition. Indeed, the Chief Economist of DG Competition, Tomasso Valletti, made several speeches in the latter part of 2018 advocating for a shift in the burden of proof for "killer acquisitions" made by "super-dominant" companies to increase enforcement against deals that kill off innovative projects or future competition from smaller rivals.

Behavioral Investigations

The European Commission has continued to actively enforce European rules against anticompetitive agreements/conduct (Article 101) and the abuse of dominant positions (Article 102).

— *Cartels*. Until recently, the European Commission enjoyed a full pipeline of cartel cases generated by successive immunity and leniency applications, in particular in the automotive and financial sectors. There are signs, however, that the continued growth in private damages actions in Europe (discussed further below), may have dampened the appetite of potential immunity applicants to come forward. Nevertheless, the European Commission has shown a willingness to prosecute cases outside of a conventional "seller" cartel context, with several ongoing cases focusing on potential coordination between buyers on industrial pricing benchmarks, and on the development of clean emission technology for cars.

— *Abuse of Dominance*. Two of the European Commission's three 2018 infringement decisions in this area related to the technology sector. In January, the European Commission fined Qualcomm €997 million for paying rebates to Apple on condition that Apple did not buy 4G baseband chipsets from Qualcomm's rivals. Most prominently, in July the European Commission levied a €4.3 billion fine on Google, alleging that Google had tied its Google Search app and Chrome browser to its Play app store for the Android operating system, making payments to Android device manufacturers and mobile network operators conditioned on the exclusive pre-installation of the Google Search app, and imposing contractual restrictions on the development and distribution of incompatible versions of the Android operating system.

Continued Growth of Private Enforcement

The growth of private antitrust litigation continues apace in Europe. 2018 marked the date by which all 28 European Union Member States had implemented the European Commission's 2014 Damages Directive, which is intended to foster opportunities for victims of antitrust infringements to obtain redress before the national courts of the Member States. The European Commission's 2016 and 2017 trucks cartel decisions alone—which saw six trucks manufacturers fined a total of almost €4 billion—have seen claims worth over €1 billion filed across Europe, including in the United Kingdom, Germany, The Netherlands, Ireland, Spain, and Hungary, with two class actions seeking certification before the United Kingdom's specialist Competition Appeal Tribunal. MasterCard and Visa are currently facing claims worth billions of euros arising out of the multilateral interchange fees set by the four-party card schemes, including a class action seeking damages of around £14 billion. With prominent litigation funders continuing to invest in claims across Europe, the tendency for cartel decisions to lead to follow-on claims in Europe looks set to continue in 2019.

Brexit

Finally, the United Kingdom is currently scheduled to leave the European Union on March 29, 2019. Particularly, in the event of a "no deal" exit, national UK competition law would likely apply in parallel to deals or antitrust matters that are not subject to a decision by the European Commission on that date. Going forward, there is consequently a significant likelihood that many international M&A deals will be subject to the dual competence of the European Commission and the UK Competition and Markets Authority, raising the profile of the UK agency in this area.

Antitrust in China

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Antitrust enforcement in China continued to be active in 2018, particularly with the integration of three Chinese antitrust agencies into one. The integration appears to have led to an increase in enforcement, a more cautious approach, and some delays in case handling due to staff reshuffling. In 2018 there was also a rapid increase in antitrust litigation cases in China, particularly those involving "standard essential patents".

New Antitrust Agency

As of late April 2018, China's three antitrust agencies, the Anti-Monopoly Bureau of Ministry of Commerce (MOFCOM) for merger review, the Price Supervision and Anti-Monopoly Bureau of the National Development and Reform Commission (NDRC) for price-related investigation, and the Anti-Monopoly and Anti-Unfair Competition Bureau of the State Administration for Industry and Commerce (SAIC) for non-price-related

The integration appears to have led to an increase in enforcement, a more cautious approach, and some delays in case handling due to staff reshuffling.

investigation, began their integration into the State Administration for Market Regulation ("SAMR"). The integration is expected to streamline and further bolster antitrust enforcement and to improve consistency in antitrust rule-making and enforcement practices. SAMR indicated that its antitrust enforcement priorities are administrative monopolies, infringements by public utilities, failure to notify, and remedy implementation.

Remedy Implementation and Failure to Notify

In January 2018, SAMR penalized Thermo Fisher Scientific for non-compliance with the behavioral conditions imposed in 2014 in connection with its acquisition of Life Technologies. During 2018, SAMR lifted long-term behavioral conditions imposed in three cases (*i.e.*, General Electric/China Shenhua (imposed in 2011), MStar Semiconductor/Media Tek (imposed in 2013), and Henkel Hong Kong/Tiande (imposed in 2012)). SAMR also issued a record 14 penalty decisions in 2018 for failure to notify joint ventures, multi-step transactions, and other acquisitions.

Conglomerate Effect and Behavioral Remedies

SAMR continues to favor behavioral remedies, some of which are unconventional and are used to address concerns from Chinese industries. When stakeholders raise vague conglomerate effects theories, which SAMR takes seriously, it can result in significantly prolonged review, and often results in behavioral remedies. All four of the conditional approvals granted by SAMR in 2018 involved China-specific behavioral remedies and three of them involved conglomerate effects theories.

— *Bayer/Monsanto*. In March 2018, SAMR approved the agriculture merger between Bayer and Monsanto with conditions including the divestitures required in the European Union, as well as additional behavioral conditions guaranteeing Chinese app developers and users access to the merging parties' digital agricultural platform.

— *Essilor/Luxottica*. In July 2018, SAMR conditionally approved the conglomerate merger between a French optical group, Essilor, and an Italian luxury eyewear group, Luxottica. The merger involves very limited overlaps and was unconditionally cleared in the European Union and the United States. However, SAMR imposed multiple behavioral conditions, including prohibition on tying, exclusivity distribution, and selling below costs, as well as commitment to supply to Chinese retailers on fair, reasonable and non-discriminatory ("FRAND") terms and report future acquisitions.

— *Linde/Praxair*. In September 2018, SAMR conditionally approved the merger between Linde and Praxair, both active in industrial gases. In addition to divestitures, SAMR also imposed behavioral conditions requiring stable and timely supply of products to Chinese customers at reasonable price and volume.

— *UTC/Rockwell Collins*. In November 2018, SAMR conditionally approved the acquisition by United Technologies Corporation of Rockwell Collins, both active in the aerospace components sector. SAMR's conditions included the divestitures required in the European Union, and multiple behavioral conditions with regard to certain specific products, including prohibition on tying or bundling, a guarantee to continue the supply of existing products to Chinese customers, technological licenses on FRAND terms, and performance of existing contracts with Chinese customers.

Merger Review Timeline

Although review of most merger cases with limited exposure to Chinese stakeholders that are under the simplified procedure could be completed within 30 days after being accepted, SAMR's review of whether the case qualifies for the simplified procedure has become very strict, data heavy, and time consuming. There were cases in 2018 that were required to be pulled from the simplified procedure and refiled under the normal procedure a few months after the case was initially filed.

The Chinese merger review process for cases under the normal procedure continues to be lengthy and unpredictable, in particular in international mega-deals. All four conditional approval cases took more than a year to conclude.

Behavioral Investigations

SAMR continues to take a hard stance against unlawful antitrust behaviors, particularly cartels and resale price maintenance. In 2018, SAMR examined more than 30 monopoly agreements and abuse of dominance cases. SAMR also issued its first antitrust penalty on individuals for obstructing an antitrust investigation.

SAMR appeared to have prioritized investigations in domestic markets and on monopolies by local governments or public utilities in 2018, and therefore there were fewer high-profile investigations involving multinationals compared to 2015-2017. The two noteworthy investigation inquiries involving multinationals are both in the semi-conductor sector: SAMR launched an official investigation on three major suppliers of dynamic random access memory, Samsung Electronics, SK Hynix, and Micron Technology, and SAMR may also have issued inquiries to Taiwan Semiconductor Manufacturing Co.

Legislative Developments

China is in the process of amending its Anti-Monopoly Law. The upcoming amendments may include reconciliation of different understandings of vertical agreements, incorporation of fair competition review, and revisions to penalty provisions.

After integration, SAMR also started consolidating the existing implementation rules and continued drafting guidelines regarding antitrust enforcement in the automobile industry and in the areas of intellectual property rights, calculation of antitrust fines and illegal gains and leniency programs, among others. These guidelines are expected to provide more guidance to companies in these areas.

Judiciary Developments

In 2018, the number of antitrust litigations in China continued to increase steadily. Chinese courts have handled more than 100 lawsuits involving standard essential patents over the past year. In early 2018, Shenzhen Intermediate People's Court handed down a detailed decision in *Huawei v. Samsung*.

The court found that Huawei had fulfilled its FRAND obligations in the licensing negotiations, and granted an injunction against Samsung for infringement of Huawei's standard essential patents. In late 2018, China's Supreme People's Court announced that as of January 1, 2019, it will establish a new Intellectual Property Rights Tribunal to hear antitrust appellate trials, among others, which are currently heard by lower courts. This move aims at unifying adjudication standards and improving adjudication quality in complicated and technical cases, including the rapidly increasing antitrust-related civil and administrative lawsuits.

CFIUS Enters a New Landscape

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The most significant change brought about by FIRRMA is the introduction of mandatory notifications covering certain transactions involving critical technology, critical infrastructure, or sensitive personal data (so-called "other investments"), as well as an expansion of jurisdiction over minority investments in those areas.

In August 2018, the U.S. Foreign Investment Risk Review Modernization Act of 2018 ("FIRRMA")[41] updated the statute authorizing reviews of foreign investment by CFIUS to reflect changes in CFIUS's practice over the 10 years since the last significant reform, expand CFIUS's jurisdiction, and make significant procedural alterations to the CFIUS process.

Introduced to "modernize and strengthen" review of foreign investment in the United States, FIRRMA cements a relatively aggressive approach to foreign investment review. However, ultimately, the changes to current CFIUS practice are modest, and many of the changes merely codify practices in place since the later years of the Obama administration.

The most significant change brought about by FIRRMA is the introduction of mandatory notifications covering certain transactions involving critical technology, critical infrastructure, or sensitive personal data (so-called "other investments"), as well as an expansion of jurisdiction over minority investments in those areas. CFIUS has also been granted broader jurisdiction over real estate transactions, successive transactions involving the same parties, and transactions designed to evade or circumvent CFIUS jurisdiction. CFIUS has for a number of years been closely examining transactions in these areas, as well as in the semiconductor space and "big data" generally, telecommunications and cybersecurity, and integrity of the defense industry/ government supply chain.

The rules for "critical technology" transactions have already been implemented as a pilot program. Under those rules, CFIUS notification is mandatory if a foreign person is acquiring "control" (closer to "substantial influence" under existing CFIUS practice; as a rule of thumb, CFIUS has historically tended to assert jurisdiction when an ownership stake exceeds 15% and includes any significant formal governance right such as a board seat) or a direct or indirect non-controlling investments that afford a foreign person any of the following:

— access to any material nonpublic technical information (financial information is excluded, but many operating joint ventures would be caught);

— membership, observer, or nomination rights to the board of directors or equivalent; or

— any other involvement in substantive decision-making related to "critical technologies," other than mere voting of a minority block of shares.

"Critical technologies" are in turn defined as certain export-controlled technologies (essentially, all but the least-controlled categories) that the company manufactures or develops for use in one of several specified industries. In practice, industry participants are struggling with ambiguities in all facets of these

41 For more on FIRRMA, see our memorandum: https://www.clearygottlieb.com/-/media/files/alert-memos-2018/congress-passes-cfius-reform-bill.pdf

definitions—exactly where the limits are for non-notifiable investments, identifying export-controlled technologies (which is especially challenging if those technologies are developed for a company's own internal use), and identifying the correct industry code (for which there is no official government source; different government agencies take inconsistent positions). The consequences of these difficulties can be severe—failure to make a required filing carries a fine of up to the value of the transaction.

Pilot programs have not yet been created for the critical infrastructure and personal data categories, but they are expected to be structurally similar.

Boards should consider the expansion of CFIUS jurisdiction and the scope of mandatory filings to evaluate the effects of CFIUS requirements on potential transactions. Boards should also identify the potential need to file with CFIUS early in a transaction, assess the benefits and risks of voluntarily filing with CFIUS, and consider structuring investments and acquisitions so as to mitigate CFIUS scrutiny. Finally, boards should bear in mind CFIUS risk as a potential constraint on strategic exits for both existing and new investments.

United Kingdom Government Intervention on National Security Grounds

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In July 2018, the UK Government published proposals for legislative reform that would give it significantly greater powers to intervene in transactions on national security grounds. These proposals have been seen, in part, as a response to Brexit, which is likely to give the United Kingdom greater freedom to determine its own merger policy than is currently permitted under E.U. law. They also follow the debate on foreign investment in the Hinkley Point nuclear power station, the Hytera/Sepura and GKN/Melrose transactions, where the UK Government required undertakings to address national security concerns, the attempted takeover of AstraZeneca by U.S. company Pfizer in 2014, and wider public concerns about national defense and cyber security.

The proposals describe a "voluntary" notification regime whereby parties to a transaction notify the UK Government when a potential "trigger event" is contemplated or in progress. The UK Government would also have the power to "call in" trigger events that have not been notified by the parties.

The proposals describe a "voluntary" notification regime whereby parties to a transaction notify the UK Government when a potential "trigger event" is contemplated or in progress. The UK Government would also have the power to "call in" trigger events that have not been notified by the parties.

Consultation on the proposals closed in October 2018 and greater clarity on the anticipated timeline for enactment of the new regime is expected in the coming months when the UK Government publishes its response. The regime is not likely to come into effect until 2020.

Scope of the Proposed Regime

The scope of "national security" is explained in a draft statutory statement of policy intent; however, the term has not been defined precisely. National security threats may include acts of terrorism or actions of hostile states related to: cyber-warfare; supply chain disruption of certain goods or services; disruptive or destructive actions or sabotage of sensitive sites; and espionage or leverage.

The regime will not be limited to any particular sectors, nor will there be turnover or market-share thresholds to place certain transactions out of scope. However, the following aspects of the UK economy have been identified as particularly likely to give rise to national security risks:

— core national infrastructure sectors such as the civil nuclear, communications, defense, energy, and transport sectors;

— certain advanced technologies, including computing, networking and data communication, and quantum technologies;

— critical direct suppliers to the UK Government and emergency services sectors; and

— military or dual-use technologies.

The range of transactions covered includes acquisitions of businesses, companies or assets as well as new projects and (in "exceptional instances") loans. The proposals set out the following potential trigger events:

— the acquisition of milestone thresholds of voting rights, shares or equivalent ownership rights (25%, 50%, 75%);

— the acquisition of significant influence or control over an entity or asset; and

— the acquisition of more than 50% of an asset, particularly where the asset is land in close proximity to a sensitive location.

For a trigger event to be called in, the entity or asset must carry on activities in the United Kingdom or supply goods or services to the United Kingdom or be used in connection with activities taking place in the United Kingdom. Therefore, activities relating to entities incorporated outside of the United Kingdom, assets located outside of the United Kingdom and rights governed by foreign law may all fall within the scope of the regime.

The regime does not only apply to the acquisition of control by a foreign entity (although that could be a factor as to whether a transaction creates a national security threat).

Notification and Calling In of a Trigger Event

Following voluntary notification by the parties to a transaction when a potential trigger event is contemplated or in progress, a preliminary screening will facilitate the decision to call in the event for further review. However, the UK Government also has the power to call in transactions where there was no voluntary notification. Transactions that were not notified voluntarily may be called in within six months of completion.

If called in by the Government, the parties must provide any information required by the UK Government and the trigger event must not occur until approved (*i.e.*, the transaction would be blocked from closing). In the event that the trigger event has already taken place, the parties must neither take any further measures that increase the acquirer's control, nor take steps that would make it more difficult for the trigger event to be unwound. The UK Government would have up to 30 working days to complete the assessment, but the UK Government may "stop the clock" while parties respond to information requests. If it is determined that there is a risk to national security, the review period could be extended by an additional 45 working days to further consider the extent of the risk and decide upon appropriate remedies.

Remedies and Sanctions

The proposals envisage three possible outcomes of an assessment: (i) confirmation that the deal can proceed; (ii) clearance of the deal subject to conditions preventing or mitigating the national security risk; or (iii) blocking the transaction. Potential remedies to mitigate the risk include limiting access to certain sites and carving out divisions or assets of a business.

Sanctions for non-compliance could include the introduction of criminal offenses, most of which could carry a maximum custodial sentence of five years, and civil sanctions such as fines.

Practical Implications of the Proposals for Boards of Directors

The proposed regime will introduce additional complexity and uncertainty around investments, including the possibility of delay, remedies or outright prohibition. The regime would apply to transactions that would not otherwise require regulatory approval prior to closing. Boards should carefully consider the allocation of risk in purchase agreements and the potential impact on transaction timetables. There remains uncertainty surrounding the interaction of the new regime with existing merger control, E.U. law, and the UK Takeover Code.

To the extent a board is considering a transaction with a timetable likely to extend beyond the enactment of the regime, the board may consider separating or divesting sensitive businesses, mitigating sensitive operations (via firewalls or transaction structuring) and pursuing non-controlling investments. Boards would be well advised to engage early, frequently and transparently with the relevant UK Government authorities.

Expansion of Corporate Governance and Government Oversight in the United Kingdom

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Directors of UK companies will naturally be watching Brexit-related developments with a mixture of trepidation and hope as the United Kingdom draws nearer to a point at which there will be greater clarity on how the legislative framework will look after the March 2019 exit date and beyond (and particularly how it will look after any transitional period expires). The continuing uncertainty around the legislative framework, and the likely focus that all UK companies will have on preparation for the various potential outcomes, should not lead directors to take their eyes off areas of regulatory change where there is already greater clarity. Directors should, for example, be preparing for the raft of UK corporate governance reforms underway and proposals for a strengthened national security and investment regime.

The Expansion and Intensification of Corporate Governance Requirements

Key elements of the corporate governance reform proposals set out by Prime Minister Theresa May's Conservative government in 2017 came to fruition (or neared fruition) in the latter part of 2018, and directors will feel their effects in 2019 and beyond. The reforms increase both the scope and burden of corporate governance requirements, and, if their ultimate aim is achieved, should help companies achieve even better relationships with investors and other stakeholders.

Revisions to the UK Corporate Governance Code

A revised version of the UK Corporate Governance Code (the "Code") applies for financial periods that begin on or after January 1, 2019, primarily to companies listed on the premium segment of the London Stock Exchange. Accordingly, the revised Code will affect reporting in 2020, although the relevant governing body is expecting certain changes to have an impact on corporate governance in 2019. Key revisions include new or amended recommendations that have the effect of encouraging companies to:

The reforms increase both the scope and burden of corporate governance requirements, and, if their ultimate aim is achieved, should help companies achieve even better relationships with investors and other stakeholders.

— have an ongoing dialogue with their shareholders, for example, by recommending that companies (i) disclose what they are going to do in order to understand the underlying reasons behind the opposition if there has been significant dissent (20% or more of votes cast) against a board-recommended shareholder resolution, (ii) report (six months later) on shareholder feedback and (iii) disclose in the annual report the impact of that feedback on the board;

— engage with their workforce by effecting one of the following: appointing a director from the workforce; establishing a workforce advisory panel; designating an existing non-executive director to represent the interests of the workforce; or putting in place other arrangements (provided the company can explain how these arrangements are effective in enhancing workforce engagement). The concept of “workforce” is drawn broadly so that it can encompass, for example, workers on “zero-hour” contracts and also agency workers;

— consider more broadly who their other stakeholders are outside of their shareholders and workforce, and take into account their views so companies can report on the impact of those views;

— shift toward better progression of board chairs by recommending that chairs do not stay on for longer than nine years (including any years served as an independent non-executive director (an “INED”) before becoming chair), subject to a possible grace period to allow for succession planning;

— focus even more on the independence of directors if they fail on one or more of the independence impairment indicators in the Code by guiding companies to give greater detail when reporting on why the board concluded the relevant director was nevertheless independent;

— think harder about the suitability of appointing INEDs with significant other commitments, by recommending companies disclose more about those other commitments, including expected time spent on them and disclosure of why they were permitted; and

— unify their thinking on executive and workforce remuneration by extending the remit of the remuneration committee. In addition to its existing role of determining remuneration for the chair, executive directors and senior management, the remuneration committee should also review (but not determine) workforce remuneration.

Application of Corporate Governance Rules to Large Private Companies

The bulk of UK corporate governance requirements have historically applied only to publicly listed companies. Following a spate of failures of private companies with far-reaching impact, and in recognition of the importance of private companies to the UK economy, the Financial Reporting Council recently published a corporate governance code for large private companies (known as the “Wates Principles”). Broadly, the Wates Principles relate to: (i) the alignment of the company’s purpose with its values, strategy, and culture; (ii) the effectiveness, balance, and size of the board; (iii) the board’s responsibilities; (iv) identifying opportunities and managing risks; (v) sustainable executive remuneration; and (vi) stakeholder engagement and consultation. Companies applying the Wates Principles must clearly explain how their governance practices achieve the outcomes embedded in each of these six principles.

Application of the Wates Principles is voluntary, but may in practice be widely adopted by large private companies as a result of the Companies (Miscellaneous Reporting) Regulations 2018, which became effective on January 1, 2019. These make it mandatory for any company (public or private) with (i) more than 2,000 employees or (ii) turnover of more than £200 million and a balance sheet of more than £2 billion ("large companies") to disclose which, if any, corporate governance code they apply. Deviations from a corporate governance code or non-application of a corporate governance code must be explained. Unlisted subsidiaries of listed companies can qualify as large companies in their own right.

The new regulations also institute a number of other corporate governance requirements applicable to private companies, including obligations:

— on large companies to describe how the directors have discharged their statutory duty to promote the success of the company for the benefit of its members; and

— on companies with more than 250 UK employees to describe how the directors have engaged with employees and had regard to their interests.

CEO Pay Ratio Reporting

As of January 1, 2019, UK-incorporated companies with over 250 UK employees and shares admitted to the UK Official List, officially listed in the EEA, or admitted to dealing on the NYSE or NASDAQ are required to disclose the ratio of the CEO's total remuneration to the full-time equivalent remuneration of their UK employees at the median and the 25th and 75th percentiles.

Please call any of your regular contacts at the firm or any of the partners and counsel listed under Corporate Advisory, Capital Markets, Executive Compensation, Crisis Management, Enforcement, Cybersecurity, Data Privacy, Antitrust, Taxation, Litigation, or Mergers and Acquisitions in the Practices section of our website (https://www.clearygottlieb.com/) if you have any questions.

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