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# Selected Issues for Boards of Directors in 2020

*January 2020*


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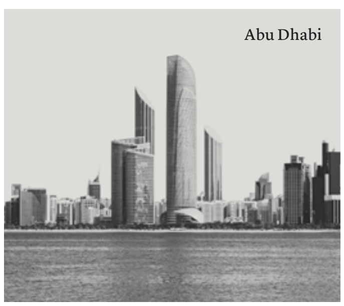
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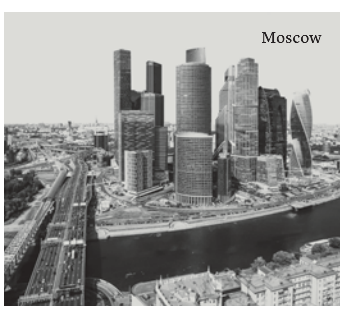
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Recent changes in political climates, legal reforms and social norms have had varying (and sometimes conflicting) impacts on how companies are run; however, they have all contributed to a growing demand that companies expand their focus beyond shareholder value creation. Environmental, social and governance concerns dominate shareholder proposals and engagement efforts, and discussions of corporate purpose have moved beyond the academic realm. The external threat of activism has evolved, with companies facing pressure from social activists and institutional investors as well as "traditional" activists. The disruption of business practices through advances in technology and societal shifts has raised new issues and questions from shareholders. The legal landscape is also shifting; for example, in the United States, state governments are increasingly pursuing their own agendas through legislation, litigation and enforcement on matters ranging from board diversity to antitrust. As we start the new decade, companies will need to identify both the opportunities and the obstacles raised by these challenges. And as more is asked of companies in 2020, so too will more be asked of their directors. This memo highlights key issues for consideration by boards and management alike.

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# Auditing and Accounting: What's New in 2020


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## Accounting Practices: Spotlight on SEC Enforcement

Last year at this time, companies and boards were wrestling with the impact of the new revenue recognition standard and the new lease accounting standard. The next big innovation in accounting standards is the new Current Expected Credit Losses (CECL) model for recognizing credit losses, which takes effect in 2020 for most public companies.

The significant impact will be mainly at financial institutions, but even companies with limited financial assets face challenges for implementation and related internal controls. In addition to the technical accounting considerations, major changes of this kind present disclosure and governance challenges, which most companies and boards have learned to address in revenue recognition and lease accounting exercises over the last two years.

Board members should consider the implications of two important recent enforcement cases. One has implications about management practices that may not be unusual, while the second is a good cautionary tale for companies with significant regulatory proceedings.

— ***Marvell and Its "Pull-ins.***" Marvell Technology Group, a producer of semiconductor components, will pay $5.5 million to settle SEC charges arising from its use of "pull-ins:" obtaining a customer's agreement to reschedule an existing order from a future quarter into the current quarter. Marvell used pull-ins to meet revenue guidance and to mask declining demand and falling market share, as well as reduced future sales; these effects were not disclosed to the public, the board or the auditors. Unlike many revenue-related enforcement cases, the SEC did not find fault with how the sales were accounted for; instead it found that Marvell made misleading public statements and failed to disclose a material trend, event or uncertainty in MD&A. According to media reports, the SEC is pursuing a similar theory in an investigation involving Under Armour.

The Marvell case is worth noting because so many public companies provide guidance on expected revenue, and many of them have management practices they can use to affect the timing of revenues (or expenses). Boards should make sure they understand how these tools are used and whether their material effects are disclosed. Our blog post on the case can be found here.

— ***Mylan and Its Regulatory Proceedings***. In October 2016, Mylan, maker of the EpiPen, announced that it had settled for $465 million a US Department of Justice case involving classification of the EpiPen. (It had not previously disclosed the existence of government investigations into whether the product was properly classified.) In September 2019, the SEC settled its action against Mylan. The SEC alleged that (i) Mylan should have disclosed the DOJ investigation, because a loss was reasonably possible, at least by October 2015 (in its third quarter 2015 10-Q); and (ii) Mylan should have accrued for a loss, because it was probable and reasonably estimable, at least by May 2016 (in its second quarter 2016 10-Q).

The Mylan case is a classic illustration of the challenge companies regularly face in determining when to disclose proceedings and when to accrue a loss. As Mylan's experience shows, disclosing a major case for the first time when it is settled is a lightning rod for SEC attention. Our Alert Memo on the Mylan case can be found here.

## Focus on Auditor Independence

In 2019, the SEC adopted amendments to Rule 2-01 of Regulation S-X to ease a burdensome element of auditor independence rules related to loans, and in December the SEC proposed additional changes to those rules. Compliance with these standards remains a practical challenge for audit firms, as the SEC and Public Company Accounting Oversight Board (PCAOB) have continued to bring cases against many of the major audit firms during the past year. Some of these violations appear to be "foot faults;" others are more substantive. PCAOB rules allow an auditor to continue the engagement despite an independence violation when the audit firm and the audit committee each determine that the auditor remains "capable of exercising objective and impartial judgment" and that a reasonable investor with knowledge of all relevant facts and circumstances would agree. The PCAOB has stressed the audit committee's "important role in representing the interests of the audit client's investors" in this regard.[1]

**Board members should consider the implications of two important recent enforcement cases. One has implications about management practices that may not be unusual, while the second is a good cautionary tale for companies with significant regulatory proceedings.**

A whistleblower letter sent to Mattel in August 2019, in addition to alleging accounting errors that ultimately led to the restatement of its 10-K, questioned the independence of the company's auditor. The letter claimed that the audit firm knew about the errors but did not insist on reporting them to senior management or the board, and that the lead audit partner took certain HR-related actions that violated the independence rules. Following an investigation, Mattel's audit committee and auditor

[1] *See* PCAOB Staff Guidance, Rule 3526(b) Communications with Audit Committees Concerning Independence, available here.

**Although the audit firm is often the party in the brightest spotlight when independence issues arise, responsibility for auditor independence is shared among the audit committee, management and the auditors, and if the SEC ultimately disagrees with the independence assessment, it can have implications for the company.**

concluded that the objectivity and impartiality of Mattel's auditor had not been impaired. The audit committee retained the firm as its auditor, though the lead partner and certain other members of the audit team were replaced.

Although the audit firm is often the party in the brightest spotlight when independence issues arise, responsibility for auditor independence is shared among the audit committee, management and the auditors, and if the SEC ultimately disagrees with the independence assessment, it can have implications for the company. On December 30, 2019, the SEC released a statement (available here) from Chair Jay Clayton, Chief Accountant Sagar Teotia and Director of the Division of Corporation Finance William Hinman reminding audit committee members of the importance of their role in financial reporting. One observation they emphasized was that the audit committees share responsibility for compliance with the auditor independence rules, and they suggested that the committees "periodically consider the sufficiency of the auditor's and the issuer's monitoring processes." Prior to the whistleblower letter, it is not clear whether any of the independence matters were discussed with Mattel's audit committee as part of the required annual communications between the auditor and the audit committee, but the case and the recent SEC statement both underscore the importance of the board's engagement on these issues.

## Critical Audit Matters in Action

Last year, we began to see auditors include critical audit matters (CAMs) in audit reports, implementing a 2017 amendment to PCAOB standards. More CAMs will be coming in 2020, as the change takes effect for calendar year large accelerated filers, and in 2021 for most other issuers.

CAMs are 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.

Some patterns are already clear from the several hundred Form 10-Ks already filed with CAMs, and from our conversations with clients so far. In general, the advent of CAMs may seem like something of an anticlimax, particularly in view of the buildup from the auditing profession and the PCAOB.

— ***Number of CAMs***. So far the average number of CAMs per filer is under two. It appears that no auditor has reported zero CAMs and none has reported more than four. Outside the United States, a very similar requirement to report "key audit matters" has typically yielded a larger number of topics for each issuer, and of course the "critical accounting estimates" disclosed in MD&A are usually more numerous. The risk that CAMs would be confused with critical accounting estimates seems to have been largely avoided.

— ***Leading Topics***. The CAMs most often reported relate to goodwill and intangible assets, revenue recognition and income taxes. There is of course variation among issuers depending on industry and on company-specific events, like a large acquisition or contingent liability. Which matters are CAMs for each issuer may also vary from year to year.

— ***Engagement***. The PCAOB and the audit firms have encouraged the use of "dry runs" for auditors to engage early on with the audit committee and management on what CAMs would be reported and how. At some companies these dry runs were early and disciplined, but at others the process has been lighter.

— ***Original Information***. A key concern about the CAMs requirement was that it will result in new disclosures that the issuer would otherwise have judged to be immaterial and sensitive. Anecdotally, this does not seem to have been a major issue so far. Of course, in delicate areas where disclosure of audit challenges might have implications for the issuer's disclosure practices (such as litigation provisions or uncertain tax positions), the difficult discussions stay behind the scenes.

## Turmoil at the PCAOB

The PCAOB was in the media in 2019, and often in an unflattering light. In October, a whistleblower letter surfaced claiming that the agency has severe internal problems. According to media reports, the letter, signed by multiple PCAOB staffers, was delivered to the agency in May and to the SEC in August, and it claimed that the agency had slowed its work amid board infighting, multiple senior staff departures and an internal climate of fear. After receiving the letter, the SEC appointed one-time SEC Chair Harvey Pitt to review the PCAOB's corporate governance.

The letter came on the heels of the PCAOB's semi-public struggles with personnel issues, as senior staff positions remained unfilled for months. And of course it followed the dramatic KPMG scandal, which led to the March 2019 criminal conviction of the former No. 2 partner in the firm's US audit practice for, in effect, trying to cheat on PCAOB exams.

In late October, former SEC Chair Arthur Levitt published a *New York Times* opinion piece warning about the increasing politicization at the PCAOB. He charged that the board is being weakened by political appointments and internal strife.

The PCAOB has sought to address some of these concerns. It has emphasized engagement with stakeholders beyond the auditing profession itself, including companies and audit committees. At a conference in New York in December, Chair Duhnke said that the PCAOB has heard from all sides that it needs to undergo transformational change. He mentioned outreach to audit committees, saying that the PCAOB has already spoken to nearly 400 committee chairs and plans to publish a readout of takeaways soon. He also described internal steps to improve the agency's performance and sought to rebut some of Mr. Levitt's contentions.

Today, the PCAOB seems paradoxically aggressive and embattled at the same time. It is too early to tell whether boards and audit committees will see the impact of the turmoil. As the PCAOB implemented its mandate over the past decade and a half, and made auditing a more fully regulated profession, it had a significant impact on relations among companies, auditors and audit committees. If the agency is weaker or less proactive, the pace of change could slow or stop.

# Corporate Purpose, Human Capital and Compensation Considerations


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## Corporate Purpose

On August 19, 2019, the Business Roundtable released its latest Statement on the Purpose of a Corporation, emphasizing commitment to all stakeholders.[1] The Statement received a lot of attention in the press and focused attention on a simmering, somewhat academic, debate regarding "shareholder primacy"—i.e., the idea that the most important purpose of a corporation is to increase shareholder value, which should supersede other considerations cited in the Statement such as "supporting the communities in which we work" or "investing in our employees."

Since Milton Friedman's advocacy of the idea in the early 1970s, it has been an article of faith in most of the business community that, as he put it, "there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits." Notably, there is reason to believe that many companies whose executives signed the Business Roundtable Statement did not do so on the basis of prior discussions with their boards.

Academics debate whether the law in Delaware reflects shareholder primacy or not; not surprisingly, there are statements in cases, old and new, that can be cited for either side—and some that can be, and are, cited by both sides. In the end, while there are important exceptions, the divide between the purists and others is in many circumstances easily bridged as a practical matter, since other corporate goals often tend to correlate in practice with shareholder value—e.g., doing good by employees can in most circumstances be justified as likely to benefit shareholders.

1 *See* Business Roundtable, Statement on the Purpose of a Corporation (August 2019), available here.

Our suggested takeaway for boards about the Business Roundtable Statement is that, while the dust is still settling, the Statement seems likely to resonate into 2020 and beyond in at least two important ways.

## Human Capital Management

On August 8, 2019, just a few days before the Business Roundtable Statement, the SEC proposed an amendment to its rules that, if adopted, would require disclosure of certain material "human capital measures or objectives that management focuses on in managing the business." The SEC's proposal is in obvious alignment with the practical import of the Business Roundtable Statement discussed above.

While management's focus on human capital barely shows up in financial statements, the SEC's proposal is an acknowledgement that investors are now attuned to the fact that, for many companies, a well-managed workforce is imperative for success. This shift is a function both of tight labor markets in the US and the changing nature of work. As we mentioned in last year's memo, we continue to believe that coinciding with this shift in investor focus is an investor expectation that the board is overseeing carefully management's attention to measures indicative of the health of a company's human capital.

We recommend that boards allocate time and resources to ensuring that companies are prudently managing their workforce, with specific attention to two key issues:

— First, what are the indicators that the management/labor relationship is healthy and not being undermined by new models of employment—i.e., outsourcing, use of independent contractors, joint employers, etc.?

— Second, what are the indicators that the company's investment in its workforce is providing a healthy return on investment?

We provide some examples of key indicators and best practices below, but directors should recognize that this is a rapidly expanding area of investor interest and not assume that there is a one-size-fits-all approach.

### *Employee Satisfaction & Motivation*

— Assess diversity, pay equity and representation of minorities and women in management by measuring performance against management's goals and improvement over prior years.

— Use company-wide employee surveys to measure employee engagement, including a "net promoter score" asking how likely an employee is to recommend the company as a place to work among friends and family.

— Monitor changes in the rate of discrimination and whistleblower claims, absenteeism and voluntary turnover, focusing on upticks over time.

### *Talent*

— Consider the current workforce within the context of anticipated industry changes, assessing the ability of the current talent to meet new demands.

— Evaluate whether recruiting efforts are aligned to meet new demands, and whether current employee training programs will sufficiently prepare the workforce for new demands.

### *Culture*

— Identify key cultural tenets for the organization, and evaluate how senior management embodies and communicates these tenets.

— Use employee surveys, internal cultural audits, whistleblower hotline reports, visits to corporate offices, social media and customer complaints to get a read on company culture, and compare it against the company's identified key cultural tenets.

**While management's focus on human capital barely shows up in financial statements, the SEC's proposal is an acknowledgement that investors are now attuned to the fact that, for many companies, a well-managed workforce is imperative for success.**

— Request quarterly reports by management to the board highlighting behavioral misconduct, allowing the board to contemplate cultural drivers of these infractions.

— Ensure that the leadership pipeline established through succession planning reflects cultural values.

As always, to drive effective management investment in the workforce, boards should consider whether cultural alignment and key human resources management performance indicators should impact incentive pay for senior executives. Boards should also remain cognizant of their fiduciary duties under Delaware law's *Caremark* standard to stay abreast of significant human capital management issues affecting their organization. As with as other important compliance issues, in many business sectors, the workforce is a key to shareholder value.[2]

## Environmental and Social Metrics in Executive Incentive Plans

The Business Roundtable Statement's focus on stakeholder interests also calls attention to environmental and social concerns. Large-cap public companies have been increasingly adding environmental and social metrics to their executive incentive plans as a way to highlight their attention to these issues, incentivize management to achieve long-term shareholder value objectives and respond to the concerns of stakeholders. According to a 2019 analysis by compensation consulting firm FW Cook:[3]

— In a survey of large public companies, 62% of companies using a strategic performance measure (or 26% of all companies with formulaic annual incentive plans) disclose using at least one environmental, social or governance (ESG) goal as part of their strategic performance measure, either as a pre-defined objective or as a consideration in arriving at the strategic performance score (excluding companies that use ESG measures as an individual performance consideration).

— Of the largest 250 companies using ESG measures, 43% use human capital goals (e.g., diversity, employee engagement, company culture, customer satisfaction, etc.); 25% use health, safety or environmental sustainability goals; and 32% use both types of ESG goals.

— Companies in the utilities and energy sectors have the highest prevalence of ESG goals within their strategic performance measures (81% and 77%, respectively).

As companies begin to incorporate ESG goals into their business strategies, we recommend that boards consider whether ESG metrics should be incorporated into their executive incentive plans. While perhaps not right for all companies, boards should reflect on whether it would make sense for their companies and, if so, how to choose and measure the appropriate metrics.

[2] Recent Delaware Supreme Court decisions suggest a renewed receptivity to claims by shareholders of fiduciary breaches by directors on the basis that they failed to sufficiently oversee risks central to a business. See *Marchand v. Barnhill,* No. 533, 208 (Del. June 18, 2019). In other words, a board's inaction can lead to extended litigation and potential liability. Because of the material risks to a business that inattention to human capital management can entail, and the rapidly changing rules and environment affecting management of the workforce, *Caremark* risk is relevant to board oversight of human capital.

[3] *See* FW Cook 2019 Annual Incentive Plan Report (October 2019), available here.

## Compensation Clawbacks and Advancement of Legal Fees

A perennial regret of companies that have disputes with their executives arising from alleged misconduct is the cost of paying the executives' legal fees to defend themselves. These costs arise from near-universal director and officer indemnification provisions in corporate articles of incorporation and by-laws. Typically, those provisions require companies to advance executives' legal fees to the fullest extent permitted by law. When boards have occasion to take a step back to think about the appropriateness of those broad protections, they almost always decide that the protections are appropriate, in the corporation's interest and necessary to attract and retain executives.

The courts in Delaware and many other jurisdictions permit the enforcement of such obligations in a very broad range of circumstances. Companies regularly challenge their obligation to advance legal fees—and they routinely lose.

One of those challenges occurred at the beginning of 2019 in the Delaware courts in a novel context. Hertz Corporation sought a clawback of the compensation of executives (and sought other damages, totaling about $270 million) arising from a financial restatement that dated back to the actions of an executive team that was subsequently terminated. The executives sought to have the company pay their legal fees to defend themselves. The Delaware Court of Chancery was, unsurprisingly, unmoved, forcing Hertz to pay the legal fees.

We highlight these issues because our experience suggests that many compensation committees that have adopted compensation clawback provisions over the past few years have not expressly considered whether they should advance legal fees to executives who contest the company's allegations that their conduct merits a clawback. In our view, most companies that do consider the issue will conclude that advance of legal fees is appropriate, but consideration of the issue would enhance the governance process. Any board considering these issues should consider how their corporate obligations dovetail with their directors and officers insurance protection in this context.

# Board Composition and Shareholder Proposal Highlights

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We foresee investors continuing to both refine and expand their demands on corporate boards in 2020. With the particular focus on board refreshment and diversity, significant pressure is placed on nominating and governance committees to play an increasingly prominent role.

Nominating and governance committees will also need to pay attention to the changing landscape of shareholder proposals, including changes to the SEC's procedures for the 2020 proxy season and the SEC's proposed changes to the Rule 14a-8 process.

## Overboarding

Institutional investors and proxy advisory firms have paid increasing attention to the number of corporate boards on which directors serve. During the 2019 proxy season, 5.8% of directors received support levels below 80%, the highest rate in nine years, which can largely be attributed to investors' changes to, and enforcement of, their overboarding policies.

Vanguard updated its director overboarding policy in April 2019, announcing that it would generally vote against named executive officers serving on more than one outside public company board (a total of two public company boards), though not at the company at which he or she is an executive officer, and against outside directors who sit on more than four public company boards. Vanguard's revised guidelines largely track those of BlackRock, although it applies Blackrock's policy regarding CEO board participation to all named executive officers.

The major proxy advisory firms continue to have more permissive policies. Institutional Shareholder Services (ISS) generally recommends against CEOs who sit on more than three public company boards and other directors who sit on more than five public company boards, while Glass Lewis generally recommends against executive officers who sit on more than two public company boards and other directors who sit on more than five public company boards. Because Vanguard and BlackRock routinely own in the aggregate approximately 10% of shares of many US public companies, however, boards should take into account Vanguard's and BlackRock's policies, depending on their ownership stakes.

## Board Refreshment

Accompanying this increased focus on director overboarding has been a continued emphasis on board refreshment. Some argue a correlation between lengthy board tenures and diminished board independence from management. For example, The California Public Employees' Retirement System (CalPERS) Global Governance Principles state that "director independence can be compromised at 12 years of service," while ISS's QualityScore metric gives positive scores to companies where non-executive directors with fewer than six years of tenure make up more than one-third of the board.

Nominating and governance committees should be sure to consider board refreshment carefully, addressing any issues of overboarding and lengthy tenures while balancing the benefits of experience along with other skills. These considerations also present nominating and governance committees the opportunity to grapple with another matter of ever increasing importance: diversity.

## Diversity

Diversity maintained its place among the forefront of social and governance issues facing corporate boards in 2019. While the primary focus remained board gender diversity, the year also saw a greater focus on racial and ethnic diversity, as well as management diversity and pay equity, and we expect these trends to accelerate further in 2020.

Out of nearly 50 shareholder proposals regarding diversity that were submitted to companies in 2019, four proposals on board and other employee diversity matters received majority support. Institutional investors and proxy advisory firms have played a key role in this push. BlackRock has indicated that it will vote against nominating and governance committee members for failure to improve diversity if there are not at least two women directors on the board. Vanguard has declared it will support proposals requesting diversity policies (e.g., the Rooney Rule) and board skills matrices. In 2019, the New York State Comptroller voted against directors on boards with no women at 616 companies and nominating and governance committee members on boards with only one female director at 450 companies. And beginning in 2020, ISS will recommend voting against the chair of the nominating and governance committee of a Russell 3000 or S&P 1500 company that has no women on its board.

**A significant milestone has been achieved: there are no longer any boards in the S&P 500 without any women directors. Increased racial and ethnic diversity on corporate boards, as well as female and minority representation in senior management, have been slower and more pressure on these fronts can be expected in the future.**

Numerous states have also followed California's lead on board diversity: New Jersey, Michigan and Pennsylvania have proposed legislation similar to California's mandate for women directors for companies headquartered in those states, while Illinois, Maryland and New York all passed laws requiring reports or studies on board and/or management diversity.

The emphasis on board gender diversity has produced results, with 46% of S&P 500 board seats now filled by women compared to only 17% in 2009 (and boards are increasingly placing women into committee leadership roles). In fact, a significant milestone has been achieved: there are no longer any boards in the S&P 500 without any women directors.

Increased racial and ethnic diversity on corporate boards, as well as female and minority representation in senior management, have been slower and more pressure on these fronts can be expected in the future. Trillium Asset Management and the New York City Comptroller (as the third stage of its Boardroom Accountability Project) started this drive, showing a willingness to file shareholder proposals with companies that lack racial and ethnic diversity and calling on companies to adopt a version of the Rooney Rule for every open board seat and for CEO appointments.

The SEC has not taken much action on this topic, but in February 2019, the SEC staff released two new Compliance and Disclosure Interpretations (C&DIs) stating that it expects a discussion of how nominating and governance committees consider director self-identified diversity characteristics.

## Trends in Proxy Proposals

Dovetailing with the focus on management and board diversity, pay equity proposals continued to increase in prominence. Sustainable investor Arjuna Capital filed over 20 proposals regarding gender pay equity and continued to publish its Gender Pay Scorecard. Citigroup has already agreed to Arjuna's demands to publish median pay gap data for women and minorities. ISS has taken note and revised its proxy voting policies to signal that it will consider supporting shareholder proposals for disclosures of pay data by race or ethnicity, in addition to gender, and will make its determinations on a case-by-case basis, taking into account the company's current policies and disclosures and recent controversies related to gender, race or ethnicity pay gaps.

Beyond board refreshment and diversity, for the third year in a row, environmental, social and governance (ESG) proposals were a majority of all shareholder proposals filed in the 2019 proxy season, with their subject matter running the gamut. Support for ESG proposals rose for the fourth consecutive year, and 42% of ESG proposals received above 30% support. Highlighting the significance of shareholder engagement, voluntary withdrawals of ESG proposals also increased, as nearly half were withdrawn. For additional details, see Navigating the ESG Landscape in this memo.

Political spending proposals have increased in advance of the 2020 US elections, making up a majority of ESG proposals filed in 2019. Four ESG proposals passed in 2019, the highest rate since 2016, and all of them related to political contributions and lobbying disclosure. The so-called "Chevedden Group" (Chevedden, McRitchie, the Steiners and Young) accounted for nearly a third of political spending proposals, indicating that they have scaled back efforts from proxy access and special meeting proposals to enter the social proposal realm.

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But shareholders have not abandoned governance as a subject of proposals. There was a slight upward trend in proposals to split the role of board chair and chief executive officer in 2019, and independent chair proposals were the most common type of governance proposal companies received, with half submitted by Chevedden. As in 2018, none of the proposals passed in 2019, but average support remained relatively stable. Proposals submitted by shareholders on action by written consent also continued to increase, with six such proposals receiving majority support. And although there was a significant decrease in the number of proposals to reduce shareholder meeting thresholds (25 in 2019, compared to 56 in 2018), average support for these proposals was relatively high at 43%, with five proposals passing.

## SEC Updates

During the second half of 2019, the SEC announced a series of procedural changes, guidance and proposals to revamp how it and companies manage shareholder proposals. In September 2019, the staff of the Division of Corporation Finance announced it may respond orally to a no-action request or decline to state a view and will generally reserve written responses for instances where the staff "believes doing so would provide value, such as more broadly applicable guidance about complying with Rule 14a-8."[1] The staff released its first response under this new process and posted a Shareholder Proposal No-Action chart on the SEC website in November 2019 (view it here). The chart has been updated regularly, and companies and proponents have been receiving emails notifying them to check the website when an oral informal response is given.

In response to these changes, Glass Lewis announced it will generally recommend a vote against members of a company's governance committee if a company omits a shareholder proposal from its proxy statement without evidence of receiving no-action relief from the SEC and if a company fails to provide disclosure regarding an oral response from the SEC granting no-action relief that lacks a written record of its determination.

In October 2019, the staff released Staff Legal Bulletin (SLB) No. 14K (view it here), which emphasized the staff's view that in making no-action relief requests, it is helpful for the company to include a well-developed discussion of the board's analysis of whether the particular policy issue raised by the proposal is sufficiently significant to that company. Finally, in November 2019, the SEC proposed amendments to modernize the procedures to include a shareholder proposal in a company's proxy statement under Exchange Act Rule 14a-8.

Nominating and governance committees should follow carefully the development of the 2020 proxy season in response to the procedural changes from the SEC, as well as the proposed 14a-8 rules and the proposed rules with respect to proxy advisory firms as these may have long-reaching impacts on the shareholder proposal and engagement landscape going forward. For more information on these developments, see SEC Disclosure and Proxy Guidance and Proposals in this memo.

[1] *See* Announcement Regarding Rule 14a-8 No-Action Requests, available here.

# The Evolving Privacy Landscape at a Glance: Compliance Considerations for a New Decade


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Increased regulation continues to be the trend in data privacy law, with 2019 bringing forth a host of new regulations and guidance on existing laws. This year, the pace will not likely slow, with January 1, 2020, having marked the official arrival of robust data privacy law in the United States as the California Consumer Privacy Act (CCPA) came into effect.

Boards and management will need to continue to monitor the evolving privacy compliance landscape to ensure that they are considerate of privacy obligations and attendant risks when implementing their business objectives and oversight going into 2020.

## CCPA

In its 2019 session, the California legislature amended the CCPA and the California Attorney General issued a set of regulations that implement, clarify and impose new obligations under the CCPA. Commentators expect that the law and regulations will be further amended, but as of now, if the CCPA applies to your business,[1] notable obligations include:

— Updating websites, mobile applications and other locations where consumers' personal information is collected in order to provide the consumer with meaningful understanding of the information collected about them at or before collection, as well as the purposes for which the information will be used. If information is sold (as defined broadly under the CCPA), providing the consumer with a "Do Not

[1] The Act applies to any entity doing business in California that meets one of the following thresholds: (i) it has annual gross revenues in excess of $25M; (ii) it annually buys, receives for its commercial purposes, sells, or shares for commercial purposes personal information relating to 50K or more consumers, households, or devices; or (iii) it derives 50% or more of its annual revenue from selling consumer personal information.

Sell My Personal Information" link at the point of collection.

— Updating privacy policies to apply to online and offline (brick-and-mortar) practices. The policies must detail the categories of information that are collected, the sources of the information, how such information may be used and with whom, as well as the consumers' rights under the CCPA and how to exercise those rights, including the right to opt out of sale of data and the right to access and delete data. If no notice of the right to opt out of sale is provided, companies must expressly state that they do not and will not sell personal information.

**If the CCPA applies to your business, notable obligations include updating websites, mobile applications and other locations where consumers' personal information is collected in order to provide the consumer with meaningful understanding of the information collected about them at or before collection, as well as the purposes for which the information will be used.**

— Updating contracts with vendors that receive personal information to ensure your vendors qualify under certain exceptions under the law (such that sharing information with them does not constitute a "sale") and collaborate with respect to consumers' access or deletion requests.

— Training employees who are responsible for handling consumer inquiries about your business' privacy practices, the requirements of the CCPA and how to direct consumers to enable consumers to exercise their rights.

— Implementing methods for complying with the rights granted by the CCPA, including:

- Designating an official contact for questions about your company's privacy policies.
- Offering two or more designated methods for receiving consumer requests under the CCPA.
- Establishing, documenting and complying with a method for verifying that the person making a request for access or deletion is indeed the subject consumer.
- Ensuring your business can identify an individual consumer's data to provide that individual with access to that data, delete it from your records or remove such data from data sets that are sold to third parties.

## Other Privacy Legislation

— ***Other US State Laws.*** Many states followed California's lead, and last year 16 other states introduced legislation offering comprehensive consumer privacy reform. However, only Maine and Nevada passed legislation, and the Maine law applies only to Internet service providers operating in Maine when providing Internet access service to customers physically located in Maine, while the law in Nevada is focused solely on data sales. Connecticut, Texas and a few other states passed legislation to enact advisory councils or task forces to study and recommend data privacy laws.

— ***International Laws.*** China and India each had notable legislative action over the past year. In May 2019, the Cyberspace Administration of China issued draft Measures on Administration of Data Security that, when issued in final form, will constitute binding regulations on network operators who collect, store, transmit, process and use data within Chinese territory. In December 2019, India was poised to pass a GDPR-inspired data privacy law that would require express consent for most uses of an individual's personal data and allow for individuals to request their personal information be deleted.

— ***Biometric Laws***. In two separate rulings in 2019, the Illinois Supreme Court and a three-judge panel in the Ninth Circuit sided with the plaintiffs in cases regarding alleged breaches of the Illinois Biometric Information Privacy Act (BIPA). While the Ninth Circuit federal case, *Patel, et al. v. Facebook* is stayed to allow Facebook to petition to the US Supreme Court, the Illinois Supreme Court decision in *Rosenbach v. Six Flags* found plaintiffs need only show violation of their rights under BIPA—as opposed to actual injury—to bring a claim for violation of BIPA. In addition, a bipartisan federal bill to regulate facial recognition and state biometric privacy laws in New York, Florida, Massachusetts and Arizona was introduced in 2019. Many states have also amended the definition of personal information in their existing privacy or data breach notification laws to include biometric information.

## Notable Enforcement

Early in 2019, the French Data Protection Authority announced a €50 million fine against Google for alleged GDPR violations for allegedly not properly disclosing to users how personal data is collected and used across its personalized ads services.

Additionally, in October of 2019, the Berlin Commissioner for Data Protection and Freedom of Information issued a €14.5 million fine against a German real estate company, die Deutsche Wohnen SE, for its failure to maintain a GDPR-compliance data retention policy and consequently storing tenants' personal information longer than necessary for the purposes for which the data was initially collected, and without a legal basis for such excessive retention. This shows that a seemingly minor offense—over retention of data—can also bring serious penalties.

These two actions differ from those enforcement actions highlighted in Cybersecurity: What Keeps Us Up at Night in this memo, in that these actions did not arise out of a cybersecurity incident, but relate solely to privacy violations—an alleged failure to obtain adequate consent from users prior to collecting and processing their information and improper retention of personal data, respectively.

## Key Takeaways

— The 2019 GDPR enforcement action against Google and legislative proposals demonstrate that authorities and legislatures are focused on consumer privacy—and not just cyberattacks.

— Legislative and enforcement trends indicate that companies need to continue to stay abreast of their data collection, processing and sharing activities and compliance obligations as this landscape evolves in 2020.

# Cybersecurity: What Keeps Us Up at Night


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According to a 2019 survey, Chief Legal Officers ranked data breaches as the most important issue keeping them “up at night.”[1] Cybersecurity also remained top of mind for boards and other corporate stakeholders, particularly given the increasing reputational, regulatory and litigation consequences that often follow from a significant cybersecurity incident.

[1] ACC Chief Legal Officers 2019 Survey, available here.

## Major Data Breaches in 2019

Last year saw a continued steady stream of major cybersecurity incidents, including:

— The compromise of personal and financial information for approximately 100 million Capital One customers.

— The exposure of 885 million bank records from First American Corporation.

— Quest Diagnostics’ disclosure that approximately 7.7 million patients’ personal and financial data had been accessed through its external collection agency.

— The city of New Orleans declaring a state of emergency and shutting down its computers after being subject to a ransomware attack.

These are just some examples of a range of different kinds of cyberattacks that companies face, including system intrusions, business email compromise attacks (often through spearfishing) and ransomware. The continued prevalence of these attacks and their significant consequences underscore not only why companies and other organizations must devote sufficient resources to cybersecurity protection, but also why boards must be vigilant in exercising oversight of the preparation for, and response to, these incidents.

In assessing the lessons and trends reflected in these cyberattacks, companies continue to benefit from having well-developed and practiced incident response plans to ensure timely and appropriate reaction to an incident. The benefits of "segmented" data was another recurring theme. Certain companies were able to minimize the fallout from cyber incidents because they had segmented the data they stored, meaning that hackers were only able to obtain limited information and could not fully access customer personal identifying information and/or financial information. In addition, ransomware attacks on businesses are reportedly at an all-time high and becoming increasingly sophisticated. Board members should be aware of these developments and ask appropriate questions concerning management's policies and procedures around identifying and addressing these significant data security risks.

## Regulatory Focus on Cybersecurity

In 2019, many regulators were active in bringing cybersecurity enforcement actions against companies that allegedly maintained inadequate cybersecurity protections or failed to comply with related obligations. In addition to the large financial penalties they are imposing, one significant trend is how US regulators imposed significant ongoing obligations on companies' business operations, boards of directors, corporate officers and compliance professionals. These obligations serve as an important signal of the developing (and increasingly onerous) cybersecurity expectations of regulators:

— ***Business Operations***. In settlements reached with Equifax involving the Federal Trade Commission and Attorneys General from 48 states, Equifax was not only ordered to pay a $700 million monetary penalty, but it was required to implement a robust and documented information security program that includes risk-based assessments, safeguards and qualified third-party evaluations, as well as specific security measures such as password encryption, multi-factor authentication and periodic penetration testing. The AG settlements further mandated that Equifax conduct biannual incident response exercises and weekly vulnerability scans of network systems, as well as begin remediating any "critical" security vulnerabilities within 24 hours.

**In assessing the lessons and trends reflected in these cyberattacks, companies continue to benefit from having well-developed and practiced incident response plans to ensure timely and appropriate reaction to an incident.**

— ***Compliance***. The FTC settlement with Equifax also required Equifax to designate the board of directors, a relevant committee thereof or a "senior officer" "responsible for [the] Information Security Program" to annually certify *under penalty of perjury* that Equifax has established the required information security program, is cooperating with the required third-party assessor evaluating the information security program and is not aware of any material non-compliance with the federal orders. Similarly, in connection with Facebook's settlement with the FTC related to Cambridge Analytica, CEO Mark Zuckerberg and Facebook compliance officers must personally certify quarterly that Facebook has established and maintained the privacy program required under the FTC settlement.

— ***Board Oversight***. In connection with Facebook's FTC settlement, the company was also required to create two new board committees: an Independent Privacy Committee and an Independent Nominating Committee. The Independent Privacy Committee is comprised of independent directors demonstrating certain minimum privacy and data protection capabilities and is responsible for meeting at least quarterly with other independent directors and a third-party privacy assessor mandated by the order to discuss privacy issues, risks and compliance with the order, among other things. The committee must also approve any effort to remove or appoint an assessor. The Independent Nominating Committee, in turn, recommends and approves the appointment or removal of members of the Independent Privacy Committee, including determining whether members of that committee have the required privacy and data protection expertise.

Another important development is the increasing aggressiveness of European regulators in enforcing the General Data Protection Regulation (GDPR). In particular, the UK Information Commissioner's Office (ICO) announced headline-grabbing enforcement actions relating to alleged cybersecurity breaches and data protection violations in 2019:

— ***British Airways***. While not quite reaching the maximum fine permitted by the GDPR (up to the higher of €20 million or 4% of a company's global turnover), the ICO announced its intention to fine British Airways £183.4 million for a cybersecurity incident resulting in the misappropriation of the personal data of approximately 500,000 British Airways customers. The ICO has not disclosed how it determined the size of this fine, but it amounts to approximately 1.5% of British Airways global passenger turnover. The ICO noted that its investigation revealed that British Airways had "poor security arrangements" in relation to its customers' information.

— ***Marriott***. In July 2019, the ICO published its intention to fine Marriott £99.2 million for a cybersecurity incident affecting the Starwood guest reservation database starting as early as 2014—notably, before Marriott acquired Starwood in 2016—but not discovered until 2018. Records relating to about 30 million individuals in the European Economic Area were affected—7 million of which were related to individuals in the UK. Like the fine in British Airways, the ICO did not disclose how it calculated the fine, but it appears to amount to approximately 0.6% of Marriott's revenues in 2018.

One final regulatory note heading into 2020: More and more jurisdictions are imposing affirmative cybersecurity and data protection obligations on companies, beyond data breach notification obligations. Among other developments, in 2019, New York passed the SHIELD Act that, for the first time, affirmatively requires covered businesses to develop, implement and maintain "reasonable" data security safeguards, which include, among other things, conducting risk assessments and addressing identified risks. This will be a particular area to watch as regulators continue their focus on cybersecurity compliance in 2020.

**Among other developments, in 2019, New York passed the SHIELD Act that, for the first time, affirmatively requires covered businesses to develop, implement and maintain "reasonable" data security safeguards, which include, among other things, conducting risk assessments and addressing identified risks.**

## Litigation Developments

2019 also saw a significant uptick in US shareholder litigation relating to data breaches. Until 2019, shareholder derivative cases against board members arising out of a data breach had resulted in either dismissals or settlements with relatively low monetary payments. However, in early 2019, *In re Yahoo! Inc. Shareholder Litigation* resulted in a significant monetary settlement by the defendants, potentially breathing new life into shareholder derivative claims following a significant data breach.

The complaints alleged, among other things, that Yahoo and its former and current executives and officers breached their fiduciary duties by failing to timely disclose and concealing two data breaches. The settlement reached by the board members and other defendants provided for a $29 million payment to settle the derivative claims, by far the largest such settlement to date.

Shareholder securities fraud litigation also proceeded at a brisk pace, largely mirroring claims filed in prior years by claiming that public companies failed to adequately and/or timely disclose material cybersecurity incidents and risks. The success of these cases has turned on whether the company's public disclosures concerning cybersecurity risks and incidents were sufficiently robust to defeat claims that shareholders were misled.

## Key Takeaways for Boards of Directors

— Data breach incidents continue to proliferate, with business email compromise and ransomware attacks against businesses on the rise in particular. Board members should focus on whether adequate resources are being dedicated by management to identify and address such risks, and whether management has a well-tested plan in place to execute in case of an attack.

— Regulators in the US and Europe continue their focus on cybersecurity. In addition to monetary penalties, certain regulators are also seeking to require companies to implement privacy and cybersecurity risk assessments, third-party monitoring, specified director and officer responsibilities and changes to board composition. If these promises are violated in the future, the company is subject to significant additional fines.

— Shareholders, regulators and courts will expect that boards, management and compliance personnel play increasingly active roles in privacy and cybersecurity oversight.

— The announced enforcement action against Marriott with respect to the Starwood breach, as well as related sprawling litigation, underscores that purchasers and investors should consider the necessary transactional due diligence with respect to material cybersecurity and privacy risks.

— US litigation risk following a data breach continues to be significant, with derivative actions against board members potentially on the rise following developments in 2019.

# CFIUS Jurisdiction Continues to Expand

LAW


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In 2020, boards of directors will continue to face an evolving landscape in reviews of foreign investment by the Committee on Foreign Investment in the United States (CFIUS), particularly with respect to issues relating to technology, infrastructure and personal data. Boards, and Technology Committees in particular, should be aware of these developments for their possible ramifications for foreign investment.

On September 17, 2019, the US Department of the Treasury proposed regulations[1] implementing most of the remaining provisions of the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA), which updated the statute authorizing CFIUS reviews of foreign investment. FIRRMA mandates that the final regulations enter into force by February 13, 2020.

Although the proposed regulations primarily codify CFIUS practice over the past decade, they underline CFIUS's focus on foreign investment in businesses that develop critical technology, perform specified functions with respect to critical infrastructure and handle sensitive personal data of specified types and volumes (defined collectively in the proposed regulations as "TID US Businesses"):

— ***Critical Technologies***. Unchanged from the 2018 critical technologies pilot program, "critical technologies" includes a wide range of export-controlled technologies, as well as "emerging and foundational technologies" to be controlled under the Export Control Reform Act of 2018 (which remain to be defined).

[1] For additional details on the Proposed Regulations, see our September Alert Memo here.

— ***Critical Infrastructure***. A business qualifies as a "critical infrastructure" TID US Business if it performs specified functions corresponding to particular types of infrastructure (including assets in the telecommunications, energy, financial services, transportation, manufacturing and defense sectors), as detailed in an appendix to the proposed regulations.

— ***Sensitive Personal Data***. The regulations focus on data of US persons that is "identifiable" to an individual's personal identity and that falls within one of 10 enumerated categories (including genetic, biometric, geolocation and certain health- and financial-related data). The relevant businesses are those that (i) "target or tailor" their products or services to US national security agencies or their personnel (including, for example, military discounts), (ii) maintain or collect covered data on greater than 1 million individuals, or (iii) integrate such data with the US business' primary products or services and intend to serve more than 1 million US persons.

Under the proposed regulations, TID US Businesses are subject to a mandatory filing regime for entities linked to foreign governments (at least 49% owned by a foreign state, directly or indirectly) acquiring at least a 25% voting interest in the US business, subject to an exception for some passive investments through US funds. CFIUS's already broad jurisdiction over any investment with substantial governance rights is even further expanded to cover observer rights and access to technical data or decisions (e.g., with joint R&D). Whether or not the new rules technically apply, TID US Businesses will continue to be an area of CFIUS focus.

The proposed regulations also expand CFIUS's jurisdiction over real estate transactions involving certain property rights at airports, maritime ports or near a list of identified government locations.

**Although the proposed regulations primarily codify CFIUS practice over the past decade, they underline CFIUS's focus on foreign investment in businesses that develop critical technology, perform specified functions with respect to critical infrastructure and handle sensitive personal data of specified types and volumes.**

## Key Takeaways

In 2020, boards should:

— Identify the advisability or requirement to file a notification 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.

— Be aware that CFIUS is now devoting significant resources to identifying and investigating transactions that are not voluntarily notified, particularly in early-stage technology companies.

— Bear in mind CFIUS risk as a potential constraint on strategic exits for both existing and new investments.

# Shareholder Engagement Trends and Considerations


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Shareholder engagement continues to be an important consideration for companies in communicating their long-term strategy and deepening relationships with their investors, and boards are becoming ever more involved in the process.

In PwC's 2019 "Annual Corporate Directors Survey," 51% of the directors reported that a member of their board, apart from the CEO, engaged directly with a shareholder in the past year.[1] One third of more than 300 directors, senior executives and legal advisors surveyed by KPMG in June 2019 reported more significant board engagement with shareholders over the last two to three years than in the past.[2] Not only has director engagement increased, but directors have also reported "a positive impact on shareholders' voting and investing decisions" as a result.[3]

Below, we discuss the latest trends in shareholder engagement and considerations for companies and their board members in crafting and executing an effective strategy for communicating with investors and other constituents, both during proxy season and in the off-season.

## Communication Trends

Communication with investors no longer takes place solely within the bounds of the proxy season. Investors and companies alike benefit from year-round communication. In Morrow Sodali's 2019 "Institutional Investor Survey," 87% of respondents indicated that "proactive and regular engagement with the board of directors" assists them in evaluating a company's culture, purpose and reputational risk. Companies are increasingly

1 PwC 2019 Annual Corporate Directors Survey.

2 Stephen L. Brown, "What is Your Company's Engagement Strategy?" *NACD Directorship* (September/October 2019), available here.

3 PwC 2019 Annual Corporate Directors Survey.

engaging with shareholders during the quieter off-season in one-on-one "sunny day" meetings, which allow companies to establish a foundation for communications with shareholders and increase the likelihood of shareholder support when there is a contested situation such as an aggressive shareholder proposal or proxy contest.

In 2019, shareholder proposals were withdrawn at higher rates than in prior years, indicating productive engagements between companies and investors. Approximately 46% of environmental and social proposals filed in 2019 were withdrawn, compared to prior seasons' lower withdrawal rates of 35%-40%.[4]

**Companies are increasingly engaging with shareholders during the quieter off-season in one-on-one "sunny day" meetings, which allow companies to establish a foundation for communications with shareholders and increase the likelihood of shareholder support when there is a contested situation such as an aggressive shareholder proposal or proxy contest.**

After successful engagement with shareholders, several companies committed to increase and improve disclosure on topics such as sustainability, social responsibility, diversity and political spending. Some companies committed to consider more diverse candidates for board member and executive officer positions and agreed to set renewable energy targets.

For example, Trillium Asset Management submitted many proposals to companies requesting reports on diversity of the executive leadership teams and eventually withdrew such proposals at various of the companies, following successful engagement that resulted in commitments to strengthen public disclosures related to workforce diversity and inclusion or to provide such information in a report. This positive trend indicates that shareholders and companies are communicating more effectively and more often, and that companies and boards can benefit from continuing to improve their engagement process.

Large institutional investors are more focused on financial and strategic matters in engagement. As noted in BlackRock's 2019 "Investment Stewardship Annual Report," BlackRock expects that boards "should be fully engaged with management on the development and implementation of the company's long-term strategy."[5] Approximately 46% of BlackRock's engagements in 2019 touched upon long-term corporate strategy, and one-third of such engagements included multiple meetings with the same company on strategy. Institutional investors are not only focused on companies identifying and implementing a corporate strategy but also expect the board to oversee such implementation and be able and willing to engage with investors on the company's strategy.

Similarly, Vanguard assesses the board's understanding of a company's strategy and ability to identify and govern material risks. Overall the trend is toward increased scrutiny from investors on board composition and directors' experience, expertise and ability to understand the company and its strategy for creating long-term value. Investors also indicated that independence and the skills of directors are critical in evaluating individual board members.[6]

Another trend that remains at the forefront of investor concerns is disclosure. Shareholders are not simply requesting additional information but also are focusing on the quality of disclosure, in particular with respect to certain topics such as human capital management and climate change.[7] Investors would like to see more detailed disclosure when a factor is material to a company's business, such as a discussion of fair

4 ISS US Environmental and Social Shareholder Proposals 2019 Proxy Season Review.

5 BlackRock 2019 Investment Stewardship Annual Report.

6 Morrow Sodali Institutional Investor Survey 2019.

7 Morrow Sodali Institutional Investor Survey 2019.

labor practices for an apparel company.[8] As investors become more sophisticated, companies and boards must strategically prepare and respond to these types of investor concerns.

## Considerations for the 2020 Proxy Season

In preparation for the 2020 proxy season and engagement with shareholders, companies and boards should consider the following in developing a strategy for engaging with shareholders and communicating with other stakeholders.

***Strategize on a Long-Term Plan for the Company***

— Be informed and aligned with management in developing the company's long-term strategic vision. The board should revisit the long-term plan for the company annually.

— Ensure there is consistent messaging among all constituencies (e.g., investors, employees and customers). A unified and consistent message with robust shareholder communication builds support for the company's long-term plan.

— Be specific in identifying a corporate purpose and culture and demonstrating how it informs the company's plans for growth and financial performance.

***Know Your Investors***

— Identify the company's largest shareholders and key stakeholders.

— Review the investors' published guidelines, policies, statements, voting history and involvement in campaigns for shareholder proposals, governance initiatives or activism.

***Review and Revise Disclosure***

— Include voluntary disclosure regarding current engagement with shareholders, feedback received from shareholders and how the company responded. Many companies are providing this information in their proxy statements in the summary, corporate governance and executive compensation sections.

— Provide more granular disclosure specific to the company, its business and its risks.

— Take investor concerns into consideration when creating and updating public information, including disclosure, presentations, websites, CSR reports and other public forums, including social media.

— Ensure that the board, management and others throughout the company coordinate to maintain current and consistent disclosure and communication with investors and other stakeholders.

***Focus on Key Topics***

— Focus on how ESG topics relate to sustainability and the company's long-term plan.

— Consider adding disclosure and reporting on key concerns for investors such as human capital management and climate change, after determining which metrics and ratings are relevant to the company.

— Highlight steps the company is taking to ensure value creation is not impeded by adverse impacts arising from neglect of ESG issues.

8 Morrow Sodali Institutional Investor Survey 2019.

— Consider linking executive compensation practices to strategy and performance, including financial, operational and increasingly sustainability measures.

— Address topics about which there are misunderstandings or controversies (whether raised by analysts, media or activists, or conveyed privately to the company).

— Benchmark governance and other practices against similarly situated issuers, including competitors, others in the sector or index and others in a specific investor's portfolio.

### *Consider Process for Engagement*

— Determine who will be authorized to engage directly with investors:

- Management participants almost always include the head of IR and may include the CFO, the GC or corporate secretary to discuss governance items; the CEO if there are controversies in the market relating to strategic direction; and, in some cases, the heads of specific business units of interest.

- Many engagements involve a non-management director (the board chair or lead independent director and compensation committee chair often engage with investors).

- Many large institutional investors expect to be able to engage with a director.

— Timing of shareholder engagement is a crucial consideration. The proxy season is often the busiest time of the year for many institutional investors, so consider communicating with investors during the off-season and conduct so-called "sunny day" engagements during the late summer or early fall, which is typically the least busy time for most institutional investors:

- *Format*. Be flexible on whether to hold telephonic or in-person meetings.

- *Information in the Meeting Request*. Propose a list of topics and attendees and highlight recent developments that the company wants to discuss.

- *Whom to See*. Top 20 shareholders and additional smaller institutional holders.

— Consider engaging third-party firms to provide services: 26% of companies polled in PwC's 2019 "Annual Corporate Directors Survey" engaged a third party to advise the board on potential activism, and 26% used a stock-monitoring service to receive regular updates on ownership changes.[9]

[9] PwC 2019 Annual Corporate Directors Survey.

# Navigating the ESG Landscape

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Investors and other stakeholders continue to focus on environmental, social and governance (ESG) issues at public companies, both as a driver of financial performance and as a factor of social importance.

The ESG landscape continues to evolve, both in the United States and in Europe, and boards should continue to consider ESG issues, particularly in connection with overall company strategy, and monitor new developments closely.

## Investor Focus on ESG Matters

Much of the focus on ESG matters in recent years has been driven by large asset management firms and pension funds that have sought to influence corporate governance and strategy on ESG matters. Firms such as BlackRock have indicated their intention to act as leaders in this area by incorporating ESG criteria into their portfolio management strategies on an ongoing basis. This includes adjusting fund allocation based on ESG criteria, including downgrades or removals from ESG indices based on negative press or crises that are indicative of poor ESG governance.

In the UK, the concept of sustainability was included in recent changes to the definition of "stewardship" in the UK Stewardship Code (effective January 1, 2020),[1] which sets out certain expectations for those managing assets of UK investors. The code, developed by the UK Financial Reporting Council, requires firms wanting to become signatories to produce an annual Stewardship Report explaining how they have applied the code in the previous 12 months.

[1] Stewardship is now defined as the "responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society" In the UK Stewardship Code, available here.

ESG issues also continue to be topics of heightened shareholder activism and engagement. For the third year in a row, environmental and social (E&S) proposals were a majority of all shareholder proposals in the 2019 proxy season. Support for E&S proposals included in company proxy materials rose for the fourth consecutive year, with 48% of E&S proposals receiving above 30% support.

In particular, climate change proposal submissions in 2019 were at a record high, with requests shifting to the establishment of hard targets for reducing company emissions, rather than simply the production of a report. At Amazon, a group of 7,500 employees brought a climate change proposal, which received approximately 30% support, highlighting an increasing trend of engagement by employees, particularly in the technology industry, who are leveraging their equity compensation to promote change at their workplaces. In 2019, Institutional Shareholder Services (ISS) also issued a custom climate voting service, which provides a framework to help investors address climate issues in proxy voting and engagement policies proactively, including through climate disclosure indicators, climate performance signals, future performance signals, sector-specific materiality and norms violation analysis.

We expect investor focus on climate change to continue. A 2019 Morrow Sodali survey found that 85% of institutional investors surveyed consider climate change to be the most important engagement topic, compared to 31% last year; and CDP, an international nonprofit, analyzed the submissions from 215 of the world's largest 500 corporations and found that companies potentially face $1 trillion in costs related to climate change (a majority within the next five years) unless they take proactive steps to prepare.

Human rights proposals also exhibited a steady uptick, increasing by more than 25% in 2019 and dealing with topics including human trafficking, forced labor, prison labor and immigrant detention. Human capital management has been another area of significant shareholder engagement. Investors, employees and other stakeholders expect companies and boards to make further progress on issues such as employment and human resource practices (in light of #MeToo), gender pay equity, workplace diversity, employee retention and corporate culture. See Board Composition and Shareholder Proposal Highlights in this memo.

**It is no coincidence that these issues reflect press headlines and social media hot topics: boards should make sure to monitor the latest trends relevant for their companies as a bellwether for future investor focus.**

Other areas of significant shareholder engagement include social issues such as the opioid epidemic and immigration detention, as well as political spending and corporate lobbying. It is no coincidence that these issues reflect press headlines and social media hot topics: boards should make sure to monitor the latest trends relevant for their companies as a bellwether for future investor focus.

## Sustainability Reporting: A Move Toward Strategy

The proliferation of sustainability reporting has led to the growth of a variety of frameworks, each with its own standards and requirements, leading to considerable confusion about which ones (and how many) companies should follow and whether investors prefer particular types of disclosure. Recently, however, a more coherent approach seems to be emerging.

Companies and investors alike have been focusing increasingly on the tie between ESG issues and long-term company strategy, with many companies refining their sustainability reporting to focus on key metrics and issues related to their overall business strategy. The latest iteration of the Sustainability Accounting Standards Board's (SASB) 79 industry-specific sustainability accounting standards appears to be helpful in developing disclosure that is material, comparable and relevant for investors; with Glass Lewis' incorporation of SASB's standards into its proxy voting recommendations in 2019, use of these standards is likely to increase.

A number of sustainability advocates and companies have also continued to move toward integrated reporting—combining corporate financial disclosure and sustainability reporting into one report—and one key advocate, the Principles for Responsible Investment (PRI), now has large institutional investors with a total of $70 trillion of assets under management as signatories to its integrated reporting framework.

Whatever the format, companies should ensure their ESG disclosure is subject to good processes and controls, as with any US public disclosure.

## A More Formal European Disclosure Approach

Despite a 2018 petition filed with the SEC requesting formal rulemaking requiring US companies to publish ESG disclosure, and continuing SEC guidance reminding companies to include disclosure about climate change risk, ESG reporting in the United States is largely voluntary. The European Union, by contrast, has taken several regulatory steps in rendering its ESG disclosure framework more comprehensive.

Since 2017, the EU has required listed companies and certain other entities to include in their public reports a "non-financial statement" on corporate social responsibility matters.[2] At a minimum, this disclosure must address considerations relating to environmental, social and employee matters; respect human rights, anti-corruption, bribery and diversity matters; and evaluate how the company is integrating these factors into its business model, policies and due diligence processes, risk management program and key performance indicators (or if it has not adopted policies covering these matters, why not).

In 2019, the European Union went a step further by issuing guidance on disclosure of climate-related information.[3] This guidance requires disclosure if climate-related information is necessary to understand either: the development, performance or position of the company (i.e., information typically of principal interest to investors); or the external impacts of the company (information typically of principal interest to other constituents such as consumers, employees and other interest groups). Board engagement on climate change is one of the factors that should be disclosed, including board oversight of climate-related risks and opportunities and whether the company has access, through internal and external sources, to expertise on climate-related issues.

**Companies and investors alike have been focusing increasingly on the tie between ESG issues and long-term company strategy, with many companies refining their sustainability reporting to focus on key metrics and issues related to their overall business strategy.**

In addition to climate change matters, the European Union has also introduced new disclosure requirements on conflict minerals in supply chains (somewhat similar, although narrower in scope, to the conflict minerals disclosure requirement in the United States) and, in certain countries (e.g., the UK's Modern Slavery Act and France's Duty of Care Law), the overall human rights impact of companies' operations and procurement practices.

Any company with operations or securities listings in Europe or the UK should be sure to consider whether the EU and UK ESG disclosure requirements are applicable.

2 *See* European Union Directive 2014/95/EU of October 22, 2014, amending Directive 2013/34/EU as regards disclosure of nonfinancial and diversity information by certain large undertakings and groups, available here.

3 *See* Guidelines on non-financial reporting: Supplement on reporting climate-related information, C(2019) 4490 final, available here.

# SEC Disclosure and Proxy Guidance and Proposals


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## SEC Disclosure and Reporting Developments

Recently, the US Securities and Exchange Commission continued to move forward with a number of disclosure effectiveness and simplification initiatives, the details of which are available in our Disclosure Simplification Tracker.

Although many of these changes are administrative in nature, collectively they represent an ongoing shift toward principles-based disclosure. In the coming year, we expect that the practical limits of principles-based disclosure will be tested as the SEC moves to implement its August 2019 proposal for the simplification of the narrative description of the business and risk factor items, and attempts to tackle simplification of the MD&A section, which they have included on their Fall 2019 regulatory short-term agenda.

While we expect these changes will give wider latitude for companies to customize their disclosures, the impact may be less than expected because they will do little to address the underlying legal judgments about litigation and reputational risk management that have shaped the form of current disclosure practices.

## SEC Disclosure Priorities

This year, we expect that the SEC will continue to be focused on the following areas:

— ***Earnings Management***. In fall 2019, the SEC instituted enforcement actions against Marvell Technology Group and Under Armour for pulling forward sales in order to meet quarterly revenue guidance. For companies that still provide quarterly guidance, directors should engage with management to determine whether earnings management is occurring and may wish to reconsider the practice of providing quarterly guidance altogether. For additional details, see our article in the *Harvard Law School Forum on Corporate Governance and Financial Regulation* and Auditing and Accounting: What's New in 2020 in this memo.

— ***Cybersecurity***. Disclosures should include material cybersecurity risks and incidents and should focus on specific cybersecurity risks and incidents involving harms to the company, including injury to the company's reputation, financial performance and customer and vendor relationships, as well as potential litigation or regulatory investigations. The SEC has reiterated its view that where a company has become aware of a material cybersecurity incident or risk, it will not be sufficient to merely disclose that such an incident "may" occur. For additional information about developments in this area, please see Cybersecurity: What Keeps Us Up at Night in this memo.

— ***Brexit***. Although the effects of the UK's pending exit from the European Union (Brexit) remain uncertain, a company's annual report and other relevant disclosures should describe management's views on the risks posed by Brexit, to the extent material, and any actions the company is taking to address those risks. Companies should avoid boilerplate disclosure merely stating that Brexit presents a risk with an uncertain outcome, but should instead write a disclosure that would "satisfy the curiosity of a thoughtful, deliberative board member considering the potential impact of Brexit on the company's business, operations, and strategic plans."[1] See View from the UK: Recent Development in Brexit and Corporate Governance in this memo.

— ***Non-GAAP Financial Measures***. The SEC remains focused on Non-GAAP disclosure, especially with respect to using "equal or greater prominence" when disclosing Non-GAAP financial measures. As a reminder, on December 26, 2018, the SEC issued a cease-and-desist order under Section 21C against ADT Inc. for providing Non-GAAP financial measures, such as adjusted EBITDA, adjusted net income and free cash flow before special items, without giving equal or greater prominence to the comparable GAAP measures.

— ***Sustainability***. Investors are increasingly interested in how companies address environmental, social and governance (ESG) matters. Yet, the SEC disclosure regime does not include—at least for now—specific rules calling for ESG disclosure, and SEC officials continue to encourage a materiality-based approach to such disclosure. For example, existing MD&A and risk factor requirements could require disclosure of ESG matters if the information is material and the failure to disclose makes other disclosures misleading. See Navigating the ESG Landscape in this memo.

**For companies that still provide quarterly guidance, directors should engage with management to determine whether earnings management is occurring and may wish to reconsider the practice of providing quarterly guidance altogether.**

— ***LIBOR Transition***. The planned discontinuation of the London Interbank Offered Rate (LIBOR) will continue to raise significant challenges with risk identification, evaluation and mitigation efforts related to existing or new contracts for banks, insurance companies and other companies with significant LIBOR exposure. Companies with strong balance sheets and/or limited LIBOR-denominated debt may find that this issue is not material.

— ***Accounting Changes***.

- *Lease Accounting.* New standards on lease accounting under US GAAP (ASC 842) are now fully effective for SEC filers. ACS 842 generally requires a lessee to recognize a new lease asset (representing the right to use the leased item) and a new lease liability (representing the obligation to pay rentals). The new standard may have a dramatic impact on some balance sheets, income statements and financial ratios and performance

[1] Remarks by SEC Director of the Division of Corporate Finance, William Hinman, in a March 2019 speech at the 18th Annual Institute on Securities Regulation in Europe.

metrics that are used in covenants. The new standard may also trigger transition disclosure requirements applicable to accounting changes, which will generally be included in the notes to the financial statements. Companies should assess the impact of the transition to the applicable standard on other sections of Form 10-K.

- *CECL*. The Financial Accounting Standards Board's standard introducing the current expected credit losses (CECL) methodology is effective for SEC filers in fiscal years beginning after December 15, 2019. The new standard replaces the Allowance for Loan and Lease Losses standard, and focuses on estimating allowances for credit losses over the life of a company's loans. The impact of CECL is likely to be more significant to banks and other financial institutions than to other companies, but every company should assess and disclose any material impact that the new standard is expected to have on credit losses.

## SEC Proxy Developments

In 2019, the Securities and Exchange Commission moved forward with Chairman Jay Clayton's ambitious review of the framework for shareholder voting at public companies with two rule proposals adopted by 3-2 votes along party lines. We expect aspects of the proposals will attract significant interest and opposition during the comment process as shareholder groups, asset managers and corporate governance watchdogs, as well as ISS and Glass Lewis, attempt to shape the course of Clayton's reforms.

A challenging comment process and the upcoming elections may set the stage for the SEC to make substantive amendments to the proposals before it finalizes them or perhaps delays implementation altogether.

In August, the SEC announced interpretive guidance, and in November it proposed new rules (the "Proxy Advisor Rule Proposal") addressing the concerns of many public companies that the proxy advisory process is not as careful, reasonable and fair as it should be in light of the substantial influence of the proxy advisory firms. In a contemporaneous release, the SEC proposed changes to Rule 14a-8 that, in part, are intended to address the view of many public companies that the proxy process requires a disproportionate dedication of resources to proposals from the more prolific proponents (the "Shareholder-Proposal Rule Proposal").

**A challenging comment process and the upcoming elections may set the stage for the SEC to make substantive amendments to the proposals before it finalizes them or perhaps delays implementation altogether.**

### *Proxy Advisor Rule Proposal*

The most significant benefits of the Proxy Advisor Rule Proposal for public companies are new rights to review and comment on proxy advisors' recommendations prior to their release as well as a requirement that proxy advisors, if so requested by the company, include a hyperlink to a company statement along with their own recommendations.[2] This would be a marked improvement to what can be a particularly frustrating area for public companies, which must rely on the goodwill of the proxy advisory firms to correct errors in their recommendations. If and when mistakes slip through, the options available to a company to correct them are often inadequate.

These changes are premised on the SEC's view, as expressed in the August guidance and in the November proposal, that proxy voting advice as it is currently provided by ISS and Glass Lewis constitutes a "proxy solicitation" under the Exchange Act and therefore subjects the proxy advisory firms to regulation. This position resulted in a swift legal challenge from ISS, which if successful could undermine the basis for the entire Proxy Advisor Rule Proposal.

[2] For additional details on this proposal, see our November Alert Memo here.

The ISS complaint gives a preliminary idea of the arguments ISS expects to make. It seeks to distinguish proxy advisory firms, which have no business interest in the shareholder vote other than to earn fee income from their advice, from others involved in the solicitation of proxies incident to another business interest that is not limited to providing advice; and it argues that only the second category should be regulated as proxy solicitation while the first should be regulated as investment advice. Whether that distinction limits the SEC's authority to regulate the proxy advisory firms will now be for the federal courts to determine.

The Proxy Advisor Rule Proposal would also codify the view that such recommendations are subject to the prohibition on making false or misleading statements under Rule 14a-9[3] and require proxy advisory firms to include specific disclosures on conflicts of interest that the advisory firm has with respect to the company.

Unsurprisingly, how to strike the right balance between the interests of companies and proxy advisors continues to be a hotly contested topic. The Proxy Advisor Rule Proposal sparked immediate dissent from corporate governance advocacy groups that worry such rules will pressure proxy advisory firms to take a more management-friendly approach in their reports and vote recommendations.[4]

### *Shareholder-Proposal Rule Proposal*

By contrast, the Shareholder-Proposal Rule Proposal provides for a more modest change by raising or adding new procedural hurdles for submitting shareholder proposals. Most notably, the dollar threshold for the share ownership requirement to submit a proposal would be raised, limitations on resubmission of proposals would be increased, individuals would be limited to one proposal each (per company) and shareholder proponents would be required to participate in a minimum level of engagement with the company.[5]

These standards have not been revisited in more than 20 years, and a refresh to account for inflation and new developments in shareholder practices appears overdue. Despite the SEC's intention, in its current form we think the Shareholder-Proposal Rule Proposal is unlikely to reduce the number of proposals received by companies from the most prolific shareholder proponents, but will have the benefit of reducing the number of "zombie" proposals—proposals that are made every year but do not have a chance of passing.

### *Timing and Potential Roadblocks*

In 2020 we will be keeping a close eye on the timing of both the Proxy Advisor Rule Proposal and the Shareholder-Proposal Rule Proposal (the "New Rule Proposals") and the related ISS litigation as they move forward. Comments to the New Rule Proposals are due by February 3, 2020, which will likely result in final rules being published in the spring of 2020. For early calendar year filers, the Shareholder-Proposal Rule Proposal would first impact the shareholder proposals they receive in the fall of 2020; however, the Proxy Advisor Rule Proposal provides for a one-year transition period and therefore would not go into effect until the spring of 2021, at which point early calendar year filers may be unable to avail themselves of the new rights offered until the 2022 proxy season.

Another wrinkle is that the New Rule Proposals were both issued in 3-2 votes, with Republican members Clayton, Peirce and Roisman forming the majority and Democratic Commissioners Jackson and Lee dissenting. Chairman Clayton's term expires in 2021, so the views of his successor could play a large role in how the rules are implemented. Likewise, if ISS prevails in its litigation against the SEC, the conceptual basis for the Proxy Advisor Rule Proposal would be removed—which would either severely dilute, or completely nullify, its impact.

3 This also raises the interesting question of whether a company could successfully bring a claim against a proxy advisor based on the content of their recommendation. While there is case law finding that an investor has a private right of action against a company under Rule 14a-9, a claim by a company against a proxy advisory firm would be a step further—one it seems unlikely that companies will take for practical and reputational reasons in the ordinary course, although perhaps in a particularly contentious proxy battle or merger, a party might have a sufficient incentive for bringing such a claim.

4 *See* Leading Investor Group Rebukes SEC for Proposed Rules That Undercut Critical Shareholder Rights, available here.

5 For additional details on this proposal, see our November Alert Memo here.

# Shareholder Activism in 2020: New Risks and Opportunities for Boards of Directors

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The era of stakeholder governance and corporations with a purpose beyond profits is taking hold, with corporate directors expected to answer to more constituencies and shoulder a greater burden than ever before. At the same time, investors—both in the US and abroad—continue to expect corporations to deliver superior financial performance over both the short and long term.

This convergence of purpose and performance will not only shape discussions in the boardroom, but also the complexion of shareholder activism. As the nature of the activist threat has evolved it has created additional obstacles for directors to navigate. But at the same time, this environment has created additional opportunities for boards to level the activist playing field and lead investors and other stakeholders into this new era.

## Environmental, Social and Corporate Activism

Today, shareholder activists and governance gadflies are not the only constituencies using the corporate machinery to advocate for change. Social activists and institutional investors are increasingly joining forces and borrowing tactics from the shareholder activist playbook, particularly as they push for ESG reforms. For example, in 2019, prominent pension funds, asset managers and other charitable organizations sent a joint letter to all Fortune 500 companies calling for greater disclosure of mid-level worker pay practices. In addition, the Interfaith Center for Corporate Responsibility—on behalf of over 100 investors—spearheaded the submission of more than 10 shareholder proposals focusing on environmental and labor issues for the annual meeting of a single corporation.

We expect this type of stakeholder activism—or the convergence of shareholder activism and social activism—to continue and eventually move beyond the ESG realm. Although this marks yet another trend that boards must be prepared to face, it also offers directors an opportunity to embrace stakeholder interests other than EPS accretion or margin expansion to support the company's governance profile and long-term strategic plan. To be sure, financial performance of the corporation over the long term, which benefits all stakeholders, will remain paramount, but focusing on the merits of the strategic plan for all stakeholders should help the board ensure management has sufficient runway to implement that plan and garner the support of more, rather than fewer, corporate constituencies along the way.

## Long-Only Activism

At the same time, activism by traditional long-only investors also has increased. For example, Neuberger Berman pushed for board refreshment at Ashland Global as part of a Cruiser Capital-led campaign and launched a short-slate proxy contest at Verint Systems that settled when the company agreed to refresh its board and enhance its investor disclosures. Wellington Management also joined the fray, publicly backing—and by some accounts initiating—Starboard's efforts to scuttle the Bristol Myers/Celgene merger. And T. Rowe Price doubled down on its activism efforts by publicly backing the Rice Brothers' successful campaign to take control of the EQT board.

The takeaway for directors from this sort of activism is clear – no longer will institutional investors be content to sit on the sidelines or express their views privately. Directors should expect that increased long-only activism will create a challenging environment for active managers (including continued pressure on management fees) and will likely lead more of them to embrace activism, and to do so more publicly, as a way to differentiate their investment strategy.

The question for boards in this new environment is not just whether institutional investors will be a source of ideas for an activist or side with the board or the activist in the event of a campaign, but also whether its institutional investors are likely to themselves "go activist." Shareholder engagement efforts will continue to be crucial in building support for a strategic plan and counteracting activist tendencies among long-only investors. But in the course of such efforts, directors must be mindful of the fact that not all institutional investors will have the same objectives and be careful to structure their interactions with investors accordingly. Well-advised boards will look for ways to find common ground with long-only investors while articulating the company's long-term strategy in a manner that emphasizes its corporate purpose and is more likely to resonate with all stakeholders.

## Large-Cap Activism and Settlement Agreements

Another trend boards must be aware of in 2020 is the success of certain brand-name activists in "settling" large-cap campaigns without committing to a settlement agreement with a standstill undertaking. Typically, a standstill, preventing the activist from exerting pressure on the company for a certain period of time, is the price the activist pays for the company committing to take certain of the steps proposed by the activist. The standstill is intended to ensure that the company has the breathing room necessary to implement the agreed-upon changes and make its case to investors.

**The question for boards in this new environment is not just whether institutional investors will be a source of ideas for an activist or side with the board or the activist in the event of a campaign, but also whether its institutional investors are likely to themselves "go activist."**

However, several recent large-cap activist situations followed a different script. The companies engaged with the activists and announced a series of changes designed to appease the activist, ranging from purported governance and operational enhancements to full-blown strategic reviews. The activist then issued a separate, choreographed press release, often taking much of the credit for the changes and promising to work with the company to bring about the proposed changes. But that was it—there was no settlement agreement or other commitment by the activist to cease its efforts to influence the board.

Not surprisingly, in at least one of these situations, the company "settled" with an activist without a standstill only to face additional demands from the same activist several months later (and which required additional concessions). As always, the terms of peace with an activist will be shaped by the situational dynamics, but as 2020 dawns, directors should continue to be mindful of the benefits of a standstill.

## Activism Abroad

Shareholder activism also continues to expand globally. Boards in Europe and Asia are increasingly finding themselves under pressure from activists. In these situations, boards have faced not only home-grown activists, but also US activists looking to expand their influence and investor base abroad.

We expect this trend to accelerate in 2020 for several reasons:

— The number of easy activist targets in the US has dwindled.

— US-based index funds continue to consolidate their ownership of public companies across the globe.

— Foreign investors are becoming more prone to expect US-style capital allocation policies and shareholder return metrics from non-US companies.

The message to non-US boards is clear: If you aren't thinking about activism, you should be. This doesn't mean foreign issuers should reflexively adopt US practices; they shouldn't. But it does mean that non-US boards should ensure they are prepared to deal with an activist event and consider a strategy that not only takes into account local conditions but also is informed by the relevant lessons from the US experience with shareholder activism.

# Priorities, Trends and Developments in Enforcement and Compliance

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Enforcement of anti-bribery, sanctions and money laundering laws remains a top priority for US authorities. In 2019, the US Department of Justice and civil regulators issued new or updated policies aimed at increasing incentives for self-reporting by companies. Different agencies also provided additional guidance about compliance programs, including the role of officers and directors in supervising compliance programs.[1]

## Enforcement Priorities and Trends

Over the past year, in line with the administration's stated priorities, US authorities continued to focus on enforcement actions against US and non-US persons across a variety of industries, based on violations of the Foreign Corrupt Practices Act (FCPA), US sanctions, and money laundering laws. The DOJ has continued to emphasize: (i) holding individuals accountable, including any officers and directors allegedly involved in misconduct; (ii) promoting robust corporate compliance programs; and (iii) giving companies credit for

[1] More in-depth analysis of many of the enforcement actions, priorities and trends discussed below may be found on our blog site here.

voluntary self-disclosure, cooperation and remediation. We expect these trends to continue in the coming year.

Notable enforcement actions in 2019 include criminal charges the DOJ brought against Chinese telecommunications equipment manufacturer Huawei and Turkish bank Halkbank relating to Iran sanctions violations, money laundering and fraud, as well as criminal resolutions of investigations of Swedish telecommunications company Ericsson (concerning bribery) and Standard Chartered Bank (concerning sanctions violations).

The DOJ's announcement in October 2018 of a policy relating to the imposition and selection of corporate compliance monitors, a practice that the DOJ described at the time as the exception rather than the rule, did not result in the exclusion of monitorships in several significant resolutions in 2019. The DOJ imposed independent compliance monitors as part of resolutions of bribery cases against Ericsson, Russian telecommunications company Mobile TeleSystems, German medical products company Fresenius Medical Care and US retailer Walmart.

Under the DOJ's FCPA Corporate Enforcement Policy, the DOJ declined to prosecute US company Cognizant Technology Solutions, despite the alleged involvement of senior management in the conduct (which is an aggravating factor that may warrant a criminal resolution under the policy), and a US digital and print marketing provider, based on voluntary self-disclosures, cooperation, remediation, and other factors.

In addition, last year the DOJ also pursued individuals, including executives and directors, in connection with enforcement actions against companies. In relation to the investigation of Standard Chartered, a former employee pleaded guilty and a former customer was also criminally charged. The DOJ brought charges against Huawei's CFO and against the former CEO and member of the board of directors (a Brazilian citizen) of Braskem. The DOJ also obtained a conviction against a former senior vice president (a British citizen) of Alstom (based on his actions as an agent of a US subsidiary).

**Recently, the SEC's Enforcement Division announced its plans to continue to speed up investigations, particularly in financial fraud and issuer disclosure cases.**

In addition, the DOJ pursued enforcement actions against individuals without also prosecuting affiliated companies. It brought charges against the former president and the former chief legal officer of Cognizant relating to bribery and obtained convictions against a US investment firm's chairman and CEO and a member of its board of directors relating to bribery and money laundering.

Last year, the SEC's Division of Enforcement continued its priority of protecting "Main Street" retail investors, focusing on investment advisers, financial frauds and threats to investors stemming from new technologies, such as coin offerings. The Enforcement Division's enforcement action against pharmaceutical company Mylan, based in part on the company's disclosures and accounting for loss contingencies in connection with an investigation by the DOJ, served as an important reminder of the risks surrounding a company's decision about whether, when and how to disclose an investigation.

Other enforcement actions in the past year, including one against Fiat Chrysler, highlighted the Enforcement Division's return to a focus on alleged earnings management and accounting fraud. Recently, the Enforcement Division announced its plans to continue to speed up investigations, particularly in financial fraud and issuer disclosure cases.

## Policies on Self-Reporting

In 2019, US agencies issued several updates to existing policies on self-reporting and also announced new policies. The DOJ made incremental changes to its FCPA Corporate Enforcement Policy, including to codify the application of the policy in the context of mergers and acquisitions. The US Commodity Futures Trading Commission issued an advisory on self-reporting and cooperation for violations of the Commodity Exchange Act involving foreign corrupt practices, signaling its increasing focus on foreign bribery. The advisory takes a similar approach to the FCPA Corporate Enforcement Policy, providing that companies and individuals not registered (or required to be registered) with the CFTC, who are therefore not subject to its reporting requirements but are still subject to the CFTC's jurisdiction, will receive a presumption of a resolution with no penalty if they make voluntary self-disclosures, cooperate and remediate, absent aggravating circumstances.

The DOJ announced a new Export Controls and Sanctions Enforcement Policy for Business Organizations, which updated earlier guidelines on voluntary self-disclosures in a manner similar to the FCPA Corporate Enforcement Policy. The policy clarifies that a company that voluntarily self-discloses export control or sanctions violations to the DOJ's National Security Division's Counterintelligence and Export Control Section, cooperates and remediates will be entitled to a presumption of non-prosecution and will not be fined, absent aggravating circumstances. Reporting only to regulatory agencies will not suffice to obtain credit under the policy. Unlike previous guidelines, the policy is applicable to all businesses, and it does not include a carve-out for financial institutions.

The DOJ also issued guidance explaining how it will provide credit in False Claims Act cases for voluntary self-disclosures, cooperation in an investigation or remedial measures.

## Guidance on Compliance

Last year, the DOJ updated its guidance on the factors that prosecutors should consider in evaluating corporate compliance programs. The guidance identifies three fundamental questions to consider:

— Whether a corporation's compliance program is well-designed.

— Whether the program is being implemented effectively.

— Whether the program actually works in practice.

The guidance specifically addresses the role of officers and directors, including the tone from the top, their interactions with the compliance and control functions and reporting lines to the board or audit committee.

Against the backdrop of the DOJ's guidance on evaluating corporate compliance programs and expanded sanctions enforcement by US authorities, the US Department of the Treasury's Office of Foreign Assets Control (OFAC) (responsible for civil enforcement of US sanctions) released "A Framework for OFAC Compliance Commitments," which indicates the elements that OFAC will use to evaluate a company's compliance efforts in the context of any enforcement action. The Framework endorses a risk-based approach to compliance (recognizing that no two compliance programs will be identical) and the need for a formal program that includes five essential components:

— Management commitment

— Risk assessment

— Internal control

— Testing and auditing

— Training

With respect to management commitment, OFAC stated that senior management—including senior leadership, executives and/or the board of directors—must support an organization's sanctions compliance program and ensure the compliance units have adequate resources and authority and that these units are integrated into daily operations.

## Key Takeaways

The continued focus by US authorities on bribery and sanctions, policies encouraging self-disclosure and agencies' guidance about compliance underscore the continued importance of maintaining robust internal controls and compliance, which can help prevent misconduct, detect potential issues and mitigate any penalties.

Board members in particular should be attuned to the effectiveness of internal controls and compliance programs given the potential for significant fines and collateral consequences of an enforcement action. If a company discovers misconduct and is faced with the choice of whether to self-disclose, directors involved in the decision-making process should consider the increasing incentives promoted by US authorities when conducting a risk-based analysis of the ultimate decision on self-reporting.

# View from the UK: Recent Developments in Brexit and Corporate Governance


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In 2020, businesses operating in the UK will need to grapple with the continued uncertainty caused by Brexit and will need to closely monitor a number of important corporate governance and reporting developments expected in the coming year.

## Continued Uncertainty Caused by Brexit

When we first wrote about Brexit-related risks in our 2017 memo, "The Change in Administration in the United States and Brexit and Political Uncertainty in the United Kingdom and Europe," few would have predicted that the ensuing political uncertainty would remain at the top of the UK corporate agenda three years later.

2019 saw businesses continue to face elevated levels of political uncertainty in the UK as the minority Conservative Government, led first by Prime Minister Theresa May and then by Prime Minister Boris Johnson, was unable to secure parliamentary support for any form of Brexit.

With the Conservative Party having secured a decisive majority in the House of Commons in the General Election held on December 12, 2019, the key question is whether there is now a light at the end of the Brexit tunnel. While the UK will now almost certainly leave the EU on January 31, 2020, the path from there is still opaque.

If, as we currently expect, the UK leaves the EU substantially on the terms of the revised Withdrawal Agreement that was agreed to with the EU in October 2019, a transition period will apply until December 31, 2020. During this period, EU law will continue to apply in the UK in much the same way as it did pre-Brexit, and so most businesses are unlikely to experience any significant differences in the UK legal framework within which they operate during 2020.

**While the pace of corporate governance reforms that we have seen in the UK over the last few years has begun to slow, boards should be aware of some important changes that will begin to take effect this year. In the related audit area, the prospect of significant reform remains very much on the agenda for 2020.**

But what the legal framework will look like from 2021 onward is very much still up in the air. In particular, it is not yet clear what the future trading relationship between the UK and the EU will look like, which will depend on the outcome of difficult UK-EU negotiations that are likely to occupy much of 2020. And with Prime Minister Johnson having ruled out any extension to the transition period beyond December 31, 2020—which many consider to be an unrealistic timeframe for the conclusion of trade negotiations of unprecedented scope—there remains a real risk of a "no trade deal" Brexit after this date.

## Corporate Governance and Reporting Developments

While the pace of corporate governance reforms that we have seen in the UK over the last few years has begun to slow, boards should be aware of some important changes that will begin to take effect this year. In the related audit area, the prospect of significant reform remains very much on the agenda for 2020.

### *The Corporate Purpose Debate*

In the US, the debate around the role of non-shareholder interests in corporate decision-making accelerated in 2019, most notably with the CEOs of more than 150 major US public companies pledging to act for all of their "stakeholders"—customers, employees, suppliers, communities—as well as shareholders.[1] A similar debate has also been raging on the other side of the Atlantic, driven most recently by new reporting requirements that will start to apply in 2020.

By way of background:

— The core duty of a director of a UK company[2] requires the director to act in the way that he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its shareholders as a whole. For a commercial company, "success" will typically mean a long-term increase in its financial value. This duty is the UK equivalent to the Delaware duty of loyalty.

— In seeking to promote the success of the company for the benefit of its shareholders as a whole, a director should consider a non-exhaustive list of wider social factors, including the interests of the company's employees, the need to foster the company's business relationships with suppliers and customers and the impact of the company's operations on the community and the environment.

— In the event of a conflict between what would benefit the company's shareholders and what would benefit one or more of these wider social factors, the interests of shareholders must prevail. Nonetheless, this so-called "enlightened shareholder value" principle obligates the directors of a UK company to take into account the interests of stakeholders other than shareholders in their decision making.

While the enlightened shareholder value principle has formed part of UK corporate law since 2007, critics have complained—particularly following a number of recent high-profile corporate collapses—that some boards are still failing to take into account the interests of their broader base of stakeholders or, at the very least, are failing to do so in a transparent manner.

[1] *See* Business Roundtable, Statement on the Purpose of a Corporation (August 2019), available here.

[2] Section 172 of the Companies Act 2006.

In response, the UK government has enacted legislation that will require UK companies that are required to include a "strategic report" in their annual report and accounts[3] to include an additional statement describing how the directors have had regard to the wider social factors referred to above (this is referred to as the "section 172(1) statement").

The Financial Reporting Council (FRC), the current regulator for corporate governance matters in the UK, has proposed a three-pronged disclosure approach, whereby companies should outline:

— The issues, factors and stakeholders the directors have considered and why.

— The main methods of engagement with the company's stakeholders.

— The effect of having regard to those wider social factors.

This new requirement applies to accounting periods commencing on or after January 1, 2019, so we will begin to see the first mandatory section 172(1) statements in the 2020 reporting season (although some companies have already included voluntary disclosures in their annual report and accounts).

This new requirement will sit alongside the revised UK Corporate Governance Code, which requires companies to effectively engage with their workforces and other stakeholders; and a number of related disclosure requirements that aim to enhance transparency around stakeholder engagement.[4] Boards will need to reassess whether their existing practices around consideration of the interests of, and engagement with, their stakeholders meet their legal obligations, as well as the expectations of their stakeholders and the public more broadly.

### *Audit Reform*

The audit profession and the framework within which it operates has come under sustained attack in the UK, driven by a number of high-profile corporate collapses and scandals, where critics have alleged that the auditors did not adequately identify or flag to stakeholders frauds or underlying financial difficulties in the businesses in question.

In response, three related reviews were completed over the last year:

— The independent review of the FRC,[5] led by Sir John Kingman (the current Chairman of Legal & General and former senior civil servant at H.M. Treasury), which proposes the replacement of the FRC with a new independent regulator—the Audit, Reporting, and Governance Authority (ARGA)—with a broader remit and stronger enforcement powers.

— The independent review into the quality and effectiveness of audits,[6] led by Sir Donald Brydon (the former Chairman of the London Stock Exchange), which proposes a large number of significant reforms, including:

  - a refreshed statement of purpose for audits, recognizing its role as a public interest function, and several other proposals around the interests that the company's stakeholders (beyond shareholders) have in the quality and effectiveness of audits;

  - proposals to enable shareholders to influence the scope of audits and to hold the audit committee and auditor accountable;

  - the creation of a new audit profession, distinct from the accounting profession and regulated by the new ARGA;

[3] Section 414CZA of the Companies Act 2006.

[4] *See* Schedule 7, Part 4 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (as amended), which requires directors of certain large companies to make statements detailing how they have engaged with (among others) their employees, suppliers and customers.

[5] Sir John Kingman, Independent Review of the Financial Reporting Council (December 2018), available here.

[6] Sir Donald Brydon CBE, Independent Review into the Quality and Effectiveness of Audit (December 2019), available here.

**Boards will need to reassess whether their existing practices around consideration of the interests of, and engagement with, their stakeholders meet their legal obligations, as well as the expectations of their stakeholders and the public more broadly.**

- proposals to facilitate fraud prevention and detection by directors and auditors;
- the replacement of the core audit opinion from "true and fair" to "present fairly, in all material respects," given the difficulty in using the former term when corporate reporting increasingly involves more subjective matters, such as the significant use of estimates and judgements; and
- requiring a new section in the audit report in which the auditor confirms whether the directors' section 172(1) statement reflects observed reality, based on the auditor's knowledge of the company and its processes.

— The statutory audit services market study[7] undertaken by the UK antitrust regulator (the Competition and Markets Authority), which highlighted competition concerns in the audit market driven by the dominance of the "Big Four" and made the following key recommendations to address these concerns:

- Mandatory joint audit (with very large companies exempt, as well as those choosing a sole challenger auditor).
- An operational separation between the Big Four's audit and non-audit businesses.

It is not yet clear which of these proposals will actually make it into law, but the UK government has recently reaffirmed its commitment to enacting reforms to rebuild trust and confidence in audits, and plans to announce the reforms it will adopt early in 2020. Given the significant impact that these reforms will have on financial reporting processes, boards will need to closely monitor developments in this area throughout 2020.

[7] Competition and Markets Authority, Statutory Audit Services Market Study – Final Report (April 2019), available here.

# International Tax: Choppy Waters Ahead, Life Vests Advised


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The international tax system is continuing to experience a period of significant change, as taxing authorities across the globe are continuing to adopt and implement new rules and procedures to respond to the new economy and perceptions that taxpayers are arbitraging differences among jurisdictions.

We have seen increased enforcement, widespread changes in substantive laws and an increased focus on how to tax companies engaging in digital transactions, and we expect to see more of the same over 2020 and the next few years. While many of the new rules are intended to prevent deductions from being claimed in more than one jurisdiction and income from escaping taxation entirely, they may inadvertently result in taxpayers being subject to double taxation or whipsaw, particularly as the new rules are being adopted and implemented simultaneously and without coordination. Taxpayers will need to be vigilant, thorough and proactive to minimize their risks.

## Increased Enforcement Efforts

Around the world, taxpayers are faced with new disclosure obligations, enhanced information sharing and increasingly aggressive enforcement strategies. The EU has introduced a new mandatory disclosure regime, known as DAC6, requiring intermediaries (including tax advisers, accountants, lawyers and banks) who establish or advise on certain kinds of "cross-border arrangements" to provide extensive information about those arrangements to local tax authorities.

While the first reports are not due until August 2020, the period covered looks back all the way to June 2018. Once reports start to be made, taxpayers can expect enhanced information sharing between tax authorities and wide-ranging follow up information requests.

We expect DAC6 to result in a significant increase in audits and assertions of tax underpayments by taxing authorities. In the United States, businesses using partnership structures can expect audit activity to increase in 2020, as the IRS begins examining the first wave of returns filed under the new partnership audit rules in effect for partnership tax returns filed for tax years beginning with 2018. Additionally, several jurisdictions, particularly in Europe, are increasingly resorting to criminal investigations, prosecution, and/or "dawn raids" of companies perceived as not paying their fair share of taxes. Many companies are establishing dawn-raid crisis management plans, even if they have no reason to believe they have underpaid their taxes.

## Significant Changes to Tax Systems

Recent years have witnessed an unusual increase in significant changes to tax systems, and we expect this trend to continue in the near future.

**Around the world, taxpayers are faced with new disclosure obligations, enhanced information sharing and increasingly aggressive enforcement strategies.**

The United States enacted major tax reform legislation at the end of 2017, and the US Department of the Treasury is still writing regulations and issuing guidance implementing significant aspects of the law. Mexico enacted similar reforms, effective in 2020, including a new interest expense limitation and a rule limiting deductions for payments to non-Mexican related parties. Brazil recently announced major tax reform to be enacted in four phases over several months, which is expected to include a VAT-like regime and reduced individual and corporate tax rates.

In addition, the EU anti-avoidance directive took effect in 2019 and includes extensive anti-hybrid rules modelled after the Organization for Economic Co-operation and Development's (OECD) "BEPS" recommendations. The EU has also established a "blacklist" of non-cooperative jurisdictions for tax purposes and regularly publishes updates of the commitments taken by tax haven jurisdictions to implement tax governance principles, such as transparency and fair taxation. New economic substance rules have been introduced by several jurisdictions (e.g., Bermuda, Cayman Islands) that were under EU scrutiny for facilitating offshore structures or arrangements without real economic activity.

Multinational companies should be prepared for similar reforms across the globe in the coming months and years and should evaluate their intercompany transactions and structures accordingly.

## Emergence of a Minimum Tax System?

The EU and the United States have enacted or proposed various measures intended to ensure that multinational companies pay a minimum rate of tax on global income. The 2017 US tax reform included two new minimum tax regimes: the Base Erosion and Anti-Abuse Tax (BEAT), dealing with deductible payments from US companies to non-US affiliates; and the Global Intangible Low-Taxed Income (GILTI), aimed at current US taxation of foreign subsidiaries' offshore earnings.

The EU's anti-avoidance directive also includes changes to Controlled Foreign Corporation (CFC) rules and a harmonization of the rules across the EU. In May 2019, the OECD published a new work program that proposes rules similar to the US BEAT and GILTI (so-called "Pillar 2" proposals). Multinational companies should assess the impact of these minimum tax regimes and evaluate the ongoing usefulness of their current tax-minimization strategies.

## Reshaping the Global Tax System for the Digital Economy

Various jurisdictions have introduced or enacted unilateral rules targeting digital transactions and structures, and many of these rules are set to take effect in 2020.

France and Italy have taken an expansive audit position regarding the nexus created by digital transactions, asserting that local affiliates or service providers constitute "permanent establishments" and therefore subject foreign companies to local tax. The UK government has announced a UK digital services tax (DST) that may take effect as early as April 2020. While the details and scope of the UK DST may change, it is currently proposed to apply at a rate of 2% on revenues derived by certain businesses from social media platforms, search engines, or online marketplaces. To fall within scope, the taxpayer does not have to be UK tax resident, but the relevant revenue must be linked to the participation of UK users.

In July 2019, France adopted a DST levied at a rate of 3% on the turnover derived on or after January 1, 2019, from certain digital services provided in France including online intermediation and advertising services. A similar tax is expected to come into force in Italy effective as of January 1, 2020. The US Treasury is also considering adopting regulations relating to the sourcing of income from digital and cloud transactions that could result in increased US taxation of non-US technology companies with US customers.

Finally, the May 2019 OECD program includes new proposed nexus and profit allocation rules to ensure that multinational companies (including digital companies) pay tax wherever they have significant profit-making consumer facing activities. Companies offering digital services should be prepared for drastic changes to their worldwide tax exposure and filing obligations as these measures take effect in the coming years.

# Active Times for Antitrust

## Antitrust in the United States


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Antitrust attracted significant popular and political attention in 2019: State and federal enforcers launched investigations into "Big Tech" platforms; some enforcers and 2020 Democratic presidential candidates expressed increasingly aggressive visions for enforcement; and a federal judge subjected a US Department of Justice merger settlement to unprecedented scrutiny.

### *Big Tech Investigations and State Attorney General Involvement*

Major technology platforms such as Google, Facebook, Apple and Amazon are facing ongoing antitrust investigations at both the federal and state levels. The DOJ is leading the investigations into Google and Apple, while the Federal Trade Commission scrutinizes Facebook (which it previously fined $5 billion for consumer protection violations related to data privacy) and Amazon. In addition to these investigations, the FTC has ramped up its focus on the technology sector by establishing a dedicated Technology Enforcement Division.

The federal agencies are not alone: the US House of Representatives' Antitrust Subcommittee is investigating the same four companies in parallel, with Democratic committee chair David Cicilline hiring vocal critics of big tech (including Lina Khan, author of a prominent academic article calling for antitrust enforcement against Amazon) to assist with the investigation. On the US Senate side, Republican Sen. Josh Hawley, who launched an investigation of Google while Missouri Attorney General, is among the loudest voices calling for investigation. State attorneys general hailing from both political parties have launched probes of their own, with Texas' Republican AG Ken Paxton and New York's Democratic AG Letitia James leading the way for dozens of states.

The state-level investigations are understood to focus primarily on the tech platforms' advertising businesses, while federal investigations appear to be reviewing both conduct and certain prior transactions (such as Facebook's acquisitions of Instagram and WhatsApp).

The state tech investigations are part of a broader trend toward more antitrust enforcement, which is perhaps best exemplified by the unprecedented challenge to the proposed T-Mobile and Sprint merger. There, 14 states brought a case, which went to trial in December 2019, to block the merger despite DOJ and FCC approval of the deal.

### *Aggressive Proposals From Democratic Enforcers and Presidential Candidates*

Antitrust has taken center stage in the political arena, with Democrats leading a charge for stronger enforcement. Democratic 2020 presidential candidates in particular have outlined tough stances on merger enforcement and even called for the breakup of large companies. Elizabeth Warren is rumored to be considering a proposal that would bar companies with $40 billion in annual revenue from engaging in M&A.

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While Warren and other candidates' proposals are far from becoming law, they are not alone in calling for more enforcement. The two minority Democratic FTC commissioners have authored a number of sharp dissents calling for more aggressive enforcement in actions, and the majority Republican commissioners agreed to more modest measures.

As an example, when a Republican majority required divestiture of a psoriasis treatment drug to approve the merger of pharmaceutical giants Bristol-Meyers Squibb and Celgene, both Democrats dissented. Commissioner Rebecca Kelly Slaughter lamented high drug prices and called for a broader framework that would go beyond assessing product overlaps to "consider whether any pharmaceutical merger is likely to exacerbate anticompetitive conduct by the merged firm or to hinder innovation." Commissioner Rohit Chopra likewise advocated a broad-ranging approach that would consider whether a merger will "facilitate a capital structure that magnifies incentives to engage in anticompetitive conduct or abuse of intellectual property" or "deter formation of biotechnology firms that fuel much of the industry's innovation."[1]

### *Increased Scrutiny of DOJ Settlements*

Pursuant to a 1974 statute known as the Tunney Act, DOJ antitrust consent decrees must be filed in federal court and determined to be in the public interest by a judge following a 60-day public comment period. Historically, Tunney Act procedures have been a formality, and merger parties have routinely closed their transactions while the judicial determination is pending, with DOJ's blessing. But at least one federal judge has recently sought to reinvigorate the review process.

In October 2018, the DOJ reached a divestiture settlement with CVS and Aetna to approve their $69 billion merger. District of Columbia District Court Judge Richard Leon harshly criticized the parties and the DOJ for allowing the transaction to close before his public interest determination and questioned the adequacy of the settlement. Judge Leon held evidentiary hearings with live testimony from witnesses opposed to the transaction, a step never before taken in a Tunney Act review of a merger settlement. The witnesses were allowed to testify to a wide range of concerns, over DOJ's objection that the Tunney Act authorized the court to evaluate only the adequacy of the consent decree to remedy the specific harms DOJ had alleged.

Ultimately, Judge Leon found the decree to be in the public interest and approved it without alterations—though not until nearly a year after the consent decree was filed. It remains to be seen whether other judges will follow Judge Leon's lead or require material changes to

1 *See* FTC Requires Bristol-Myers Squibb Company and Celgene Corporation to Divest Psoriasis Drug Otezla as a Condition of Acquisition (November 2019), available here.

settlements negotiated by the DOJ and merging parties, but if they do, the shift could significantly delay closing of DOJ-reviewed mergers with settlements.

*Board Takeaways*

These developments all show that antitrust enforcement un the US is alive and well. Importantly, historical practices cannot be counted on, given the new enforcers (State AGs) coming into play and the changes to once-rote procedures (consent decree approvals). While the focus on tech enforcement is rightly attracting headlines, boards in all industries should be aware of these changes, too.

## Antitrust in Europe

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Following on 2019 as another active year for antitrust enforcement in Europe, all signs point to continued vigorous enforcement in 2020.

*A New Commission*

The new European Commission, headed by President Ursula von der Leyen, took office on December 1, 2019. Competition Commissioner Margrethe Vestager (having been nominated for a second consecutive term on September 10, 2019) not only resumed her role as Competition Commissioner, but President von der Leyen also appointed Ms. Vestager one of her three Executive Vice Presidents, in which capacity Ms. Vestager will now also be responsible for helping make "Europe Fit for a Digital Age" (as described below). Ms. Vestager will serve in both positions for the Commission's five-year term.

Notwithstanding Ms. Vestager's reputation as a tough enforcer of EU competition law after her first five years in office, President von der Leyen has said she expects Ms. Vestager to further strengthen the Commission's

**Boards should also expect continued tough enforcement of European abuse of dominance rules, including, when necessary, the use of interim measures to prevent imminent harm.**

enforcement efforts over the next five years. Her mission letter to Ms. Vestager noted that this should include the Directorate General for Competition improving case detection, speeding up investigations and facilitating cooperation with and between other (European National and non-European) competition authorities.

President von der Leyen also encouraged Ms. Vestager to actively use sector inquiries into new and emerging markets that are shaping European economies and society. She asked that Ms. Vestager develop tools and policies to better tackle the distortive effects of foreign state ownership and subsidies in the EU internal market. She stressed the importance of a level playing field that provides businesses with the incentive to invest, innovate and grow and noted that EU state aid rules should support such a level playing field where market failures have created distortions.

In her role as Executive Vice President, Ms. Vestager will set the strategic direction of and chair the Commissioners' Group on a Europe Fit for the Digital Age. As President von der Leyen outlined, this role will include:

— Developing and implementing a long-term strategy for Europe's industrial future that maximizes investment in research and development.

— Working on a new SME strategy focused on supporting small businesses, entrepreneurs and startups by reducing regulatory burdens and enabling them to make the most of digitization.

— Coordinating the European approach to artificial intelligence, including its human and ethical implications.

— Coordinating a European strategy on data, including examining how Europe can use and share non-personalized big data to develop new technologies and business models that create wealth for European societies and businesses.

— Coordinating the work on upgrading liability and safety rules for digital platforms, services and products as part of a new Digital Services Act.

— Coordinating the work on digital taxation.

Ms. Vestager will be supported as Competition Commissioner by the Directorate General for Competition and new Director General Olivier Guersent. While Mr. Guersent started his career at the Commission in 1992 as part of DG Competition's Merger Task Force, he has served in a variety of roles at the Commission since then, including most recently as Director General of the Directorate on Financial Stability, Financial Services, and the Capital Markets Union. Cecilio Madero Villarejo is now Deputy Director General for Mergers, Kris Dekeyser Deputy Director General for Antitrust, and Carles Esteva Mosso Deputy Director General for State Aid. The Commission's Secretariat General will support Ms. Vestager in her role as coordinator of the digital portfolio.

### *Merger Control*

The Commission's efforts to strengthen competition enforcement will likely mean an extension of the recent trend toward longer and more document-heavy pre-notification "investigations" in merger control cases generally, more in-depth (Phase II) merger reviews, and more blocked mergers. In 2019, high-profile mergers prohibited by the Commission included the *Wieland/Aurubis/Schwermetall*, *Siemens/Alstom*, and *Tata Steel/Thyssen Krupp* transactions.

It will also mean continued aggressive enforcement of the Commission's gun-jumping rules (similar to its investigation of, and €28 million fine imposed on, Canon in June 2019 for partially implementing its acquisition of Toshiba Medical Systems without merger control approval) and stiff sanctions on parties that fail to provide accurate and complete information as part of the merger control process (just as the Commission fined General Electric €52 million for providing incorrect information during the Commission's investigation of its takeover of LM Wind in April 2019).

### *Cartels*

With respect to cartel enforcement, boards should continue to expect vigorous activity on the Commission's part. Until recently, the Commission has enjoyed a full pipeline of cartel cases generated by successive immunity and leniency applications, in particular in the automotive and financial sectors.

While there are signs that the continued growth in private damages actions in Europe may have dampened the appetite for potential immunity applicants to come forward and limited the number of immunity applications received by the Commission, the Commission has instead focused on and brought investigations in areas outside the conventional "seller" cartel context. It has several ongoing cases aimed at potential coordination between buyers on industrial pricing benchmarks and on the development of clean emission technology for cars. Indeed, in November 2019, the Commission opened an investigation into a possible purchasing cartel among two larger French retailers Casino and Intermarche.

### *Abuse of Dominance*

Boards should also expect continued tough enforcement of European abuse of dominance rules, including, when necessary, the use of interim measures to prevent imminent harm. 2019 saw a range of abuse investigations initiated and concluded. In June 2019, the Commission issued a Statement of Objections against Broadcom alleging its abuse of a dominant position in the markets for "systems on a chip" for TV set-top boxes and modems. Fearing imminent "irreparable harm to competition," the Commission then took the unusual step of imposing interim measures on Broadcom in October 2019, forcing Broadcom to cease applying provisions that the Commission views as anticompetitive in contracts with six of Broadcom's main customers.

The Commission also opened an investigation in July 2019 into Amazon's potential misuse of sensitive data from independent retailers that sell on its marketplace. Also in 2019, the Commission fined Qualcomm €242 million for abusing its alleged dominance in 3G baseband chipsets by engaging in predatory pricing with a view to forcing its competitor, Icera, out of the market, and it fined Google €1.49 billion for the misuse of its alleged dominant position in the market for the brokering of online search adverts.

***Impact on Antitrust Enforcement***

With a strong and experienced team behind Ms. Vestager and a clear mandate from President von der Leyen, boards of directors should fully expect a further strengthening of effective antitrust enforcement by the European Commission in the years to come. This will be true particularly in new and developing markets, and in markets where the Commissioner's role as Competition Commissioner overlaps with her position as the head of the Commission's digital portfolio.

## Antitrust in China

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In 2019, the Chinese antitrust authority prioritized institutional integration, legislation and enforcement in the high-tech, public utilities, automotive, pharmaceutical, construction materials and consumer goods industries. Antitrust litigation in China continued to be active and increasingly involved complicated legal issues, such as standard essential patents and ability to arbitrate antitrust disputes.

***Increasingly Important Role of Local Agencies***

In January 2019, State Administration for Market Regulation (SAMR) granted a general authorization to its provincial branches (i.e., provincial AMRs) to carry out behavioral investigations in their own provinces, without the need to seek individual authorization from SAMR prior to commencing a new case. This step is believed to be designed to ease staff shortage at central-level SAMR. The 16 out of 17 behavioral investigations closed and published in 2019 were carried out by provincial AMRs.

The central-level SAMR, apart from handling merger review and high-profile behavioral investigations, has been focusing on unifying enforcement standards, coordinating and supervising provincial AMRs and training investigative forces.

***New Implementation Rules and Guidance to Unify Antitrust Enforcement***

SAMR issued a series of new implementation rules, including three interim implementation rules on antitrust investigations of restrictive agreements, abuse of dominance, and abuse of administrative power, as well as rules and guidelines that cover subjects such as handling of complaints, whistleblower rewards and competition compliance programs. These rules unified and provided more clarification on antitrust enforcement proceedings in China.

SAMR specifically clarified that antitrust fines for restrictive agreements and abuse of dominance (i.e., 1-10% of revenues in the preceding year) should be calculated based on the total revenues of the company infringing the law, instead of the revenues generated from the sales of the relevant products related to the infringement. SAMR also clarified that illegal gains should be confiscated whenever possible. Noting that in previous cases antitrust fines were sometimes calculated based on revenues of the relevant products

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and that confiscation of illegal gains did not often occur, we expect this new guidance to increase the antitrust monetary liability for offending companies.

In addition, SAMR has been accelerating the work to amend China's 11-year-old Anti-Monopoly Law (AML). Proposed amendments to the AML were published for public comment on January 2, 2020. Of special note, the proposed amendments address the possible criminalization of antitrust violations and possible involvement of the public security authority in antitrust investigations.

### *Targeted Behaviors and Industrial Sectors in Behavioral Investigations*

Antitrust investigations focused on three types of anti-competitive behaviors in 2019, including cartel (eight cases), abuse of dominance (five cases) and resale price maintenance (four cases). For example, Shanghai AMR penalized the Chinese subsidiary of an US chemical company, Eastman Chemical, for engaging in exclusive dealing through multiple commercial arrangements (including minimum purchase requirements, take-or-pay clauses, most-favored-nation clauses, and other rebates) that aimed to lock in a significant portion (more than 75%) of customers' demand.

The public utilities, automotive, pharmaceutical, construction materials and consumer goods industries attracted the most attention of the antitrust authority in 2019. Among them, construction materials was probably the sector receiving the most intensive antitrust scrutiny, with four price-fixing cartels and one abuse of dominance case closed by provincial AMRs.

### *Merger Control Review Timeline and Revival of "Hold-Separate" Remedy*

SAMR reviewed and closed 433 merger cases from January to December 29, 2019, of which 428 transactions were unconditionally approved, five were approved with conditions, and none were prohibited. About 78% of the approved merger cases were reviewed under the simplified procedure, most of which were cleared within 30 days after the formal review was started. The review timeline for cases not subject to the simplified procedure was, however, less predictable and varied significantly, which may increasingly be the case if the AML's recently proposed "stop the review clock" mechanism is adopted. The average review time for the five conditionally approved cases was almost 400 days after filing.

In reviewing complex merger cases, SAMR has continued to be receptive to behavioral remedies and unconventional remedies. All of the five conditional clearances in 2019 involved behavioral remedies, and three of them (*Cargotec/TTS Group*, *II-VI/Finisar*, and *Royal DSM/Garden Bio-Chem*) revived the "long-term hold-separate" remedy. The long-term hold-separate remedy has been one of China's most controversial antitrust enforcement practices as it prevents the transacting parties from realizing the expected efficiencies and synergies of the transaction and intrudes into the parties' daily business operations due to the expansive oversight authorities granted to the monitoring trustee. Such remedy was imposed in four cases during 2011 and 2013, one in 2017, as well as the three in 2019.

Another unconventional remedy imposed in 2019 was restriction on supply to downstream competitors. In *Novelis/Aleris*, SAMR, in addition to requiring a divestiture, also prohibited the parties from supplying in China an upstream input cold-rolled sheets to any downstream aluminum automotive body sheet competitor for 10 years. It is unclear what specific antitrust issue this supply restriction remedy was intended to address as supply continuity to downstream competitors post-transaction would normally be viewed as pro-competitive.

### *Judicial Developments*

The Supreme People's Court (SPC), China's highest court, handed down several important rulings in 2019 on interesting antitrust issues:

— ***Legal test for Retail Price Maintenance (RPM)***. In *Hainan Yutai v. Hainan Price Bureau*, the SPC, for the first time, acknowledged different legal tests previously applied by China's antitrust authority and Chinese courts. In short, the SPC confirmed that the Chinese antitrust authority can continue to presume the existence of anticompetitive effect from an RPM agreement unless rebutted by the company (though it still remains to be seen how a company can successfully rebut the illegality presumption), whereas a plaintiff in a civil antitrust litigation will need to prove the anticompetitive effect of an RPM agreement to prevail.

— ***Ability to arbitrate antitrust disputes***. In *Hohhot Huili v. Shell*, the SPC ruled that the arbitration clause in a distribution agreement does not exclude the court from reviewing the antitrust disputes between the parties of the agreement. Nevertheless, the ruling did not view antitrust issues as matters that cannot be arbitrated.

— ***Litigations involving Standard Essential Patents (SEPs)***. The latest judgment on the FRAND royalty rate in China was handed down by a Nanjing court in *Huawei v. Conversant*, which took the "top-down" approach instead of the comparable licensing method. As shown in this case, Chinese technology companies that were sued related to SEPs overseas increasingly choose to file parallel lawsuits in China. Other recent examples include *Huawei v. InterDigital* and *Xiaomi v. Sisvel*.

### *Impact of the Geopolitical Environment*

While there was no prohibition decision or significant delay that resulted from the US-China trade tension in the vast majority of merger cases involving US companies in 2019, there have been consistently strong and widespread complaints from local stakeholders, particularly in the high-tech sector, which have in several cases complicated the review process and led to unconventional remedies that were not intended to address transaction specific antitrust issues. With regard to behavior investigations, we did not see any strong sign showing that US companies were particularly targeted or subject to much more severe antitrust penalty.

### *China Antitrust: A New Decade With a New Law*

Antitrust enforcement in China continued to be in the spotlight in 2019, particularly given the geopolitical tensions. In light of the newly proposed amendments to the AML, which are still being discussed but indicate, to some extent, the direction of China's antitrust development, continued imposition of unconventional merger remedies, more unpredictable merger review timetables, highlighted behavioral investigations and increased penalties for non-compliance (including failure to notify, non-compliance with remedies, and non-cooperation with antitrust investigations) appear to be on the horizon for 2020.

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