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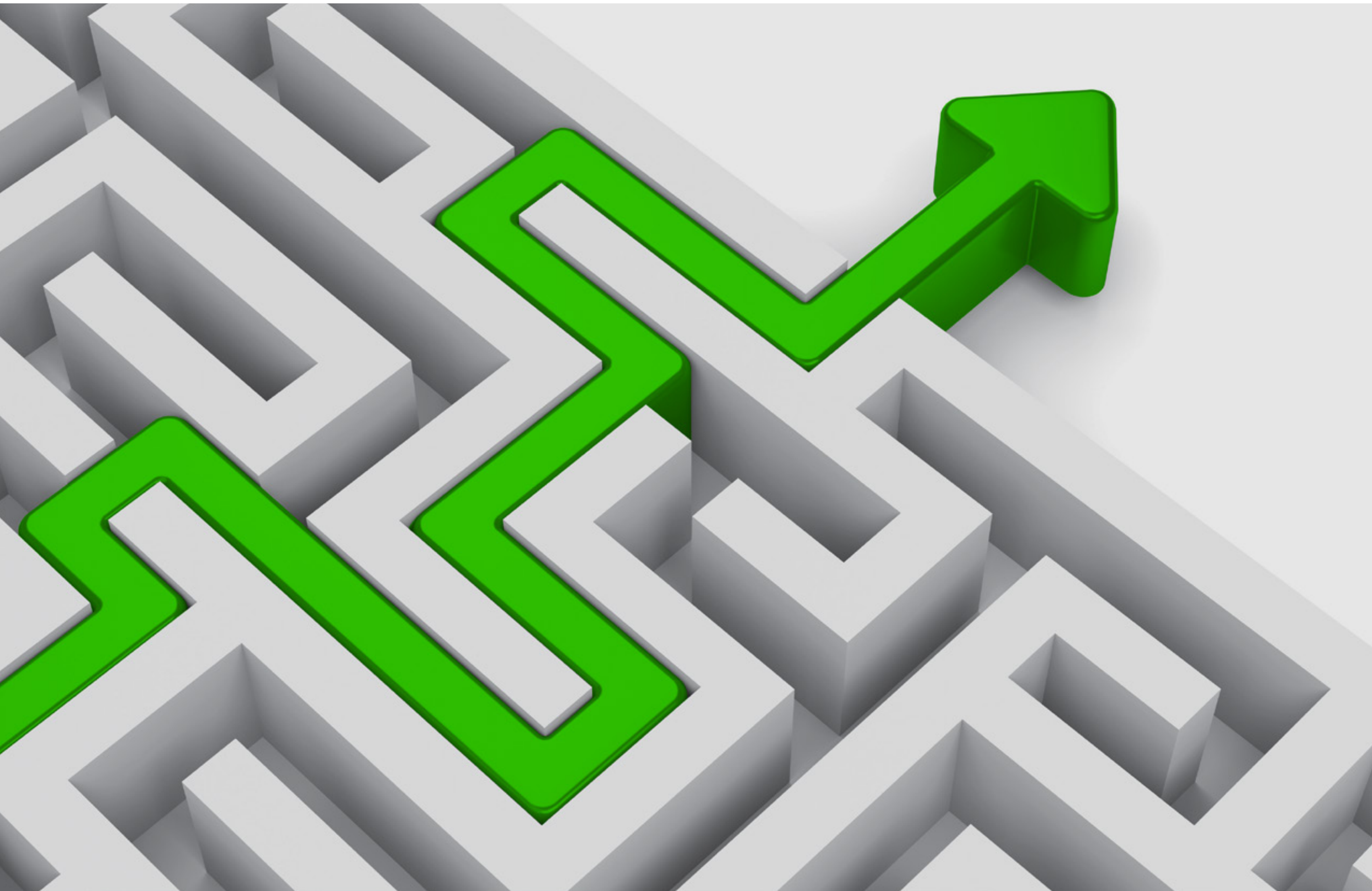
Selected Issues for Boards of Directors in 2021

January 2021

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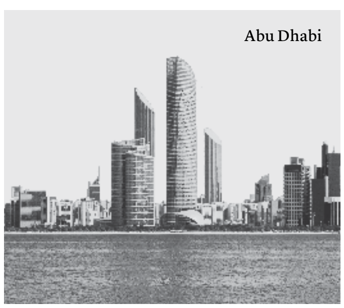
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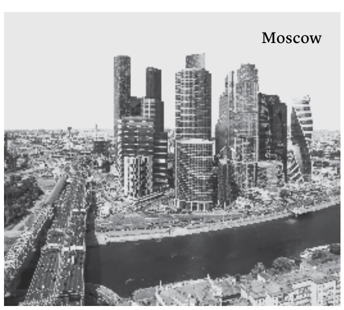
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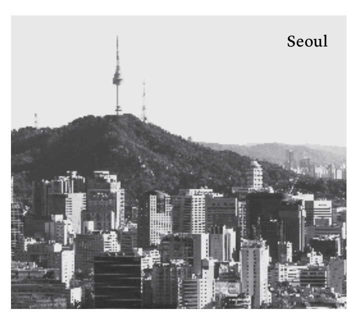
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Selected Issues for Boards of Directors in 2021

In 2020, many directors and members of senior management faced their most challenging year ever. Maybe the lessons of such a turbulent year will prove sufficient for 2021, but that seems unlikely.

To prepare this memo, we asked our colleagues in a wide range of disciplines to boil down what we learned from last year, and to look around the corner for what to expect in 2021. The result is a compendium of the trends and topics that will dominate board meetings this year. The following pages touch on many topics – including themes of sustainability and diversity that are now at the top of every corporate agenda; continuing changes in investor engagement strategies, across the spectrum from stewardship to activism; the impact of a new federal administration; emerging threats arising from new litigation strategies; and much more.

We hope you will find this helpful as you plan for the year ahead.

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Crisis Management in Unprecedented Times

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For companies and boards managing crises or cross-border matters, the COVID-19 pandemic has brought unprecedented challenges that in many ways fundamentally change how we think of crisis management. However, managing through COVID-19 has illustrated the importance of many of the fundamentals that underpin good crisis planning and management in any environment: preparedness, transparency, engagement with regulators, clear and timely communications and proactivity.

COVID-19: Our Perspectives

The COVID-19 pandemic has been a crisis unto itself. As many companies have had to find safe ways to continue essential work and move nonessential employees to work from home, companies' contingency planning has been put to the test. One of the most notable aspects of managing through the pandemic has been how crisis management planning done in anticipation of external-facing crises has, for many companies, formed the foundation for managing internal constituencies. This is particularly the case in the area of crisis communications, as companies work to provide transparency and predictability to employees while themselves working with limited information and substantial uncertainty. Crisis communications planning has always been the hallmark of a well-managed situation, and the importance of clear, action-oriented and transparent communications to employees has taken on increased importance this year. The risks of poor communication have never been greater, as companies increasingly face scrutiny (and potential liability) for poor or untimely communications regarding the impact of the pandemic on their business or business planning.

Crisis management planning done in anticipation of external-facing crises has, for many companies, formed the foundation for managing internal constituencies.

While many companies have fallen into a routine regarding operations under COVID-19 restrictions, the prospect of multiple effective vaccines suggests that the watchword of the coming year will be "reopening." There may be a tendency to view this as a "return to normal," but we anticipate that the challenges many companies will face as part of the reopening process will be no less significant than those faced to this point – and many of the risks, both to companies and their boards, are less than obvious.

As part of their contingency planning for the coming year, companies would be well-advised to adopt a formal plan for managing potential outbreaks of COVID-19, if they have not already, and for vaccination policies. That includes clear policies for:

— Quarantining employees;

— Notifying those potentially affected;

— Making testing available;

— Confirming whether reporting to relevant public health authorities is required (as it is in many jurisdictions); and

— Documenting steps taken to establish a record of following applicable protocols and how the company will handle vaccinated and non-vaccinated employees and customers.

In doing so, companies should continue to consider their own potential liability. While laws vary by jurisdiction, in the event that employees, customers or others contract COVID-19 at a company's premises, a company may face claims for negligence, misrepresentation, violation of employment contracts or work rules, or violation of common law or statutory duties to maintain a safe working environment. Likewise, in implementing policies regarding quarantines, failure to adhere to public health guidance and vaccinations, companies should consider risks under anti-retaliation, anti-discrimination and similar regimes.

Our experience advising leading companies on their contagious disease planning suggests that there is an important role for the board to play in managing all of these risks. COVID-related risk is now a fundamental environmental, social and governance (ESG) risk. How companies anticipate addressing COVID-related risk; what mechanisms are in place to ensure clear, timely and accurate communications; how the company intends to comply with existing or new public health guidance; and the occurrence of any unexpected events that lead to operational disruption are all matters that directors should consider as part of evaluating corporate readiness for the coming year.

Success Stories in Crisis Management

While COVID-19 dominated the headlines in 2020, companies have continued to face many of the same types of crises that existed in prior years. In advising our clients, we have found that success stories of companies that have successfully weathered crises in the past can provide invaluable insight into planning for the future.

Crisis management is "the process by which an organization deals with a disruptive and unexpected event that threatens to harm the organization, its stakeholders or the general public."[1] What differentiates a true crisis from more standard, even if problematic, events is the level of unpredictability, potential to affect multiple aspects of a business and size of the potential impact.

1 Marie Mikušová & Petra Horváthová, *Prepared for a crisis? Basic elements of crisis management in an organisation*, Economic Research-Ekonomska Istraživanja (2019).

A company may face a crisis as a result of a triggering event (a cyber-attack, harassment scandal, environmental disaster or something similar), regulatory action, internal escalation or whistleblowing, media reports or escalation from another source. Understanding sources of crises most likely to impact a company can assist in deciding what preparations would be most useful. A company may be vulnerable to certain types of crises because of its industry. For example, food companies are more vulnerable to crises related to disease outbreaks, while manufacturing companies are more vulnerable to product liability and product recall issues. All companies can be susceptible to public relations and employee misconduct crises. Identifying potential sources of crises can be done through good partnership with risk management, focusing on high, medium and low risks under the assumption that even small events can balloon into larger crises, particularly in the area of social media. Another important way to identify potential sources of crises is to learn from what other companies experience and continually ask whether something similar could happen at your company.

A company's ability to respond to a crisis moment is inevitably influenced by the extent to which the company has prepared itself to address a crisis ahead of time. Examples of well-managed crises teach that companies should consider the following factors as part of their pre-crisis planning:

— ***Creating a culture that is favorable to crisis management***: A favorable corporate culture is one in which there is acknowledgement and commitment by senior management, where people are encouraged to accept constructive criticism and where employees' interests are aligned with those of the company. Such a culture is one in which employees are encouraged to bring risk forward, to raise their hands, and where both policy and practice are such that employees are rewarded for identifying potential risks – even in cases of false alarms. Boards should be asking management for reporting on the culture of the company with these points in mind.

— ***Integrating crisis management into the company's strategy***: Planning for a crisis should be a formal part of corporate strategic planning. Successful companies have thought through the preparation of a crisis management plan, engaged in employee training in crisis management and emergency preparedness and often have engaged in tabletop exercises around crisis response that help to identify weaknesses and ensure a smooth response. Importantly, crisis management strategies should not confine a company's ability to respond dynamically: a strategy is a plan to respond to a crisis, not to conform a crisis to a pre-ordained plan. The companies that are most effective in responding to a crisis are those that learn from prior experience, develop guidelines and tools, empower those on the front lines who often have the best information and ability to act and reward creative and responsible problem solving. Boards should periodically be briefed on the crisis management plan.

Understanding sources of crises most likely to impact a company can assist in deciding what preparations would be most useful.

— ***Having the right communication tools***: The best messaging is only as good as the ability to get it out. Companies should consider and re-evaluate the effectiveness of internal and external communications mechanisms. In doing so, companies should focus on making sure that the communications channels are user-friendly, relevant (including channels likely to be accessed by differing stakeholders, e.g., company website, Twitter, Instagram) and ready for off-hours communications. Communication channels should be monitored to hear what the market is saying: robust brand monitoring is one way that companies can get ahead of potential risks by understanding how their products or services are being discussed in the market and on social media.

— ***Integrating crisis management into the company's governance structure***: To ensure prompt, efficient and clear communication, lines of authority should be developed ahead of time, and authority should be appropriately delegated (i.e., not centralized) so that messaging can be managed even if senior managers are unavailable or consumed with management of the crisis itself. This is particularly critical in the area of cybersecurity and data breaches. On average, companies take 197 days to identify and 69 days to contain a data breach; companies that are able to respond more quickly limit their risk and that of the data subjects by allowing proactive remedial action to be taken more quickly. Practicing this governance structure in tabletop exercises is critical, and boards should be asking what kinds of tabletop exercises management does and whether the board should be included.

— ***Updating disaster recovery and business continuity plans***: The COVID-19 pandemic has only highlighted the importance of having up-to-date policies, procedures, sites and resources to reallocate personnel and resources in a time of crisis. As companies move to the next phase of COVID-related planning, it is advisable to consider remote working as part of – but not a substitute for – a robust business continuity plan and, perhaps, long-term working structures.

Having a good plan is important, but so is executing on it. In our experience, the companies that respond best to crises, whatever their source, are those that approach the issues as part of a six-factor framework:

1. **Respond Strategically**. Consider the issues, assess priorities and ensure well-defined roles.

2. **Get Counsel Involved Early**. Managing legal risk and privilege protections are critical.

3. **Preserve Documents and Protect Data**. Avoid any perception of cover-up or spoliation.

4. **Communicate Strategically**. Manage a consistent message across constituencies – including governmental agencies, shareholders, employees and the media.

5. **Be Open to Reassessing Strategy**. Constantly look ahead to where the company would like to be post-crisis and think through the steps necessary to get there, including how to potentially turn the crisis into a positive, such as companies that changed product lines to support COVID-19 relief.

6. **Learn**. Get to the root cause of the crisis and put in remediation to prevent it from happening again, communicate that learning to stakeholders and, critically, reassess the crisis management response plan after the crisis abates to determine what worked and what can be improved.

The best messaging is only as good as the ability to get it out.

All companies are likely to face a crisis at some point. It is critical to know how to prepare for, handle and learn from a crisis. Understanding the types of crises most likely to affect your company can help you prepare effectively. Decisions about the early response can have a lasting effect on the risk profile to which the company is exposed and its ability to manage/mitigate risks.

Cleary Gottlieb's Global Crisis Management Handbook is designed to be a useful, practical desk reference and contains helpful checklists keyed to particular phases of crisis management and incident response, cross-referenced to substantive and up-to-date guidance written by Cleary Gottlieb lawyers around the world.

The current version of the handbook is available to download here.

Increased ESG Focus Shows No Signs of Slowing Down in 2021

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The focus on environmental, social and governance (ESG) matters at public companies continues to grow despite, or perhaps in part because of, the COVID-19 pandemic. ESG continues to mean many things, including company considerations around sustainability, diversity, human capital, corporate purpose and governance. While best practices, disclosure requirements and ESG ratings are developing, boards should continue to prioritize ESG issues, particularly as they relate to long-term company strategy and risk.

Institutional Investors Drive ESG

Large institutional investors started 2020 with a focus on sustainability and climate change, with an increasing push into issues surrounding human capital and diversity as the year went on. BlackRock's January 2020 annual letter to CEOs emphasized the importance of confronting climate change risk. Following a summer of protests around issues of racial equity, State Street sent a letter to board chairs of public companies in August setting forth its heightened expectations regarding board and workplace diversity. In addition to a continued focus on ESG generally, influential investors have over the course of the year called for greater uniformity to address what is currently a hodgepodge of different ESG reporting frameworks and standards. Amidst talk of convergence by the various ESG standard setters, BlackRock has put out a call for a single global framework but in the meantime is encouraging companies to use the Sustainability Accounting Standards Board (SASB) and Task Force on Climate-related Financial Disclosures (TCFD) frameworks for sustainability and climate change disclosures, respectively, while State Street rolled out a proprietary scoring system that measures ESG performance.

Shareholders Continue to Engage Through the Proposal Process

Shareholders continue to make their focus on the environmental and social (E&S) prongs of ESG known, submitting more E&S proposals than any other type of proposal in 2020. While the total number of E&S submissions was down, the percentage of E&S proposals voted on and number of E&S proposals passed continued to increase. Similar to institutional investors, other shareholders are focusing on climate change, human capital, gender parity and board and workplace diversity. 2020 also saw activists joining forces with investors, pursuing their goals through the shareholder proposal process rather than just traditional activist board contests.

The spread of COVID-19 increased the amount of attention paid to the "S" in ESG, as investors demanded to hear how companies were navigating the crisis and steps they were taking to address related human capital management issues.

Key Drivers of ESG in 2020

The drivers of ESG focus in 2020 were very much linked to events happening in the outside world. The spread of COVID-19 increased the amount of attention paid to the "S" in ESG, as investors demanded to hear how companies were navigating the crisis and steps they were taking to address related human capital management issues. The pandemic also accelerated the rhetoric toward stakeholder capitalism and away from the pursuit of short-term profit, with an increasing public focus on how companies treat their employees and customers, as capital was retained through dividend reduction and the suspension of share buyback programs.

Racial justice protests across the U.S. elevated issues of racial inequality to the forefront of the corporate conscience, as companies rushed to highlight anti-racism platforms and revisit diversity and inclusion policies. Increased focus on disclosure of racial and gender diversity followed, with institutional investors and proxy advisors asking for increased disclosure and, in November 2020, Nasdaq proposing a new rule that would require listed companies to meet certain board diversity thresholds, or explain why they do not, and to disclose a consistent set of board diversity statistics. Focus on racial and gender diversity and calls for related disclosure have been increasing, and there is no reason to expect that 2021 will be any different.

A Banner Year for Sustainable Investing

2020 is on record as the biggest year for sustainable funds, with $20.9 billion of inflows into sustainable funds in the first half of the year alone (as opposed to $21.4 billion total for all of 2019).[1] Green bonds, sustainability loans and other types of "green finance" are also on the rise. The largest institutional investors are getting in on the action; BlackRock, Vanguard, State Street and Fidelity have all opened ESG-focused investment funds in recent years. As money pours into ESG, concern over the lack of transparency around ESG performance, an absence of uniform ESG disclosure standards and "greenwashing" the impact of ESG activities has increased, leading to greater calls for regulation and standardization. In the UK and the EU, there has been a greater move toward regulating sustainability disclosure and defining what constitutes ESG investments. It will be interesting to see whether these trends toward regulation move from Europe into the U.S. market, particularly under a Biden administration.

Might the Biden SEC Embrace ESG?

The SEC's approach to ESG has been split, with Democratic commissioners signaling an interest in using the SEC to enhance climate change and ESG reporting, but the Jay Clayton-led Commission declining to mandate line-item ESG disclosure. A

1 Morningstar Direct (2020).

majority Democratic Commission has been predicted to be more willing to move beyond principles-based disclosure and embrace more standardized, prescriptive line-item requirements for key areas such as diversity, climate change and sustainability.

2020 has shown that boards should be examining ESG issues regularly, prioritizing these issues and considering the interplay among ESG, corporate strategy and risk. Boards should act to ensure that management, legal, IR and other internal teams have a shared understanding of a company's strategy and long-term plans as it relates to ESG matters and are working toward the same goals.

More ESG Insights

Our 2021 memo includes pieces discussing a number of these aspects of ESG, looking at developments and lessons learned during an unprecedented year and sharing what we see as trends and key takeaways for board focus in 2021.

Please find additional ESG insights in the following pieces:

— Shareholder Engagement Trends and Considerations

— Emphasis on Diversity Initiatives Broadens in Scope and Focuses on Impact

— Corporate Sustainability: Moving Faster and Faster to the Center of Strategy and Shareholder Value

— Progress Since Paris: Sustainable Policy in Europe in 2020 and Beyond

— Fulfilling the Board's Expanded Oversight Role in Human Capital Management

— ESG Considerations for Incentive Compensation Programs

Shareholder Engagement Trends and Considerations

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In 2020, the COVID-19 pandemic, economic uncertainty, divisive politics and a historic social justice movement presented unprecedented challenges for boards. While the pandemic eliminated the concept of an in-person boardroom, as well as investor site visits, one-on-one meetings at conferences and strategy retreats, work did not slow, and most directors reported devoting significantly more time to their duties.[1]

Boards stepped up to the challenge during the crisis, showing heightened awareness of and focus on environmental, social and governance (ESG) issues highlighted by the COVID-19 pandemic, such as company culture, human capital management, long-term strategy and executive compensation.

Shareholders will likely be pushing companies to address strategy adjustments, changes in capital allocation and executive compensation in advance of the 2021 proxy season.

In 2021, maintaining and building shareholder relationships through effective engagement will be more important than ever as boards reflect on 2020 and plan for the future. Shareholders will likely be pushing companies to address strategy adjustments, changes in capital allocation and executive compensation in advance of the 2021 proxy season.[2]

Below, we discuss what is motivating shareholders and considerations for companies and their board members in crafting and executing an effective strategy for communicating with investors and other constituents, during proxy season and the off-season.

[1] PwC 2020 Annual Corporate Directors Survey (2020).

[2] PwC 2020 Annual Corporate Directors Survey (2020).

Background

Shareholder engagement continues to be an important consideration for companies in communicating long-term strategy and deepening relationships with investors. Investors have increased their focus on shareholder engagement in recent years, and large institutional shareholders have made it a priority by expanding their stewardship teams and increasing the number of engagements every year. In the past, shareholder engagement usually involved meetings with company management or the investor relations team, but board members have become increasingly involved in the process.

According to a recent survey, 94% of institutional investors stated they must trust a company's board before making or recommending an investment.[3] In PwC's 2020 Annual Corporate Directors Survey, 58% of the directors reported that a member of their board, apart from the CEO, engaged directly with a shareholder in the past year, up from 51% in 2019 and 42% in 2017.[4] This development is partly due to investors' heightened focus on ESG and any deviations in strategy, as well as their view that directors are well-positioned to discuss company goals.[5]

Both investors and boards share positive feedback on their engagement. According to the Morrow Sodali 2020 Institutional Investor Survey, 91% of institutional investors surveyed stated that engagement at the board level is the most effective way for investors to influence board policies and engagement. From the boards' perspective, 91% of directors thought investors were well-prepared for the engagement, and 87% of directors believe that engagement has or is likely to have a positive impact on proxy voting, substantially up from 59% in 2016.[6]

[3] Edelman Trust Barometer Special Report: Institutional Investors (2020).

[4] PwC 2020 Annual Corporate Directors Survey (2020).

[5] PwC Director-Shareholder Engagement: Getting it Right (2020).

[6] PwC 2020 Annual Corporate Directors Survey (2020).

Large institutional investors continue to focus on strategic matters and remain committed to ESG issues, as part of their off-season engagement.

Off-Season: Shareholder Engagement

While a big part of shareholder engagement in the first half of 2020 was driven by the impact of COVID-19 on company operations and performance, large institutional investors continue to focus on strategic matters and remain committed to ESG issues, as part of their off-season engagement.

BlackRock's Investment Stewardship team had more than 400 engagements in which they discussed the impact of COVID-19 in the first half of 2020 and noted they were able to be supportive as companies sought flexibility from investors in the early days of the COVID-19 pandemic. In its 2020 Investment Stewardship Annual Report, BlackRock noted that "given the unprecedented circumstances, we aimed to be constructive and support companies on proposals outside our normal governance policies, such as virtual shareholder meetings, supporting poison pills, dividend cuts, off-cycle revision of executive pay, and authorization for additional financing without shareholder approval."[7] Concurrently, BlackRock emphasized the importance of corporate leaders seeking a "long-term strategic response to the crisis that is more responsive to the expectations of all their stakeholders."[8]

BlackRock's Investment Stewardship team engaged with more than 1,000 companies in 2020 on corporate strategy, an increase of nearly 50% over the prior year, and noted that companies are responding to an acceleration of strategic trends in digitalization and evolution in global supply chains with a reallocation of capital toward more sustainable business practices.

[7] BlackRock 2020 Investment Stewardship Annual Report (2020).

[8] BlackRock 2020 Investment Stewardship Annual Report (2020).

Moreover, they expected companies to stay committed to societal impact and ESG issues. In 2020, the BlackRock team engaged with over 640 companies on human capital management issues and another 125 on other social issues.[9] Vanguard similarly emphasized the board's responsibility in overseeing a company's long-term strategy and material risks, with a particular focus on climate change and diversity issues.[10] For additional details on these sustainability topics, see Corporate Sustainability: Moving Faster and Faster to the Center of Strategy and Shareholder Value and Emphasis on Diversity Initiatives Broadens in Scope and Focuses on Impact in this memo.

In 2020, investors placed high expectations on company disclosure, especially in light of the COVID-19 pandemic and various corporate measures that were taken in response. BlackRock noted, "companies will have to justify these difficult choices in their 2020 reporting and explain how they weighed their decisions in relation to balancing the interests of investors, employees, customers, suppliers, and communities."[11] Shareholders are not only requesting additional information but also are focusing on the quality of disclosure, in particular with respect to topics such as climate change, human capital management, board involvement in establishing the culture at the company and health and safety indicators.[12]

According to the 2020 Morrow Sodali survey, investors recommend Sustainability Accounting Standards Board (SASB) (81%) and Task Force on Climate-related Financial Disclosures (TCFD) (77%) as best standards to communicate ESG information. Notably, both BlackRock and Vanguard encouraged companies to publish reports aligned with the recommendations of TCFD and the SASB standards. Further, 91% of investors expect companies to demonstrate a link between financial risks, opportunities and outcomes with climate-related disclosures.[13] BlackRock noted in its 2020 annual letter that it will be increasingly disposed to vote against management and board directors "when companies are not making sufficient progress on sustainability-related disclosures and the business practices and plans underlying them."[14] State Street similarly noted that it "will take appropriate voting action against board members at companies in the S&P 500, FTSE 350, ASX 100, TOPIX 100, DAX 30, and CAC 40 indices that are laggards based on their R-Factor scores and that cannot articulate how they plan to improve their score."[15]

A unified and consistent message with robust shareholder communication builds support for the company's long-term plan.

As investors' expectations for enhanced disclosure rise, companies and boards should consider proactively disclosing information of shareholder interest and be prepared to communicate ESG information through relevant metrics.

Considerations for 2021

In preparation for the 2021 proxy season and engagement with shareholders, boards and management should consider the following in developing a strategy for engaging with shareholders and communicating with other stakeholders.

Strategize on Long-Term Plan and Crisis Management

— Be informed and aligned in developing the company's long-term strategic vision. The board should rearticulate the long-term plan for the company based on the lessons learned from the COVID-19 pandemic.

9 BlackRock 2020 Investment Stewardship Annual Report (2020).

10 Vanguard 2020 Investment Stewardship Annual Report (2020).

11 BlackRock 2020 Investment Stewardship Annual Report (2020).

12 Morrow Sodali Institutional Investor Survey (2020).

13 Morrow Sodali Institutional Investor Survey (2020).

14 BlackRock 2020 Annual Letter to CEO (2020).

15 State Street 2020 Annual Letter to Board Member (January 28, 2020).

— Ensure there is consistent messaging among all constituencies (e.g., investors, employees, customers and suppliers). A unified and consistent message with robust shareholder communication builds support for the company's long-term plan, as well as any corporate measures and responses to be taken in response to the pandemic.

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

— Be ready to discuss how key ESG and sustainability topics that are particularly salient to the company and the industry relate to the company's long-term plan.

Know Your Investors

— Identify and pay particular attention to the company's largest shareholders and key stakeholders for regular outreach.

— Review investors' stock holdings, published guidelines, policies, statements, voting history and involvement in campaigns for shareholder proposals, governance initiatives or activism, including any recent adjustments driven by the pandemic.

— Maintain an open mind. Directors often think of a shareholder proposal as a line of attack or an escalation tactic, but some investors think of it as a strategic approach to engagement. Once an investor opens the line of communication with the company, it may be willing to discuss the issue and come to a resolution that results in a withdrawal of the proposal.[16]

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. Some companies describe the number of shareholders with which they met, whether directors participated in the engagement, topics discussed and any changes that the company is implementing or considering implementing as a result.

— Consider making the connection between shareholder engagement and board member skills. Some companies are not only describing how and why the board participates in shareholder engagement but also leveraging disclosure about directors' skills to highlight what the directors bring to the discussion.[17] When proxy materials state that directors are discussing certain topics with shareholders, it is helpful for investors to see what makes those particular directors qualified on those topics.

— Provide more granular ESG-related and other 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, sustainability reports, CSR reports and other publicity vehicles, including social media.

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

[16] PwC Director-Shareholder Engagement: Getting it Right (2020).

[17] PwC Director-Shareholder Engagement: Getting it Right (2020).

Many large institutional investors, especially top shareholders, increasingly expect to be able to directly engage with directors, in particular on questions regarding strategy.

Focus on Key Topics

— Consider adding disclosure and reporting on key concerns for investors such as climate change and human capital management, consistent with frameworks and standards recommended by investors, such as the TCFD and SASB.

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

— Consider linking executive compensation practices to strategy and performance, including financial, operational and sustainability measures.[18]

— 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.

Other Process Considerations for Engagement

— Determine who will be best-positioned to engage directly with investors on a particular topic or issue:

- Management participants usually include the CEO, CFO and an IR officer and may include business development or sustainability teams and, in some cases, the heads of specific business units of interest.
- Many large institutional investors, especially top shareholders, increasingly expect to be able to directly engage with directors, in particular on questions regarding strategy.
- Directors should be trained on how to most effectively engage on these issues.

— Take into account restrictions around quiet periods ahead of earnings releases, typically right after the quarter ends.

— Be vigilant about avoiding disclosure of material nonpublic information that would violate Regulation FD.

— Set a consistent procedure and internal standards on whether to hold audio-only or video meetings as engagement has been and will be virtual for some time.

Proxy Season: Virtual Annual Meetings in the Era of COVID-19

Given various government restrictions on travel, stay-at-home orders and social distancing measures that prohibited gatherings of more than a certain number of individuals, public companies needed to think creatively and quickly about how to approach the traditional proxy season and to hold annual meetings from April through June. Most companies shifted from a proxy season of traditional in-person annual meetings to virtual shareholder meetings. Broadridge Financial Solutions, Inc., one of the most widely used vendors for a virtual meeting platform, reported that it hosted 1,494 virtual shareholder meetings during the first six months of 2020.[19]

[18] For additional details on the use of ESG metrics in incentive compensation, please see ESG Considerations for Incentive Compensation Programs in this memo.

[19] Broadridge, "Virtual Shareholder Meetings 2020 Mid-Year Facts and Figures" (2020).

Looking ahead to the 2021 proxy season, companies can draw on the lessons from 2020 and analyze a few key considerations as they plan for whether and how to hold virtual shareholder meetings.

A company considering a virtual shareholder meeting should take into account the laws of the state in which it is incorporated.

Considerations for 2021

Consider State Corporate Law

— A company considering a virtual shareholder meeting should take into account the laws of the state in which it is incorporated. The majority of states, including Delaware, allow companies to hold virtual-only annual shareholder meetings. Many states that generally require an in-person meeting or a "hybrid meeting" with an in-person component provided relief in 2020 through executive orders or amendments to the governing statutes.

— Originally, the New York Business Corporation Law (NYBCL) did not expressly authorize virtual-only shareholder meetings. New York Governor Andrew Cuomo issued an executive order in March 2020 that temporarily suspended certain subsections of the NYBCL that require meetings of shareholders to be held at a physical location. In June 2020, Governor Cuomo enacted temporary amendments to the NYBCL that codified such relief.[20] Section 602(a) of the NYBCL was temporarily amended to give boards of directors the discretion to convene a virtual-only shareholder meeting.[21] The amendments will remain effective for the duration of the state of emergency, subject to an outside expiration date of December 31, 2021. For New York corporations, boards will have an option of determining whether to hold virtual-only shareholder meetings so long as the state of emergency remains in place.

— The California Corporations Code permits corporations to hold virtual meetings provided that all stockholders consent to the format, a requirement with which it is practically impossible for public companies to comply. California Governor Gavin Newsom in March 2020 issued an executive order that temporarily suspended this shareholder consent requirement for virtual meetings for the duration of the state of emergency.[22]

— The status of this type of relief for 2021 annual meetings remains uncertain, given all the uncertainties around when pandemic related restrictions will wind down. Companies incorporated in states like New York and California will have to prepare for the possibility that a virtual-only meeting may be permitted when the company files its proxy statement but may no longer be permitted by the date of the annual meeting. Conversely, while restrictions on gatherings may be relatively loose when a proxy is filed, increases in COVID-19 cases could lead to restrictions and lockdowns at the time of the annual meeting. Companies should closely monitor developments in their state of incorporation and review their corporate governance documents to utilize any form of emergency relief provided from state restrictions on virtual-only shareholder meetings.

[20] Senate Bill 8412.

[21] Paragraph (a) of Section 602 of the NYBCL, in its amended form, states: "Meetings of shareholders may be held at such place, within or without this state, as may be fixed by or under the by-laws, or if not so fixed, as determined by the board of directors. For the duration of the state disaster emergency declared by executive order two hundred two that began on March seventh, two thousand twenty, if, pursuant to this paragraph or the by-laws of the corporation, the board of directors is authorized to determine the place of a meeting of shareholders, the board of directors may, in its sole discretion, determine that the meeting be held solely by means of electronic communication, the platform/service of which shall be the place of the meeting for purpose of this article."

[22] Executive Order N-40-20 (March 30, 2020).

Companies should engage with their shareholders during the off-season to solicit feedback on the virtual shareholder meeting process from 2020.

Consider Investor Feedback and Consult Virtual Meeting Service Providers

— In planning for 2021, companies should engage with their shareholders during the off-season to solicit feedback on the virtual shareholder meeting process from 2020 and consider implementing changes to address that feedback if necessary.

— Many investors shared positive feedback that they were able to attend annual meetings without traveling, which contributed to greater shareholder attendance. Other shareholders expressed concern about the inability to see management and board members, as a large majority of virtual meetings in the 2020 proxy season were audio only. Some also expressed concerned about a lack of transparency surrounding the Q&A sessions, as shareholders were asked to type their questions into the virtual meeting portal, which was only visible to the company, and shareholders could not see other shareholders' questions.

— While a large majority of virtual meetings during the 2020 proxy season were in audio-only format, we expect that in 2021 an increasing number of companies will incorporate video components for their meetings, as video conferencing capabilities have been enhanced during the pandemic.

— Given concerns raised by investors around these limitations, companies should consult virtual meeting service providers to understand how the platforms may be changing in 2021 and to express suggestions for additional features or enhancements that the company may want to include. With more time to plan, shareholders will be less forgiving and more insistent on opportunities to participate and on the transparency of the Q&A format. Relatedly, many investors continue to indicate a preference for hybrid meeting formats over virtual-only and companies should clearly disclose rationales for virtual-only formats, even during the continuing pandemic.

Consider SEC Staff Guidance

— While state corporate law governs the ability to hold a virtual shareholder meeting, the federal securities laws and SEC rules govern proxy disclosure. The staff of the SEC's Division of Corporate Finance and the Division of Investment Management (SEC Staff) in April issued helpful guidance for conducting shareholder meetings in light of COVID-19 concerns, addressing how companies should disclose changes to the date, time or location of a meeting, including a change from an in-person to a virtual meeting.

— The guidance suggested companies disclose "clear directions as to the logistical details of the 'virtual' or 'hybrid' meeting, including how shareholders can remotely access, participate in and vote at such meeting," and encouraged companies to provide proponents of shareholder proposals with the ability to present their proposals through alternative means, such as by phone.[23]

— Given certain investor concerns about company disclosure on how to access virtual meetings, presentation of shareholder proposals and the transparency of Q&A sessions, it is possible the SEC Staff might issue further guidance on proxy disclosure requirements for those companies planning to hold virtual shareholder meetings in 2021.

Consider Proxy Advisory Firm Guidelines

— At the beginning of 2020, Institutional Shareholder Services (ISS) did not have a policy on virtual shareholder meetings. In April 2020, ISS issued guidance supportive of virtual meetings during the

[23] Staff Guidance for Conducting Shareholder Meetings in Light of COVID-19 Concerns (April 7, 2020), available here.

COVID-19 pandemic and encouraged companies to commit to returning to in-person or hybrid meetings as soon as practicable.[24] Glass Lewis suspended through June 30, 2020, its policy of voting against director nominees who serve on the governance committee of a company that holds virtual meetings without sufficient disclosure about shareholder participation rights.

— In its 2021 proxy voting policy guidelines, Glass Lewis removed the temporary exception to its policy on virtual shareholder meeting disclosure. Specifically, for companies choosing to hold their meeting in a virtual-only format, Glass Lewis expects robust disclosure in the company's proxy statement addressing the ability of shareholders to participate in the meeting. This includes disclosure of shareholders' ability to ask questions at the meeting; procedures, if any, for posting appropriate questions received during the meeting and the company's answers on its public website; and logistical details for meeting access and technical support. When such disclosure is not provided, Glass Lewis will generally hold the governance committee chair responsible.[25]

Maintaining shareholder relationships through effective engagement during the off-season will be more important than ever.

— For 2021, ISS has adopted a policy in its U.S. benchmark guidelines regarding the format of annual meetings. ISS will generally support management proposals allowing hybrid shareholder meetings as long as the intention, in the absence of health or safety concerns, is not to hold virtual-only meetings to the preclusion of in-person meetings. ISS encourages companies to disclose the circumstances under which virtual-only meetings would be held and to afford shareholders the rights and opportunities to participate electronically comparable to those they would have during an in-person meeting. For shareholder proposals, ISS will review case-by-case proposals concerning virtual-only meetings, considering the scope and rationale of the proposal and any concern with prior meeting practices.[26]

In 2021, given the uncertainties surrounding the pandemic, in addition to public safety guidelines and state orders, companies and boards should carefully monitor developments in state corporate law and SEC guidance and consider investor feedback and proxy advisory firms' guidelines as they plan for the proxy season. Contingency planning and flexibility will be key, and maintaining shareholder relationships through effective engagement during the off-season will be more important than ever.

[24] Institutional Shareholder Services (ISS) Policy Guidance, "Impacts of the COVID-19 Pandemic" (April 2020).

[25] Glass Lewis, "2021 Proxy Voting Policy Guidelines" (2020).

[26] Institutional Shareholder Services (ISS), "2021 Benchmark Proxy Voting Policies" (2020).

Emphasis on Diversity Initiatives Broadens in Scope and Focuses on Impact

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Diversity has long been a focus for both companies and stakeholders, but 2020 in particular saw diversity come to the forefront of stakeholders' agendas. Against the backdrop of the ongoing COVID-19 pandemic and its disparate impacts on human capital, alongside increased focus on racial equity and justice and related unrest, we have seen key players across the board push to broaden the scope and impact of diversity issues in the corporate space.

Rapid Expansion of Diversity in Corporate Governance

Looking back only a few years, activists were just starting to focus on increasing the number of women on public company boards. Shareholders primarily drove the initial push by submitting shareholder proposals at companies with a lack of diversity on their boards, prompting initiatives like the NYC Comptroller's Boardroom Accountability Project, which asked companies to adopt "Rooney Rule" policies for both board and CEO appointments and advocated for disclosure of gender pay gaps. Proxy advisory firms published diversity-related voting recommendation policies, and asset owners, asset managers and institutional investors, including State Street, Vanguard and BlackRock, adopted diversity-related voting policies at the board and management levels and asked companies to disclose workforce diversity through EEO-1 Report data. State legislatures then carried the momentum and implemented board gender diversity requirements and/or board and executive diversity reporting requirements, starting with California in 2018 and followed by Illinois in 2019, with more states in the pipeline considering similar legislation.

Board diversity was the second-highest engagement priority identified by shareholders during the 2020 proxy season,[1] and significant activity has continued in this space. Companies will want to ensure they are well-positioned to engage and communicate on these topics as they head into the 2021 proxy season.

Through the COVID-19 pandemic, women and racially and ethnically underrepresented workers have been disproportionately impacted by employment and promotion challenges.

COVID-19 and Social Movements Highlight Diversity Issues in 2020

Through the COVID-19 pandemic, women and racially and ethnically underrepresented workers have been disproportionately impacted by employment and promotion challenges.[2] In September, over 850,000 women left the workforce in the U.S., more than four times as many as men during the same period.[3] At the height of the first wave of the pandemic in the U.S., people identifying as Latinx and Black suffered the highest unemployment rates, approximately 19% and 16.4%, respectively, compared to 13% for people identifying as White.[4] A disproportionate number of these people were racially and ethnically underrepresented female workers; the peak unemployment rates for Latinx women, Black women and White women during the pandemic were approximately 21%, 17.5% and 14%, respectively, compared to approximately 17%, 16% and 11.5% for Latinx men, Black men and White men, respectively.[5] Key stakeholders are well aware of this issue and have responded.

Much of shareholder engagement in 2020 centered around employee welfare and support for members of the workforce who might be more significantly impacted by the economic volatility caused by the pandemic. Similar questions regarding companies' responses to COVID-19 on its human capital, resources and management echoed at many annual meetings.

Shareholders are expecting to see progress – regardless of the degree to which the pandemic continues to have an impact.

The conversations surrounding human capital will continue to be a lively topic in 2021, and public companies should keep in mind that the level of scrutiny placed on a company's policies and progress in promoting diversity, equity and inclusion at all levels of seniority will continue into the 2021 proxy season.[6] Shareholders are expecting to see progress – regardless of the degree to which the pandemic continues to have an impact. Investor and proxy advisory firm activity in recent months, for example, shows that investors are becoming more active in utilizing their shareholder voting power to promote positive social changes, particularly when it comes to diversity:

— BlackRock released its 2021 Stewardship Expectations, which includes a reinforced focus on diversity. Citing that "41% of companies where [BlackRock] voted against directors for diversity reasons in 2019 increased

1 Harvard Law School Forum on Corporate Governance, "Four ESG Highlights from the 2020 Proxy Season" (August 23, 2020), available here.

2 See, e.g., *id.*; Centers for Disease Control and Prevention, "Health Equity Considerations & Racial & Ethnic Minority Groups" (July 24, 2020), available here; and Economic Policy Institute, "Black workers face two of the most lethal preexisting conditions for coronavirus—racism and economic inequality" (June 1, 2020), available here.

3 Michael Madowitz and Diana Boesch, "The Shambolic Response to the Public Health and Economic Crisis Has Women on the Brink as the Job Recovery Stalls" (Washington: Center for American Progress, October 22, 2020), available here.

4 Rogelio Saenz & Corey Sparks, "The Inequities of Job Loss and Recovery Amid the COVID-19 Pandemic" (August 11, 2020), available here.

5 *Id.*

6 For additional information on developments relating to human capital management, see Fulfilling the Board's Expanded Oversight Role in Human Capital Management in this memo.

their board diversity the following year,"[7] BlackRock plans to use voting against directors as its "most frequent course of action" at any company it believes is not moving with sufficient speed and urgency on gender and racial diversity during the 2021 proxy season.

— ISS proposed a new policy for U.S. companies, effective February 2022, to recommend against the chair of the nominating committee (or other relevant directors on a case-by-case basis) at any S&P 1500 or Russell 3000 company with no identified racially or ethnically diverse members on its board. ISS's guidelines already include a policy to recommend against the chair of the nominating committee of any board that has no female directors.

— Glass Lewis currently has a policy to recommend voting against the nominating committee chair at any Russell 3000 company with no female directors; Glass Lewis will increase the minimum to at least two female directors for shareholder meetings held after January 2022, placing pressure on boards that currently only have one female director. Glass Lewis also announced that it will begin tracking the quality of director diversity and skills disclosure in proxy statements, and, beginning with the 2021 proxy season, its reports for S&P 500 companies will include an assessment of such disclosures.

We expect to see more diversity shareholder proposals in the 2021 proxy season, including board diversity and skills matrices proposals and gender pay gap proposals, and to see continued higher levels of support as more institutional investors beyond the traditional ones like BlackRock, Vanguard and State Street have instituted policies of supporting these and other diversity-related proposals.

[7] BlackRock, "2021 Stewardship Expectations" (2020), available here.

Diversity Efforts Spread Beyond Investors

Historically, many of the diversity-focused efforts in the governance space have been led by investors, including institutional investors, smaller investors (Arjuna Capital, As You Sow, Trillium Asset Management and other "ESG investors"), state pension funds and comptrollers and proxy advisory firms (ISS and Glass Lewis). In 2020, however, there was a sharp increase in activity originating from parties not traditionally in this group.

These new initiatives target not only public companies but also private companies that are thinking about going public – sending a clear message that the market no longer views diversity as an option.

Much like the state-led legislative efforts in the last few years, these new efforts from market makers, regulatory bodies and stock exchanges will likely prompt even more rapid progress in the coming years. Unlike previous initiatives in this space, these new initiatives target not only public companies but also private companies that are thinking about going public – sending a clear message that the market no longer views diversity as an option.

— Private companies planning their initial public offerings now face pressure to have diversity on their boards as they go public. Goldman Sachs, one of the leading underwriters of IPOs both domestically and internationally, announced that, as of this past summer, it would no longer underwrite IPOs of any company in the U.S. or in Europe that did not have at least one director "from a traditionally underrepresented group based on gender, race, ethnicity, sexual orientation or gender identity."[8] Despite the estimated $101 million in lost fees from

[8] Washington Post, "Goldman Sachs CEO says it won't take a company public without diversity on its board" (January 23, 2020), available here.

up to 18 U.S. IPOs if the policy had been effective in 2019,[9] Goldman Sachs further announced plans to increase the threshold to two diverse directors in 2021. While other major Wall Street investment banks have not yet announced similar policies, the takeaway for private companies is that the traditional grace period for newly public companies to increase board diversity is quickly disappearing and diversity issues need to be a priority for both the board and management earlier in the process.

— At the beginning of December, Nasdaq submitted new listing requirements for board diversity to the SEC for approval.[10] Under the new listing requirements, Nasdaq-listed companies would be required to (i) publicly disclose transparent board diversity statistics and (ii) have at least two diverse directors by a certain date, including one self-identified female director and one self-identified underrepresented minority or LGBTQ+ director, or disclose why they do not. The diversity disclosure requirements include a board diversity matrix, which identifies a breakdown of the number of directors who identify as male, female and non-binary, and the number of directors who identify as LGBTQ+ and/or a number of different race and ethnicity categories.[11] This proposed listing requirement would apply to both companies already listed on Nasdaq (and continued noncompliance may result in delisting, if a company does not publicly disclose the reason for failure to comply) and companies that are preparing for their initial public offering and have decided to list on Nasdaq. Although the New York Stock Exchange currently does not have any such listing requirement, it would not be surprising if it followed with a similar proposal to the SEC, assuming the Nasdaq proposal is approved.

— This fall, the SEC adopted amendments to Item 101 of Regulation S-K, explicitly writing into the rule a requirement to include more detailed human capital disclosure in Exchange Act reports.[12] While the rule is largely principles-based and does not outline a definitive list of topics that are required for disclosure, many companies that have filed reports in compliance with the new rule have taken the position that human capital disclosure should include diversity, equity and inclusion statistics for the company's general employee workforce – in a similar vein to the disclosure of certain self-identified diversity characteristics of board directors and nominees pursuant to the C&DIs that the SEC staff published last year.[13] As companies prepare their year-end Form 10-K reports and proxy statement disclosures, boards should carefully consider whether diversity statistics, policies and other related disclosures are warranted as being material to an understanding of a company's business and, if so, how best to present such disclosures.

— Following its 2018 legislation requiring at least one female director on all boards of companies headquartered in California, California enacted a law (AB 979) in September 2020 that requires public companies headquartered in California also to elect at least one racially/ethnically underrepresented director by the end of 2021. By the end of 2022, the law requires these companies to have at least two racially/ethnically underrepresented directors on boards with five to eight members, and three racially/ethnically underrepresented directors on boards with nine or more members. While we may see similar legal challenges brought against AB 979 as we did against the 2018 gender diversity law, we may also see other states following suit and proposing similar legislation, much like they did in 2018 and after.

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9 Bloomberg Law, "Analysis: IPO Diversity Plan May Cost Goldman $101M in Lost Fees" (January 28, 2020), available here.

10 Nasdaq, "Nasdaq proposed new listing requirement rule change, filed with the SEC pursuant to Rule 19b-4 of the Securities Exchange Act of 1934" (2020), available here.

11 Nasdaq, "Nasdaq Board Diversity Matrix instructions", available here.

12 SEC Release No. 33-10825, Final Rule: Modernization of Regulation S-K Items 101, 103 and 105, available here.

13 SEC Division of Corporation Finance, Compliance and Disclosure Interpretations 116.11 and 133.13, available here.

The fact that a critical mass of companies in the Fortune 500 now have at least one female director on the board is not a sufficient demonstration of diversity at the senior levels of a company.

Looking Ahead to Engagement in 2021

The message behind these initiatives is clear – the fact that a critical mass of companies in the Fortune 500 now have at least one female director on the board is not a sufficient demonstration of diversity at the senior levels of a company. Key stakeholders are calling for more kinds of representation on the board and beyond the board, and particular attention is being paid to employees and the broader workforce. For example, this summer the NYC Comptroller sent letters to the CEOs of 67 S&P 100 companies, asking them to reaffirm their commitments to racial diversity, equity and inclusion and requesting disclosure of their annual EEO-1 Report data. Companies that did not respond to the letter are seeing related shareholder proposals submitted by the NYC Comptroller for their upcoming annual meetings. Stakeholders increasingly want to engage with companies and know what the company is doing to improve the status quo, from the board to management and employees.

Diversity being at the forefront of governance issues, especially given the experience of 2020, should not come as a surprise to anyone; however, we expect stakeholders to have a certain degree of patience, understanding that progress in this area does not happen overnight. Engagement with stakeholders will continue to be crucial in this respect, and company boards, management and investor relations teams should be prepared going into the 2021 proxy season to address diversity topics when meeting with investors and other stakeholders.

Action and progress metrics will be a key part of engagement discussions with stakeholders, as stakeholders are no longer content with just reading diversity commitments without seeing results. In 2020, shareholders filed three separate derivative lawsuits in California federal court against the directors and officers of Facebook, Inc., Oracle Corporation and Qualcomm, Inc., respectively, alleging that the boards and management teams of these companies failed to deliver on their commitments to diversity, despite public disclosures made by the companies about the importance of diversity within their respective organizations.[14] A number of other similar suits have risen since then, and while the initial lawsuits were filed in California, one of the latest in this string of derivative suits was filed in the U.S. District Court for the District of Columbia.

Whether or not these complaints are successfully sustained, they show that the trend of shareholders stepping into courts to hold companies accountable will most likely continue. Stakeholders throughout 2020 made it clear that they increasingly expect companies to follow through on their commitments and are more than willing to take proactive steps to ensure that measurable improvements and progress are being made.

Companies should be thoughtful about crafting a narrative that provides some transparency into target goals and updated progress made toward such goals with stakeholders in the coming proxy season.

Given these shareholder actions, companies should be thoughtful about crafting a narrative that provides some transparency into target goals and updated progress made toward such goals with stakeholders in the coming proxy season. Before announcing any goals and commitments to investors and the market, companies should consider their ability to adequately measure progress and how they propose to identify

[14] See Cleary's alert memo on this topic for more information, available here.

milestones that will spotlight the ways in which they are acting on and achieving these commitments.

While companies should move thoughtfully, the key to effective communication in these dialogues is to avoid a repeat of prior conversations and public statements on this topic – investors want to know how the company is thinking about diversity issues, what the short-term and long-term goals are and how a company is going to follow through on those goals within a defined period of time. As a starting point, company boards should routinely review their own membership, the composition of management and data at the broader workforce level to see what diversity profile the company has as a whole, and what plans are in place to further promote and advance diversity, equity and inclusion.

Moving forward, companies should think about diversity issues holistically: it is important to see more representation of female and racially/ethnically underrepresented directors, management and employees at a company, but equally important are adequate training and professional development initiatives, retention and promotion pipeline structures and other forms of support that ensure the long-term success of these advances. Taking a broader view will help companies meet stakeholders' expectations, now and in the future.

Corporate Sustainability: Moving Faster and Faster to the Center of Strategy and Shareholder Value

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Corporate sustainability has in a few short years become a mainstream capital allocation and voting criterion for many institutional investors. As a consequence, those investors are calling for consistent, comparable and reliable sustainability disclosure capturing the risks and opportunities faced by the businesses in which they invest.[1]

A majority of U.S. and global companies provide some form of curated sustainability disclosure,[2] but those efforts are short of what the investment community appears to want. There are reasons for this disconnect, but an evolution is occurring that likely will narrow the gap and create a more rigorous and standardized sustainability disclosure regime – and it's all happening more quickly than might have been imagined even a year ago.

Disclosure, of course, is only a means to an end. The end is a better understanding of corporate strategy and governance in light of sustainability considerations. But achieving that understanding through more structured sustainability disclosure would have significant implications for boards and management teams. One such implication is that corporate operations would be exposed to and quantified from a new perspective. Stakeholders in turn would be empowered to discuss a company's strategic and governance efforts to manage a broader range of sustainability risks and opportunities than are part of the typical dialogue with stakeholders today.

1 Many stakeholders other than investors are also interested in sustainability disclosure. We focus in this note on the investor perspective because it is an easily understood driver of corporate strategy.

2 A recent KPMG report notes that within their survey group, 80% of companies globally and 90% of companies in North America reported on sustainability in 2020. See The Time Has Come: The KPMG Survey of Sustainability Reporting 2020 (December 2020), available here (the "KPMG Report"). Other reports note slightly different numbers based on different methodologies, but the upward trend is clear.

Now is the time to form business strategies that address a similarly broad range of sustainability topics so that you're ready to have that discussion from a position of preparation, knowledge and strength.

Now is the time to form business strategies that address a similarly broad range of sustainability topics.

Why Investors Both Care About and Are Unsatisfied With Sustainability Disclosure

Private and academic research indicates a correlation between good management of corporate sustainability issues and financial outperformance, though a causal link has yet to be substantiated.[3] The investment community has taken this research, together with a number of important societal and demographic trends, to heart and increasingly views sustainability disclosure as a valuable information class to be incorporated into capital allocation and voting decisions. Within the umbrella of sustainability, climate change was the initial issue to attract wide attention as a source of financial risk. Human capital management is currently ascendant, and other issues such as diversity, fair pay and child labor, along with bio-diversity, could soon take on similar relevance.[4]

And yet frustration with the current state of the available information is noticeable. Investors point to the lack of consistency across time periods, the lack of comparability across industries and geographies and the lack of systematic assurance as to reliability (i.e., lack of internal controls and board oversight).[5]

Public companies, on the other hand, face a dizzying array of sustainability disclosure standards and frameworks under which they could report and a burdensome number of individual data requests that come in differing formats. The result is unsatisfying: a labor-intensive effort to produce a patchwork of sustainability disclosures that leave investors short of having consistent and comparable information on which to compare one company to another.[6]

Layers of issues underlie this state of affairs. The many existing sustainability standards are not necessarily substitutes for each other because they have different purposes and address the needs of different (and potentially non-overlapping) audiences. Global Reporting Initiative (GRI), for example, has a public interest focus on the impact of a business's operations from a macro societal perspective. Climate Disclosure Standards Board (CDSB) and Sustainability Accounting Standards Board (SASB), on the other hand, focus on disclosures that are material for decision-makers responsible for enterprise value creation, a perspective more analogous to that of financial statement standards such as GAAP and IFRS. By definition, competing standards that are designed for differing purposes and audiences will produce information that is difficult to compare.

Another layer is that adherence to any one standard is voluntary, which allows reporting companies discretion as to which disclosures and metrics to make public. Many sustainability reports are self-described as being "informed by" the SASB or CDSB standards, rather than being in compliance with their full scope. As a result, two companies in the same industry that adopt the same

3 HSBC Insights (March 27, 2020), available here; "Sustainability: The future of investing," BlackRock (February 1, 2019), available here; Alexander Bassen, Timo Busch, and Gunnar Friede, "ESG and financial performance: Aggregated evidence from more than 2000 empirical studies," *Journal of Sustainable Finance & Investment*, 2015, Volume 5, Issue 4, p. 210–33.

4 See the KPMG Report.

5 Reported information is more useful when it affirmatively possesses the noted characteristics. See "Statement of Intent to Work Together Towards Comprehensive Corporate Reporting", facilitated by the Impact Management Project, World Economic Forum and Deloitte (September 2020), available here (the "Five Standard Setter Statement"). See also "More than values: The value-based sustainability reporting that investors want", by McKinsey & Company (August 7, 2019), available here (the "McKinsey Report").

6 See the McKinsey Report.

reporting standard may choose to make disclosures on different topics and utilize different metrics within the standard, which creates a lack of comparability and leaves holes in the data sets used by investors.

In many ways, sustainability disclosure as a discipline is in its infancy.

In many ways, sustainability disclosure as a discipline is in its infancy. One possible path to its maturation could mimic the development of the accounting profession's standards for disclosure of financial information and the related control, oversight and assurance environment that supports it. Such a path would require that a *single trusted standard* emerge that is required to be *uniformly applied* as a consequence of investor demand or regulatory mandate. Ideally, like financial disclosure, a robust infrastructure of controls, oversight and verification would also grow around the adopted standard.

Recent Developments Point to Convergence of Standards and the Potential for Uniform Application

The past year saw a number of announcements that marked significant milestones in the march toward convergence of standards and uniform use of those standards:

— Five major sustainability disclosure standard and framework setting institutions (GRI, CDSB, SASB, International Integrated Reporting Council (IIRC) and CDP) announced a statement of intent to work together toward a comprehensive corporate reporting system.[7]

— IIRC and SASB announced their plan to merge.[8]

— Major institutional investors announced their support for specific standard setters; for instance, BlackRock endorsed both SASB (which is industry-specific) and Task Force on Climate-Related Financial Disclosures (TCFD) (which is climate-specific) frameworks.[9]

— The Biden administration will bring new leadership to the SEC and a fresh look at whether to mandate sustainability disclosure standards, possibly building on the work of one or more of the major standard setters. The European Union is also continuing its ambitious project to update its directives on sustainability reporting and is considering the development of standards. For additional information on sustainability developments in the EU, please see Progress Since Paris: Sustainable Policy in Europe in 2020 and Beyond in this memo.

We believe a key governance trend of 2021 will be increasing incorporation of sustainable business practices into corporate strategy and decision-making.

What This Means for Strategy and Decision-Making at Boards and Management Teams

We believe a key governance trend of 2021 will be increasing incorporation of sustainable business practices into corporate strategy and decision-making. In the U.S., there are many examples of management compensation being tied to one or more specified sustainability metrics. For example, Starbucks has tied a portion of compensation to diversity goals,[10] Alcoa to

7 See the Five Standard Setter Statement. Id.

8 IIRC and SASB announce intent to merge in major step towards simplifying the corporate reporting system (November 25, 2020), available here.

9 BlackRock, A Fundamental Reshaping of Finance (2020), available here.

10 See Bizjournals, Starbucks ties executive pay to diversity goals (October 15, 2020), available here.

safety, environmental stewardship and diversity goals[11] and Exelon to reducing green-house gas emissions.[12] We expect a significant expansion of the number of metrics used and the sophistication of their incorporation into decision-making and governance.

We expect management teams will expand their curated sustainability disclosures to come closer to full compliance with voluntarily adopted standards.

The standards, practices and regulatory requirements surrounding sustainability disclosure as a free-standing discipline are evolving, and events in 2020 indicate that the pace is poised to accelerate. The potential exists for a single trusted standard to emerge over the medium term through a combination of pressure from investors and regulators. Over the shorter term, we expect management teams will expand their curated sustainability disclosures to come closer to full compliance with voluntarily adopted standards. More rigorous and standardized sustainability disclosure over time will cause corporate sustainability to be at the forefront of the dialogue with stakeholders; as a result, management teams in the medium term will find themselves practicing "sustainability governance." A recent motivator of this expanding dialogue can be seen in ISS's 2021 voting policy update which for the first time includes "demonstrably poor risk oversight of environmental and social issues, including climate change" as a potential oversight failure that could lead to an "against" or "withhold" vote on directors.

Corporate operations will increasingly be exposed to and quantified from a new perspective. As a result, stakeholders will be empowered to discuss a company's strategic and governance efforts to identify, quantify and manage a broader range of sustainability risks and opportunities than are part of the typical dialogue with stakeholders today. Now is the time to form business strategies that address a similarly broad range of sustainability topics so that you're ready to have that discussion from a position of preparation, knowledge and strength.

11 2019 Alcoa Sustainability Report, available here.

12 2019 Exelon Sustainability Report, available here.

Progress Since Paris: Sustainable Policy in Europe in 2020 and Beyond

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Following the celebration of the five-year anniversary of the Paris climate conference (COP21) in December 2020, Europe stands out as one of the leaders in developing policies that support the goals of the Paris Agreement, providing frameworks for companies and investors alike to redirect capital flows toward environmentally sustainable activities, as well as various mechanisms to alleviate the social impact of the transition to a greener economy.

Although Europe has long demonstrated its commitment to sustainability, ranging from the adoption of its emissions trading system in 2003 to its 2009 climate and energy package to its 2014 framework on non-financial reporting, the approach considerably accelerated in 2020. This is largely due to the momentum following the European Commission's December 2019 announcement of its Green Deal, a comprehensive roadmap seeking to make Europe the first climate-neutral continent by 2050, as well as various calls from companies, business leaders and civil society organizations to place health, well-being and the protection of the environment and wildlife at the heart of the EU's post-pandemic recovery.

In addition to the Green Deal, which includes a broad scope of funding measures, regulatory reform and policy proposals affecting the energy, transportation, agriculture, construction and financial sectors, the European Commission has further advanced in the last year in developing policy to implement its sustainable finance action plan. The plan is designed, on the one hand, to maximize opportunities and tools for corporates, financial firms and retail investors to "finance green" and, on the other hand, to further integrate sustainability considerations into financial institutions' governance and risk management frameworks, thereby "greening finance."

This "greening" requires developing new areas of policy, most notably the new EU Taxonomy Regulation for the classification of sustainable activities, intended to provide certain businesses and investors with a common language to identify the extent to which economic activities (and, by extension, investments) can be considered environmentally sustainable or "green." Under the Taxonomy Regulation, an economic activity will be deemed to be "environmentally sustainable" if it contributes substantially to, and does not significantly harm, climate change mitigation, climate change adaptation, sustainable use of water and marine resources, the transition to a circular economy, pollution prevention and control and the protection of biodiversity and ecosystems. First disclosures with regard to the Taxonomy Regulation's climate change mitigation and climate change adaptation objectives will be due in January 2022, while disclosures with respect to the remaining four environmental objectives will be due in January 2023.

The extensive requirements are expected to drive firms to review how sustainability risks are incorporated into their investment decision-making processes.

In addition, under the EU Sustainable Finance Disclosure Regulation (SFDR), new disclosure obligations will be required for certain financial services firms – including, in particular, asset managers and fund managers – with respect to website disclosures, pre-contractual disclosures (including descriptions of sustainability risks and information on how sustainability criteria are analyzed in fund prospectuses) and periodic reporting to investors. The extensive requirements are expected to drive firms to review how sustainability risks are incorporated into their investment decision-making processes and, potentially, to make internal strategic changes as to how they operate their business, both for purposes of achieving compliance with the SFDR and (re-)positioning themselves in the financial market. This process will in turn require significant engagement with investee companies to inform decision-making and understand a fund's overall sustainability footprint (as well as with investors or other intermediaries who may themselves be subject to the requirements) and ongoing due diligence and portfolio monitoring.

Furthermore, since 2017, under the Non-Financial Reporting Directive (NFRD), publicly listed companies, banks, insurance companies, and such other companies designated as public-interest entities by national authorities are required to publish, in the context of their ongoing public reporting, on the policies they implement in relation to environmental protection, social responsibility and the treatment of employees, respect for human rights, anti-corruption and bribery, and board diversity. In 2019, the European Union went a step further by issuing guidance on disclosure of climate-related information in line with the recommendations of the Financial Stability Board's Task Force on Climate-Related Financial Disclosures.

Each of these legislative developments requires extensive drafting, debate, consultation with stakeholders and review of expert opinions, leading to significant changes that will take effect in phases over 2021, 2022 and beyond. In the meantime, EU Member States are working on transposing approved frameworks into national law and providing guidance to companies and banks on how they intend to interpret and enforce the requirements. Certain policy measures have also been subject to diverging positions among the European institutions themselves, as was seen with the EU Parliament's recent vote to increase green-house gas reduction targets to at least 60% by 2030 (whereas the Commission had previously proposed 55%). While a cohesive approach to many policy areas is being defined in Brussels, each Member State will need to apply the various frameworks in a way that appropriately takes into account the interests of its own domestic constituents.

Another policy area that has developed considerably more at the Member State level over the last year is mandatory human rights and sustainability due diligence frameworks. Certain Member States, such as France, have already adopted their own national legal frameworks while others are currently in parliamentary negotiations. In the wake of this momentum, the Commission has committed to introduce legislation for mandatory human rights and environmental due diligence on global supply chains by 2021. In general, these frameworks define human rights broadly, including not only concepts such as civil and political rights, but also more modern interpretations, such as the right to a clean environment and various implications of the right to privacy in the digital age.

None of this precludes global organizations and financial institutions from continuing their voluntary sustainability-related projects in the interim, whether relating to sustainable sourcing and procurement, efficient energy consumption, carbon offset schemes or recycling programs. Moreover, in the wake of the COVID-19 outbreak, many companies are taking stock of their sustainability footprint, which may include investing in technology, R&D and innovation projects and divesting from activities that are unlikely to ever be classified as sustainable. In fact, while different regulators work through statutory and other regimes, many companies are already far ahead in their thinking with robust programs and strategies on sustainability and will have to adapt those programs to various regulatory regimes going forward.

The absence of a common global approach to measuring sustainability efforts and ESG criteria has hindered the development of sustainable investing.

It is almost universally acknowledged that the absence of a common global approach to measuring sustainability efforts and ESG criteria has hindered the development of sustainable investing (notwithstanding its significant growth in recent years). The multiplicity of competing reporting standards (the so-called alphabet soup of goals, initiatives, frameworks and guidelines) has made accurate comparisons difficult and facilitated greenwashing. It would be impossible to address this through uncoordinated actions at the level of individual nation states and in any case some of those that might have provided leadership in this area have been distracted by domestic politics in recent years. Therefore, it is not surprising that not only has the EU become the main driver of harmonization efforts that go beyond the voluntary guidelines and take the form of binding rules, but that a number of countries outside the EU are emulating the European approach, either openly or implicitly.

One example is the United Arab Emirates: a nation built with petrodollars is now leading the regional charge toward the sustainable diversified economies of the future. In January 2020, the country's regulatory authorities published their "Guiding Principles on Sustainable Finance," aimed at increasing implementation and integration of sustainable practices among the UAE's financial entities. The second of the three voluntary principles emphasizes the importance of adopting minimum eligibility requirements for what constitute "sustainable" financial products and signals the authorities' intention to adopt an appropriate taxonomy in the UAE in due course. Until such adoption, the UAE authorities intend to rely on internationally recognized taxonomies for guidance and explicitly refer to (among others) the European Commission's 2018 Action Plan and "associated regulatory proposals" (i.e., the Taxonomy Regulation).

Many jurisdictions seem content to allow the EU to do the heavy lifting on ESG harmonization. Given that international investors based in their own markets will need to comply with the EU rules in any event, in the same way as EU-style competition and antitrust regimes have multiplied around the world in recent decades, and data protection rules modelled on the GDPR have started to appear on the global regulatory horizon, it seems reasonable to anticipate regional and national sustainable frameworks similar to the EU's Green Deal and Action Plan and the regulations and directives adopted under them. Given the change in administration, a key question for 2021 is the extent to which the U.S. approach will diverge from the European one in the coming years. For additional information on the U.S. approach to sustainability, please see Corporate Sustainability: Moving Faster and Faster to the Center of Strategy and Shareholder Value in this memo.

U.S. boards should be looking at regulation in Europe when considering green finance.

U.S. boards should be looking at regulation in Europe when considering green finance, their own sustainability and other ESG reporting and disclosure and human capital and supply chain considerations, especially as a Biden administration will likely itself look to Europe as it considers its own efforts toward climate and sustainability regulation. Against this backdrop, the first quarter of 2021 would be a good time for companies to revisit the overall sustainability outlook for the near- and medium-term and determine whether ESG factors have been appropriately reflected at all levels of the organization, whether relating to disclosure, board and management composition, operations, capital-raising, acquisitions or managing relations with employees and stakeholders, particularly with a view toward mitigating enforcement or disputes risks. In building these considerations into their broader business strategy, organizations can better ensure that projects undertaken today will be aligned with the standards that will drive investment decisions tomorrow.

Fulfilling the Board's Expanded Oversight Role in Human Capital Management


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Over the past few years, many boards have expanded their oversight and consideration of human capital management (HCM) to encompass issues beyond executive hiring and compensation. Before the COVID-19 pandemic, technology and the culture change brought by a new generation of workers had already commenced an irreversible shift in paradigm that established HCM as a board-level issue with vital strategic and risk oversight implications.

HCM issues can have far-reaching consequences for companies and their employees and, in some cases, be subject to significant scrutiny by investors, regulators and the public.

The pandemic, widespread protests for racial justice, the global #MeToo movement, election uncertainty and other recent developments have further sharpened the attention given to HCM as companies take, or fail to take, measures to protect and support employees, manage staffing levels and promote business continuity in the face of widespread economic crisis, geopolitical tensions, rising unemployment, corporate scandal and social unrest. Far from being ordinary course matters siloed in human resource departments, HCM issues can have far-reaching consequences for companies and their employees and, in some cases, be subject to significant scrutiny by investors, regulators and the public, resulting in additional reputational and financial risks.

As a driver and consequence of the increased importance of HCM, investors and other stakeholders have continued to intensify and calibrate their calls for greater attention, accountability and transparency.[1] These efforts have yielded significant results; many boards have adapted their practices and are considering HCM issues on a regular basis,[2] and on August 26, 2020, the SEC amended its rules to require public companies to disclose their human capital resources to the extent material.[3] In addition, there have been increasing calls for enhanced diversity reporting by shareholders and others both inside and outside the shareholder proposal process.

Last year, we recommended that boards identify key indicators that would help them assess the health of the management/labor relationship and the company's return on investment on its workforce. Here, we renew and expand that recommendation in light of the new SEC disclosure rule and further suggest that companies continue to fine-tune and formalize the processes and allocation of responsibility for HCM oversight at the board level.

Defining HCM Measures

In order to best consider HCM matters, companies should clearly define the factors and information that they measure, monitor and disclose. These could include measures of employee satisfaction and development (including diversity, pay equity and representation of minorities and women in management), measures of employee engagement (including changes in the rate of discrimination claims and hotline complaints, absenteeism and voluntary turnover), talent (including assessments of the current workforce's ability to meet new demands and whether recruiting efforts and training programs address future needs) and culture (including the identification of cultural tenets for the organization).

Several commentators and stakeholders have suggested specific sets of principles, frameworks and baseline measures that companies and their boards can adopt to comply with an expanded board oversight mandate and the new disclosure requirements. Framework approaches are gaining traction in other areas, such as sustainability, as they help to harmonize and standardize practices and promote comparability between companies in similar business sectors.[4] For additional information on sustainability frameworks and considerations, please see Corporate Sustainability: Moving Faster and Faster to the Center of Strategy and Shareholder Value in this memo.

At least some of the existing frameworks already include human capital metrics. The Sustainability Accounting Standards Board (SASB), which promulgates the SASB Standards for sustainability reporting, recently released a summary of topics and metrics related to human capital that companies can use to help structure their responses to the new SEC requirements. The metrics called out as relevant to HCM fall into three general categories:

1. Employee health and safety (e.g., amount of monetary losses resulting from legal proceedings associated with health and safety violations);

2. Employee engagement, diversity and inclusion (e.g., percentage of gender and racial/ethnic group representation in management, technical staff and other employees); and

[1] See, for example, BlackRock's 2021 Stewardship Expectations, available here, which asks investee companies, among other things, that their board and workforce diversity be consistent with local market best practice. The Stewardship Expectations also anticipate BlackRock's increased engagement with respect to how companies "manage their impacts on people, including their employees, suppliers, customers, communities, indigenous peoples and other stakeholders."

[2] For example, in a fall of 2019 survey of 378 U.S. public company directors, 79% of respondents said that their boards spends more time discussing talent strategy than they did five years before the survey, and 40% of the respondents said that their board discusses human capital matters at every board meeting. See EY Center for Board Matters, How the Governance of Human Capital and Talent is Shifting – Key findings from a survey of public company directors (May 19, 2020), available here.

[3] See Cleary Gottlieb, SEC Adjusts Disclosure Requirements for Public Companies (September 4, 2020), available here; SEC Release No. 33-10825 (Aug. 26, 2020), available here.

[4] Calls for standardization in environmental, social and governance (ESG) disclosure have been growing among investors and other stakeholders. For example, in his annual letter to CEOs earlier this year, BlackRock's Chairman and Chief Executive Officer Larry Fink encouraged widespread and standardized adoption of sustainability reporting, and asked investee companies to publish disclosure in line with industry-specific SASB guidelines, including with respect to labor practices, by year-end. The request came with a warning: BlackRock "will be increasingly disposed to vote against management and board directors when companies are not making sufficient progress on sustainability-related disclosures."

3. Labor practices (e.g., percentage of active workers covered under collective bargaining agreements).[5]

In the same vein, the Human Capital Management Coalition (HCMC), an influential group of major pension funds and other institutional investors, published a comprehensive framework for businesses to measure and value social and human capital in an effort to improve business and investment decision-making.[6]

Finally, shareholders continue to push for standardized disclosure. In 2020, two Rule 14a-8 shareholder proposals seeking SASB-aligned human capital disclosure passed with overwhelming shareholder support,[7] and we expect future proposals to pass where the company has not adopted substantial sustainability reporting.

Formalizing the Board's Role in HCM

Besides the adoption of HCM measures and more transparent disclosure, some boards have signaled their greater attention to HCM issues in their inclusion of HCM matters and broader employee compensation review in board committee agendas, governance charters and policies. For example, some companies have changed the name of the board committee responsible for executive compensation to reflect the committee's supervision of HCM matters (e.g., "Human Resources and Compensation Committee"). Others have explicitly included HCM responsibilities in their committee charters.

Some companies have tied executive compensation to measurable HCM goals such as diversity and inclusion, talent management, retention, and pay equity.

Some companies have gone further yet and tied executive compensation to measurable HCM goals such as diversity and inclusion, talent management, retention, and pay equity. For example, in a October 14, 2020, letter to employees, Starbucks CEO Kevin Johnson announced that beginning in the 2021 fiscal year, the company will link executive compensation to diversity, equity and inclusion goals.[8] These changes could further incentivize the development of reliable and timely metrics, while signaling to investors and other stakeholders that the company's leadership is committed to improving and investing in its workforce.[9]

Other considerations may include adding HR expertise as a factor to consider for board member qualification and explicitly calling out the management of HCM-related risks (including issues of culture that have precipitated high-profile corporate scandals and employee safety and working conditions during the COVID-19 pandemic and other health crises) in the risk committee charter.

SEC Disclosure Considerations – Principles-Based Disclosure in the Wider Landscape

On August 26, 2020, the SEC amended Regulation S-K to require public companies to include a description of their human capital resources in the Business section of their annual reports on Form 10-K to the extent material to an understanding of the business taken as a whole. Under the new rules, public companies are expected to include the human capital measures and objectives

5 SASB Human Capital Bulletin (November 2020), available here.

6 Social & Human Capital Coalition, Social & Human Capital Protocol, available here. Unlike the SASB framework, the HCMC protocol does not require or assume that companies report the results of their assessments externally – it is designed to generate information for business decision-making.

7 In April 2020, a proposal for Genuine Parts Company passed with 79.1% shareholder support (proxy statement available here). The following month a similar proposal for O'Reilly Automotive, Inc. passed with 66% shareholder support (proxy statement available here) .

8 Starbucks role and responsibility in advancing racial and social equity, available here.

9 For additional thoughts on the use of ESG metrics in incentive compensation, please see ESG Considerations for Incentive Compensation Programs in this memo.

that the company focuses on in managing the business (including measures and objectives that address the development, attraction and retention of personnel).

The SEC rule was adopted partly in response to a HCMC rulemaking petition requesting mandatory disclosure requirements regarding information about companies' human capital management policies, practices and performance.[10] The HCMC echoed broader investor views that effective human capital management is essential to long-term value creation and therefore material to evaluating a company's prospects. The rulemaking petition argued, among other things, that prescriptive disclosure standards would lead to a more efficient allocation of capital and lower cost of capital for well-managed companies due to investors' increased ability to compare human capital resources between companies.

The SEC rule did not adopt the prescriptive approach advocated by the HCMC and other commentators.[11] Instead, it is a principles-based rule that calls for reporting companies to make judgments about materiality under their specific circumstances.[12] The lack of specificity and guidance affords companies a significant degree of flexibility to tailor their disclosure, and to use, entirely or in part, existing frameworks – such as the SASB Standards or the HCMC Protocol – to guide material human capital resource disclosure. Because the materiality standards used by existing frameworks is often different than the standard used by the SEC, the metrics that a board uses to inform decision-making, however, will not necessarily be the same as the metrics that would be required to be disclosed under the new SEC rules.

As with other instances of mandatory disclosure, we expect the development of one or more acceptable market approaches over time as more companies file their annual reports with disclosure that is responsive to the amended rules. Trends should begin to emerge within each peer group and will continue to be shaped by SEC guidance, comment letters and evolving investor demands. A limited study of the first 50 Form 10-Ks filed after November 8, 2020 for companies with a market capitalization greater than $1 billion found significant differences in the approaches used but observed several common disclosure topics that were addressed in more than a generic manner. These topics include headcount data, diversity and inclusion, employee development and training, competitive pay and benefits, safety, culture, value and ethics, employee engagement, tenure, promotion, turnover and recruitment.[13]

HCM is a board-level issue with vital strategic and risk oversight implications.

Key Takeaways for Boards:

— HCM is a board-level issue with vital strategic and risk oversight implications. The COVID-19 pandemic and other events in 2020 underscored the importance of increased attention and transparency.

— New disclosure requirements and heightened investor expectations will entail the consideration and development of key HCM indicators and data. Boards should consider existing sustainability frameworks and feedback from shareholder engagement in developing these indicators.

[10] Rulemaking petition to require issuers to disclose information about their human capital management policies, practices and performance, File No. 4-711 (July 6, 2017), available here.

[11] Cleary Gottlieb, SEC Adjusts Disclosure Requirements for Public Companies (September 4, 2020), available here.

[12] The two Democratic SEC commissioners dissented from the adoption of the rule in large part due to its failure to adopt specific, prescriptive rules requiring comparable disclosures about human capital. Regulation S-K and ESG Disclosures: An Unsustainable Silence (Aug. 26, 2020), available here, and Statement on the "Modernization" of Regulation S-K Items 101, 103 and 105 (Aug. 26, 2020), available here. Commissioner Lee, for example, concluded that she would have supported the final rule if it had "included even minimal expansion on the topic of human capital to include simple, commonly kept metrics such as part time vs. full time workers, workforce expenses, turnover, and diversity." It remains to be seen whether the SEC under the upcoming Biden administration will favor more prescriptive-based rules with respect to human capital disclosure.

[13] FW Cook, 10-K Filings Show a Variety of Approaches to the New Human Capital Resources Disclosure Rules (November 27, 2020), available here.

— Boards should develop a clear approach to HCM and be ready to defend the company's disclosure approach in shareholder engagement in light of the growing push for standardized disclosure.

— Boards should consider updating board charters, agendas and policies related to HCM to reflect expanded oversight roles and consider tying executive compensation to HCM-related metrics.

ESG Considerations for Incentive Compensation Programs

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Stakeholder attention to environmental, social and governance (ESG) issues continued to grow throughout 2020 driven by the COVID-19 pandemic (health and safety), the Black Lives Matter movement (diversity and inclusion) and worldwide wildfires (climate change), to name a few. Prodded by investors and other stakeholders, companies have increasingly realized the importance to their businesses of managing human capital and monitoring human rights, whether in respect of their own workforces or their supply and customer chains. Further, disclosure and engagement around companies' human capital management (HCM) practices have become more important and even the Securities and Exchange Commission, which had in the past largely avoided specific ESG disclosure mandates, has weighed in and now requires disclosure regarding human capital resources in annual reports on Form 10-K.

The ESG issues highlighted in 2020 are long-term challenges that are likely to impact long-term value and, accordingly, should be considered in terms of long-term performance.

While many companies have long looked to certain ESG-related measures such as employee engagement and workplace safety in their incentive programs, usually for annual bonuses, the use of these measures was typically as a modifier or as a consideration for a discretionary individual performance factor. However, the ESG issues highlighted in 2020 are long-term challenges that are likely to impact long-term value and, accordingly, should be considered in terms of long-term performance. In addition, there is growing pressure by institutional investors for companies to demonstrate, and boards to monitor, progress on ESG goals. For example, in its recently released 2021 Stewardship Expectations, BlackRock stated that "[o]ur revised Global Principles and voting guidelines mark several key changes in our expectations across environmental, social and governance factors, as well as changes in how we will hold boards and management accountable in our voting."[1]

ESG is not a monolithic, one-size-fits-all framework and not all companies should focus on the same issues or use the same metrics.

Designing an ESG-Driven Incentive Program

As a result, boards and compensation committees have begun to consider and in some cases include more specific and longer-term ESG goals in their incentive programs. However, ESG is not a monolithic, one-size-fits-all framework and not all companies should focus on the same issues or use the same metrics. Before adding ESG-based incentives to compensation programs, a company needs to be able to clearly articulate the primary issues arising from its particular circumstances, assess the areas requiring improvement and map out strategies for addressing them. Many companies have developed sustainability plans and included ESG factors in their long-term business plans and so have done some of the necessary groundwork. However, integrating ESG goals into incentive compensation structures requires an additional and different set of considerations, especially with respect to HCM issues.

Designing any new incentive compensation program requires a veritable forest of decision trees.

— What employees will participate?

— To what extent will the criteria be quantitative versus qualitative?

— To what extent will achievement be determined by absolute results versus relative results of industry or other peers?

— How much of a participant's incentive award will be tied to which metrics? Should there be equal upside and downside in respect of target achievement or is another payout slope better suited?

— To what extent will board or compensation committee discretion play a role?

— And, more specifically, with respect to long-term compensation, how much discretion will there be to alter goals in light of circumstances changing over time?

Addressing all of these questions is difficult enough when using financial or operational metrics; implementing incentives based on ESG measures – especially employee-driven HCM issues such as diversity, equity and inclusion, retention and development, community and culture – raises the stakes. Making the necessary choices in program design, award grants and final payouts is a daunting task for boards, compensation committees and management when all such choices will be scrutinized by audiences ranging from award recipients, other employees, institutional investors, social advocates, industry peers and the media.

Key Takeaway – Tread Thoughtfully

Boards and management need to be thoughtful when including ESG goals in incentive plans as performance criteria need to be based on measures carefully tailored to the company and its business, measures for which the company has internal reporting resources necessary to assess performance accurately and measures that are capable of being clearly explained to and by all constituencies. Almost as importantly, boards and management have to be prepared for criticism. Any goals chosen are almost certainly going to strike some as too challenging and others as not challenging enough or even as entirely misconceived. The use of any discretion will similarly be subject to debate, not using enough may

[1] BlackRock, "Our 2021 Stewardship Expectations: Global Principles and Market-level Voting Guidelines" (2020), available here.

risk unfairly punishing participants and using too much may risk alienating investors, advocates and employees and undermining company-wide progress. The board will be required to make hard choices and must be ready to explain them and defend them, if necessary.

Many decisions in 2021 will be driven by the events of 2020. However, companies must be careful that any such decisions surrounding ESG incentives are proactive and grounded in corporate strategy, not reactive and made hastily in light of public opinion. A well-designed and implemented ESG-based incentive program should be focused on driving long-term value for all stakeholders.

The Short-Termism Debate

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A curious feature of the past three years has been the intertwined controversies over earnings guidance, corporate "short-termism" and the quarterly disclosure system. The discussion has been illuminating, and, while further regulatory attention now seems unlikely, the perils of neglecting the long-term will likely continue to color how analysts, regulators and investors view public companies and their disclosures.

Back in 2018, prominent voices were heard lamenting the short-term focus of public company management, arguing that earnings guidance creates a vicious cycle in which public company strategy focuses on short-term earnings targets rather than long-term, sustainable growth. Among these, Jamie Dimon, Warren Buffet and the Business Roundtable called for public companies to reconsider the practice of quarterly EPS guidance, with its "unhealthy" consequences for long-term growth.

Around the same time, discontent over the SEC's quarterly disclosure regime also started to make headlines. Inspired by a conversation with former PepsiCo CEO Indra Nooyi, President Trump surprisingly expressed (on Twitter) an interest in quarterly disclosure practices and asked the SEC to look into shifting from a quarterly to a semi-annual disclosure regime.

The SEC took notice of both themes, and in December 2018 it published a request for comment "on the nature, content, and timing of earnings releases and quarterly reports."[1] After receiving extensive comments, the SEC convened a roundtable in July 2019 bringing together academics, regulators and practitioners to debate the burdens of the SEC's quarterly disclosure requirements and the perils of short-termism.

In the December 2018 request for comment, the SEC took a deep dive into how regulatory changes could potentially ease the burdens of quarterly disclosure without sacrificing quality, and whether they could help promote a shift in focus from short-term results

[1] See SEC "Request for Comment on Earnings Releases and Quarterly Reports" (December 18, 2018), available here.

to long-term growth. It asked, among other things, whether Form 10-Q is too burdensome and whether a semi-annual disclosure system would be preferable. It also discussed the relationship between periodic reporting (10-Ks and 10-Qs) and earnings releases. And on short-termism, the questions boiled down to these: Is it real? If it's real, is it bad? And if it's bad, is it fixable?

The July 2019 roundtable elicited a wide range of views, including some strong support from the investor side for the rigors of Form 10-Q and for the virtues of guidance. The participants generally converged on the view that while there is room to lighten the load of quarterly disclosure requirements on public companies, it will not be an antidote to short-termism. In fact, some proposed disclosure reforms that promote a long-term focus (on climate change and human capital, for example) would surely increase the disclosure load for public companies.

Suddenly faced with pandemic-fueled uncertainty, a large number of public companies began to suspend or withdraw earnings guidance.

As with so many other things, the COVID-19 pandemic put these issues in a different light. Suddenly faced with pandemic-fueled uncertainty, a large number of public companies began to suspend or withdraw earnings guidance. Between March 16 and June 10, 2020, 851 companies withdrew annual guidance and 71 companies withdrew quarterly guidance.[2] Meanwhile, the SEC sharpened its focus on the quality of quarterly reporting and the importance of forward-looking disclosures. In particular, the SEC issued Disclosure Guidance Topic No. 9 on March 25, 2020, encouraging companies to include discussions in their quarterly earnings releases and reports that addressed the impact of COVID-19 on future operating results, near-and-long-term financial condition, overall liquidity and outlook.[3] Shortly thereafter, SEC Chairman Jay Clayton and Director of the Division of Corporation Finance William Hinman issued a joint statement on April 8, 2020, in which they stressed that companies should focus on the quality of quarterly disclosures in light of the challenges posed by the pandemic and asked companies to "strive to provide, and update and supplement, as much forward-looking information as is practicable" in order to increase transparency in understanding the impacts and effects of the COVID-19 pandemic.[4] It did not come as a surprise when the SEC recently downgraded the quarterly disclosure reform project by removing it from its fall 2020 short-term agenda.

As the initial months of the pandemic passed, many public companies resumed earnings guidance. Of the 285 S&P 500 companies that historically provide earnings guidance, 138 (48%) did so in the second quarter, which was a 37% increase over the first quarter earnings season. This increase was mainly the result of companies resuming guidance after withdrawing or not providing guidance during the first quarter of 2020.[5] During the third quarter, even more companies resumed providing earnings guidance, and the trend looks like it will continue.

The future of quarterly disclosure reform is now uncertain, and quarterly earnings guidance will soon be as prevalent as ever. The immediate effects of the COVID-19 pandemic were to sharpen the SEC's focus on quarterly reporting and forward-looking disclosure, but the debates over burdensome quarterly disclosure, earnings guidance and the perceived unhealthy focus on short-term results are sure to continue.

2 See IR Magazine, "How Covid-19 is affecting earnings guidance and dividend payments" (April 1, 2020), available here.

3 See SEC Disclosure Guidance Topic No. 9 (March 25, 2020), available here.

4 See "The Importance of Disclosure – For Investors, Markets and Our Fight Against Covid-19" (April 8, 2020), available here.

5 See Factset, "More than one in four S&P 500 companies are still not providing EPS guidance for 2020 or 2021" (October 9, 2020), available here.

The Changing Face of Activism

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As we enter 2021, shareholder activism continues to evolve. The traditional campaigns waged by repeat activists leveling familiar critiques will undoubtedly persist into the new year and beyond. But by now most companies are well-versed in the old activist playbook and have developed their own game plan. In past years, some became their own activist and dismantled or reshaped their companies before the first shot was fired. Others rightly believed their strategic plan was the right path and focused on execution while remaining on high alert and preparing behind the scenes in the event an activist emerged. And still others became ensnared in activist attacks and sought a truce unless the price of peace was too great. Against this backdrop, a new world of activism with a different set of rules continues to emerge. In the coming era, we expect that activist-like fire will come from new directions, shareholder engagement will become more visible and louder, and ESG and stakeholder purpose in many cases will be the tip of the spear. This is the activist landscape that boards must be prepared to navigate in 2021.

The New Constructivists and Activists

For the last several years, the lines between activists and other investors have continued to blur. Activists have sought to become private equity investors, long-only investors have adopted an activist mentality and now financial sponsors are turning into constructivists (and in some cases, full-bore activists). Financial sponsors are well-positioned to engage in their own brand of public equities constructivism. They have an abundance of capital to deploy with over $850 billion in dry powder reported as of Q3 2020. They also have a deep bench of investment professionals and turnaround experts with sector-specific insights and relationships capable of driving the M&A activity and operational enhancements that have become the hallmarks of activist campaigns.

In fact, last year several name-brand financial sponsors built significant stakes in public companies using activist-like techniques, such as continuing to amass their positions during the 10-day window after the 5% threshold was crossed but before the Schedule 13D filing was made and using derivatives to increase their economic exposure. We have also witnessed an uptick in large-cap financial sponsors acquiring stakes in public companies and confidentially filing for Hart-Scott-Rodino approval to increase their stake – another classic activist pressure tactic. Many of these situations have resulted in constructive engagements, with representatives of the financial sponsor welcomed to the company's board of directors, and others have yet to spill out into the public spotlight. But other engagements have not been as constructive, with one $30 billion AUM private equity manager waging a short-slate proxy contest at a tech company and another activist fund joining forces with an independent financial sponsor to mount a hostile takeover at a property data firm.

We expect financial sponsors and other non-traditional activist investors to continue to become more active in their approach to engaging with public companies.

As the market for buyouts and traditional private equity investments becomes increasingly competitive, we expect financial sponsors and other non-traditional activist investors to continue to become more active in their approach to engaging with public companies as an alternative method for achieving returns. Unsolicited acquisition approaches and bear hugs by financial sponsors will also continue to rise, and financial sponsors' Schedule 13F filings will be monitored–much like those of activist funds – to track their next move. At the same time, more alliances between activists and financial investors can be expected to emerge and drive even more unsolicited M&A activity and hostile campaigns. The message to boards and management teams is clear:

— Today's investors are more active and engaged with boards than ever and we expect that trend to continue.

— Not all financial sponsors are the same – while many will not behave like activists, some will. Companies cannot rely on the traditional categories of investor – e.g., activist, long-only, financial sponsor – as a predictor of behavior and objectives.

— Companies must be nimble and prepared to respond to approaches by investors who have objectives and playbooks that differ from those of traditional activists.

Engagement Becomes More Visible and Louder

Today, more shareholders – including institutional and traditionally long-only investors – are harnessing the power of public disclosure to amplify the impact of their voices and votes. Last year, BlackRock dramatically ramped up its publication of voting bulletins profiling how it voted in high-profile situations and why. BlackRock also recently expanded its quarterly stewardship reports to disclose portfolio-wide engagement and voting decisions, including details on which companies it engaged, the number of engagements and the topics discussed. Vanguard and State Street are not as prolific – yet – but are also providing the market with greater insight to their engagement activities. Several long-only investors have followed suit, with Neuberger Berman announcing it will publicize how it will vote in advance of shareholder meetings at 25 more of its portfolio companies each year. At the same, pension fund managers – including the New York City Comptroller, CalPERS and others – have ramped up their demands to remake corporate America and effectively wield shareholder proposals as a weapon when their demands aren't met. For further discussion of shareholder engagement developments, please see Shareholder Engagement Trends and Considerations in this memo.

Although different from traditional shareholder activism, this brand of activism is on the rise and can be quite potent. In this new era, boards and management teams should be prepared to do the following:

— Use the increased transparency regarding shareholder stewardship activities to your advantage – learn from the successes as well as the mistakes of others.

— Stay abreast of key shareholders policies and voting decisions – particularly at peer companies – to identify potential areas of focus.

— Understand that what you say to shareholders – even if not an activist – can become public and structure dialogue with this in mind.

Shareholder Activism and ESG Activism Collide

In last year's memo, we predicted that "stakeholder activism – or the convergence of shareholder activism and social activism – will continue and eventually move beyond the ESG realm." In many ways, that's exactly what happened in 2020, with impact and ESG-focused investment strategies increasingly becoming mainstream. In June, Inclusive Capital Partners – ValueAct's former Spring Fund founded by Jeff Ubben – embarked on a mission to "partner with management and the boards of companies whose core business seek to achieve the reversal of corporate harm." Later in the year, Engine No. 1–a new "impact-focused fund" led by former Andor, Jana and BlackRock executives–partnered with CalSTRS to launch a proxy contest at one of the largest U.S. energy companies for its alleged failure to adequately respond to evolving energy needs and emissions standards. At the same time, investment capital has continued to flow into ESG-focused investment strategies – according to a recent report, ESG capital has grown over 40% since 2018 and now represents one third of the $51.4 trillion in U.S. assets under management.

Be prepared to engage with stakeholders of all stripes–long-only investors, pension plans, governance gadflies, activists, etc.

We expect each of these trends to accelerate in 2021. Activist campaigns focused on diversity and human capital management issues likely also will be in the cards. What should boards and management teams do? We recommend several measures:

— Assess your ESG profile holistically and recognize it can be core not just to your corporate governance profile but also your long-term financial performance.

— Be prepared to engage with stakeholders of all stripes – long-only investors, pension plans, governance gadflies, activists, etc. – and actively consider what they have to say and what actions they may take while doing what's best for the business and stakeholders over the long-term.

— View ESG as an area where you potentially can go on offense and not just play defense – attracting ESG capital can positively shape financial performance.

— Recognize that you will be held accountable for delivering on ESG promises and so be prepared to practice what you preach.

2021 M&A Outlook: Cautious Optimism for Robust Dealmaking

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As we look back on the mergers and acquisitions landscape of 2020, clear trends emerge and paint a picture of what can be expected in 2021. Certain of these trends seemingly came from nowhere, while others have long been brewing. In either case, directors of both potential acquirors and potential targets will need to consider the implications, if any, of these trends as they approach M&A in 2021.

With more players on the prowl for attractive investments … sellers continue to have the luxury of being picky when it comes to choosing their dance partners.

The Seller's Market Continues

Other than a relatively brief swoon following the initial outbreak of COVID-19 in the United States in the spring, 2020 largely saw the continuation of the robust seller's market we have witnessed over much of the last decade. This has played out not only in the high valuations sellers have enjoyed but also in the deal terms that sellers (particularly sellers of private companies) have been able to extract from buyers. The key contributing factor to the seller's market? Demand, of course. With more players on the prowl for attractive investments – not only private equity funds and strategic investors but also sovereign wealth funds, family offices and now SPACs (as discussed in greater detail below) – sellers continue to have the luxury of being picky when it comes to choosing their dance partners.

Private equity-backed M&A transactions accounted for 16% of overall M&A activity in the first nine months of 2020, the highest level since before the global financial crisis,[1] and private equity sponsors have been increasingly willing to get a deal done by accepting seller favorable deal terms. The advent of representation and warranty insurance (RWI) has exacerbated this trend, as premiums remain sufficiently low such that, for many buyers, procurement of RWI continues to be an attractive alternative to in-depth (and time consuming) due diligence and difficult and competitively undesirable negotiations of indemnity provisions.

SPACs – Another Competitor for Transactions Enters the Ring

2020 was the year of Zoom, Peloton and special purpose acquisition companies (SPACs). As of December 12, 2020, a total of 230 SPAC IPOs raised over $77 billion in 2020 – five times the amount of money raised by SPACs in 2019, and 20 times the amount raised in 2015. In fact, SPACs raised more money than traditional initial public offerings in 2020.[2] As discussed above, we have seen a seller-friendly market develop over the last decade, and adding SPACs to the private company toolbox as an alternative means to achieve liquidity creates more competition among potential acquirers for accretive transactions.

A SPAC is a shell company that generally raises money from public markets with the intention to later merge with a private company. The SPAC engages in an IPO shortly after its formation, attracting interest among public investors based largely on the track record and reputation of its sponsor and management team. Flush with the proceeds from its IPO, the SPAC searches for a private company with which to merge. In the early days of the SPAC evolution, SPACs typically acquired private targets for cash, much like a private equity buyout. More recent transactions have involved mergers of SPACs with target companies many times their size, more akin to a reverse IPO.

The merger between the SPAC and the private target company, which effectively results in the target company becoming a public company, is referred to as a "De-SPAC transaction." The De-SPAC transaction requires the approval of the SPAC's shareholders. In addition, SPAC shareholders may require the SPAC to redeem their shares for cash (and a small return) at any time, while retaining some exposure to future upside appreciation from the transaction via warrants that are issued by the SPAC together with its shares in the IPO.

For private companies, going public by merging with a SPAC offers two principal benefits – avoiding the unpredictability of the IPO market and speed. In a SPAC transaction, a firm exchange ratio – and thus economic value for the target company – is agreed upon up-front by the parties. Also, IPOs can take six to 12 months to complete with additional time necessary to prepare, while De-SPAC transactions can be completed within two to three months of signing, providing immediate liquidity and access to the sponsors' expertise and public company infrastructure. On the other side of the coin, the potential target must weigh the dilution resulting from the sponsors' typical 20% ownership stake and the uncertainty created by the requirement of SPAC shareholder approval and the possibility of shareholder redemption.

Nonetheless, SPACs have become a significant player in the M&A market, and the uncertainties created by COVID-19 have made SPACs a more attractive alternative than an IPO. Further, current low interest rates make locking up a significant portion of cash for the length of a SPAC far less disadvantageous to investors, and the recent history of public market "busts" for venture capital-backed companies, e.g., Uber and WeWork, has ignited even more interest in SPACs.

Of course, long-term results remain an open question. A recent Goldman Sachs report indicates that in deals completed since 2018, SPAC equities following completion of the acquisition have underperformed

1 Refinitiv, "Records broken in global capital markets during Q3" (November 2, 2020), available here.

2 SPACInsider, "SPAC IPO Transactions: Summary by Year" (2020), available here.

the broader market. Time will tell if this year's spate of SPACs perform and if SPACs and similar vehicles retain their current popularity.

The Impact of COVID-19 on M&A Deal Terms

Overall, we have seen M&A deal terms adapt fairly rapidly to the COVID-19 pandemic. Following a brief period of dislocation as buyers sought to walk away from or renegotiate deals entered into prior to the outbreak of COVID-19 in the United States, we have generally seen the M&A market recover with sellers implementing some standardized edits to transaction agreements to account for the pandemic. The key revised terms are (i) express inclusion of pandemics (and COVID-19 in particular) in the carve-outs to the definition of material adverse effect and (ii) wide latitude under the interim operating covenants for actions taken by targets in response to COVID-19. We expect the former to be a feature of M&A agreements going forward, but it remains to be seen how COVID-19 and future similar as yet unknown exogenous events will be treated for purposes of interim operating covenants once the tide of this current pandemic recedes.

While many lawsuits were filed earlier in the year, mostly in the Delaware Court of Chancery, by sellers seeking to force reluctant buyers to close the vast majority settled without a ruling from the bench, leaving unanswered the question – as between buyer and seller – who bears the risk of COVID-19 and, perhaps more importantly at this point, any future similar exogenous events.

In December 2020, Delaware Vice Chancellor Laster finally provided some guidance by ruling that South Korean asset manager Mirae Asset Financial Group (Buyer) was excused from closing its purchase of 15 U.S. luxury hotels from Anbang Insurance Group, Ltd. (Seller) for $5.8 billion and was permitted to terminate the agreement. Although the Buyer failed to prove a material adverse effect had occurred, the Buyer had successfully shown that the Seller's response to the COVID-19 pandemic, including furloughing staff, laying off employees and closing properties, breached the interim operating covenants. The court found that the Seller's actions in response to the pandemic were not ordinary course, i.e., not routine or consistent with its past practices in ordinary times, even though the Seller's response was consistent with actions taken by comparable companies in response to COVID-19.[3]

While sellers will likely continue to include a COVID-19 exception to interim operating covenants for some time into the future, boards of sellers should consider going forward how to prepare for the next unknown exogenous event that they may need to respond to. Sellers may consider being explicit that actions taken in response to the exogenous risks laid out in the exceptions to the material adverse effect definition (e.g., hurricanes, acts of terrorism, etc.) should be allowed under the interim operating covenants so long as they are generally in line with the responses of similarly situated companies. While this would be a major (and very seller-friendly) shift in the way that interim operating restrictions currently work – as long as the seller's market continues and with sellers able to point to the recent COVID-19 experience – buyers may have a hard time saying no.

We expect that a Biden presidency will provide fertile ground for a robust M&A market in 2021.

A Biden Presidency and M&A

With another COVID-19 stimulus package passed, providing additional support for the economy, and the Federal Reserve continuing to be hesitant to reverse low-interest policy as the U.S. economy recovers from the pandemic, inexpensive debt financing should be plentiful, encouraging more M&A. While this all sounds promising for dealmakers, if Democrats control the White House and both houses of Congress, it will enable them to pursue a broader legislative agenda that

[3] *See AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC*, C.A. No. 2020-0310-JTL (Del. Ch. Nov. 30, 2020)

may hinder, or at least slow, the pace of M&A. As of printing, it seems likely that the Democrats will hold a majority in the Senate (with fifty Senate seats and the tie-breaking vote by Vice President Harris). While it is generally recognized that dealmakers would have preferred divided government (which would have ensured no major policy changes and would have in turn provided a stable environment for M&A activity), it is as yet unclear how activist Democrats will be in light of their slim majorities in the Senate and House. A Democratic-controlled legislative branch is more likely to pass additional COVID-19 stimulus packages, providing juice for the economy and indirect tailwinds for M&A, however proposed Democratic policies around tax increases as well as continuing focus from both sides of the aisle on consolidation in the technology sector and bipartisan wariness regarding foreign buyers in certain industries may serve as a countervailing drag on M&A activity. On balance, even with Democratic control of the legislative and executive branches, we expect that a Biden presidency will provide fertile ground for a robust M&A market in 2021.[4]

[4] For discussion of developments in U.S. and EU antitrust rules and enforcement, please see U.S. Antitrust: Developments and Outlook and EU Antitrust: Developments and Outlook in this memo.

Caremark Claims on the Rise, Fueled by Section 220 Demands

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As the 25th anniversary of the seminal Delaware Court of Chancery decision *In re Caremark Int'l Inc. Deriv. Litig.* (*Caremark*) approaches, there has been a notable rise in the number of cases in which Delaware courts are allowing *Caremark* claims against company directors to survive motions to dismiss. Significant drivers of this trend appear to be plaintiffs' increased use of books and records demands under Section 220 of the Delaware General Corporation Law and the expanding boundaries of stockholder inspection rights resulting from recent Delaware court decisions interpreting that statute. Often armed with considerable amounts of information gleaned from a corporation's books and records with which to draft a complaint, and with the benefit of the inferences afforded to plaintiffs at the pleading stage, plaintiffs have, in some recent cases, been able to plead *Caremark* claims that have overcome the courts' traditional reluctance to sustain such claims.

Plaintiffs have, in some recent cases, been able to plead *Caremark* claims that have overcome the courts' traditional reluctance to sustain such claims.

These decisions will likely encourage more stockholder plaintiffs in the coming year to demand books and records, particularly when some corporate "trauma" or bad publicity occurs, in an attempt to plead a *Caremark* claim against the board. Boards should prepare for such claims by ensuring they (i) are kept reasonably informed of all material risks facing the company and (ii) make informed decisions about how the corporation should navigate significant risks. Separately, but equally importantly, the board's formal records – its minutes and centrally stored materials (e.g., board books) – should reflect (at a high level) all of the information the board receives and the decisions it makes so that the courts are not left to evaluate the board's exercise of its oversight duties on an incomplete record.

The Blue Bell Case and Subsequent *Caremark* Decisions

In *Caremark*, the Court of Chancery explained that directors' fiduciary duties require them to exercise reasonable oversight of the company's affairs, but they may only be held liable for breach of that duty if they either (i) "completely failed to implement any reporting or information systems or controls" or (ii) "having implemented such a system or controls, consciously failed to monitor or oversee its operations." Before the Delaware Supreme Court's 2019 decision in *Marchand v. Barnhill*, Delaware courts routinely dismissed *Caremark* claims at the motion to dismiss stage, even in the face of substantial "corporate traumas," underscoring Chancellor Allen's oft-cited warning in *Caremark* that duty-of-oversight claims are "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."

That is not to say that plaintiffs *never* succeeded on their *Caremark* claims, but complaints were often dismissed on the grounds that, while the corporation may have engaged in wrongdoing, there were no factually specific allegations that the board was aware of such wrongdoing and consciously ignored it or had utterly failed to implement a reporting process to keep itself reasonably informed.

In its 2019 *Marchand* decision, the Delaware Supreme Court reversed a Court of Chancery decision and held that a *Caremark* claim could proceed against directors of one of the country's largest ice cream manufacturers, following a deadly listeria outbreak caused by its products. The court found that plaintiffs had adequately alleged that the directors had failed to implement any food safety performance or compliance monitoring system.

In particular, the court highlighted the centrality of food safety to Blue Bell's success as a company with a single product (ice cream) subject to stringent regulations and faulted the board for having no system to monitor and report specifically on this mission-critical risk, even though the board received risk reports from management generally.

In the year and a half since *Marchand*, four Court of Chancery decisions have likewise allowed Caremark claims to proceed past the pleading stage. There are two noteworthy features of these decisions:

— As in *Marchand*, in all but one of these cases plaintiffs had conducted a pre-filing investigation by seeking books and records under Section 220, which the plaintiffs then used to craft a complaint with specific allegations concerning the board's alleged failure to exercise its duty of oversight. In the only other case in this period, *Inter-Marketing Group USA, Inc. v. Armstrong*, the court specifically noted that the sufficiency of the plaintiff's complaint did not suffer from its failure to seek books and records under Section 220 because the plaintiff had access to a fully developed criminal trial record involving the same underlying facts.

— In some instances, the courts relied on the absence of any board discussions about specific events in materials produced by the company in response to a Section 220 demand to infer that no such discussions took place. For example, one court stated that "if [a] [c]ompany failed to produce a document that it would reasonably be expected to possess if a particular event had occurred, the plaintiff is entitled to a reasonable inference that the event did not occur." This is particularly noteworthy in the *Caremark* context, where plaintiffs may satisfy either prong of the *Caremark* test by showing an absence of board activity (either the absence of an appropriate monitoring system or the absence of any response to a red flag).

Despite the rise in the number of *Caremark* cases surviving a motion to dismiss, these decisions do not signal a marked expansion of *Caremark* liability so much as an increasingly effective use of Section 220 to plead detailed facts about board conduct. Four of the cases involved allegations of serious failures of board oversight of "mission critical" risks: food safety (*Marchand*), drug safety (*In re Clovis Oncology, Inc. Deriv. Litig.* and *Teamsters Local 443 Health Services & Insurance Plan v. John G. Chou*) and oil pipeline integrity (*Inter-Marketing*).

The sole exception – *Hughes v. Hu* – involved an extreme set of facts. In *Hughes*, the company, based in China, had publicly acknowledged material weaknesses in its financial reporting and oversight systems and had pledged to remediate those problems, but the directors nevertheless allegedly ignored red flags indicating that the company was failing to take the necessary remedial steps, resulting in three years of financial restatements.

Indeed, even in the past year, the Court of Chancery dismissed *Caremark* claims in which plaintiffs did not allege the requisite particularized facts to show that the directors' failures implicated the bad faith or disloyalty necessary to sustain a *Caremark* claim, for example, because there were no specific allegations that the directors failed to implement a reasonable monitoring system or consciously ignored red flags.

The Growing Use and Expansion of Section 220

Concurrently with the recent uptick in *Caremark* claims – and significantly contributing to that uptick – stockholder demands for books and records have been on the rise in recent years. For years, Delaware courts exhorted stockholders to use the tools at hand – namely, Section 220 –before filing derivative lawsuits. Stockholders appear to be listening. Section 220 actions increased 13-fold from 1981–1993 to 2004–2018. In addition, in the past couple of years, Delaware courts have significantly expanded the boundaries of Section 220, both with respect to what purposes are considered proper for making a Section 220 demand and the scope of books and records review that courts will grant to plaintiffs, as detailed below. Although data is not yet available, anecdotal evidence suggests Section 220 demands have exploded in the past couple years from their already elevated levels.

— ***Purpose***. Delaware courts have long held that investigating possible wrongdoing to gather facts before filing derivative litigation against a board of directors is a proper purpose for making a Section 220 demand so long as the stockholder can show a credible basis from which to infer the possibility of wrongdoing. In early 2020, the Court of Chancery issued a decision, which was subsequently affirmed by the Delaware Supreme Court in December 2020, that extended the circumstances in which investigating wrongdoing could be used by stockholders as the purpose for a Section 220 demand. In *Lebanon Cnty. Emp. Ret. Fund v. AmerisourceBergen Corp.*, the court held that a stockholder (i) need not state what it plans to do with the fruits of its investigation and (ii) need not demonstrate a credible basis to suspect *actionable* wrongdoing on the part of the board. The court further held that, consequently, the existence of an exculpatory charter provision would not preclude the stockholder from obtaining books and records to investigate possible wrongdoing by the *company* even when the stockholder cannot show a credible basis to suspect bad faith or disloyal conduct by the *board*. In a subsequent decision, the Court of Chancery warned that if corporations continue to withhold books and records on these grounds – and refuse to produce any documents, even core board-level materials – they may be liable for the stockholder plaintiffs' attorneys' fees.

These decisions suggest that requests for electronic communications will only be granted when formal board materials are insufficient.

— ***Scope***. In 2019, the Delaware Supreme Court held that electronic communications, including emails and text messages used for board-related communications, may be available as part of a books and records demand when formal board-level materials are not sufficient to satisfy the stockholder's demand. Subsequent Court of Chancery decisions, including several in 2020, continue to delineate the circumstances in which stockholders are entitled to electronic communications. In sum, these decisions suggest that requests for electronic communications will only be granted when formal board materials are insufficient because, for example, there is evidence that the board conducts much of its business informally via electronic communications or there are "gaps" in the formal board materials that may be "filled" by electronic communications.

Key Takeaways for Boards in 2021

— In 2021, boards of Delaware companies should expect that any significant negative event affecting the company will be followed by demands for books and records by stockholder plaintiffs, potentially followed by *Caremark* claims alleging that the board failed to exercise adequate oversight. This trend will likely further accelerate in light of the increased focus on environmental, social and governance (ESG) issues and as a result of the anticipated uptick in enforcement activity expected under the Biden administration, which we discuss in Priorities, Trends and Developments in Enforcement and Compliance in this memo.

— Boards should prepare for such claims by ensuring they (i) are kept reasonably informed of all material risks facing the company and (ii) make informed decisions about how the corporation should navigate significant risks. This includes consideration of the mission-critical risks facing the company and ensuring that there are specific reporting systems in place that are designed to keep the board informed of those risks. While no reporting system is perfect, it is also critical that when an issue is brought to the board's attention, the board promptly considers it and makes an informed business judgment as to how it should be handled.

— As important, the board's formal records – including board minutes, board books and other centrally maintained files – should reflect, at a high level, all of the information the board receives and the decisions it makes so that courts are not left to evaluate the board's exercise of its oversight duties on an incomplete record. The board's minutes need not, and should not, be overly detailed, but they should reflect a summary of the information brought to the board's attention, as well as summaries of any decisions the board makes. Boards should be aware that the absence of discussion about a particular topic and corresponding board action or recommendation in meeting minutes may create a pleading stage inference that the board never discussed that topic or took any action, potentially allowing a *Caremark* claim to proceed to discovery that might otherwise have been dismissed. Moreover, ensuring that formal board records are reasonably complete will mitigate the risk that a court will order the company to produce electronic communications in response to a Section 220 demand.

Priorities, Trends and Developments in Enforcement and Compliance

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The tumultuous events of 2020, including the ongoing pandemic and the election of a new U.S. President, will have direct and lasting impacts on white-collar and regulatory enforcement in the years to come. As we enter 2021, we anticipate that white-collar and regulatory enforcement will be more active under the Biden administration, as policy priorities shift toward financial and corporate fraud, as well as ESG issues, environmental and social justice, more generally. At the same time, we expect the already-visible pandemic and recession-related enforcement trends to continue, with a sustained focus on financial statement and accounting fraud. Finally, we expect that the increased reliance on whistleblowers will continue (and potentially grow) in 2021.

Transition to the Biden Administration

New leadership at the DOJ, U.S. Attorney's Offices, SEC, CFTC and other regulatory agencies will lead to changes in priorities consistent with those associated with prior Democratic administrations.[1] While the DOJ under President Trump placed significant emphasis on confronting violent crime and immigration offenses, we are likely to see under President Biden's administration a greater emphasis on financial and corporate frauds.

[1] See Cleary Gottlieb, "What to Expect from the Biden Administration" (November 9, 2020), available here.

The Obama-Biden administration oversaw historically high levels of regulation, investigations and corporate fines, all in the wake of a worldwide financial crisis with significant economic impacts.

We face different challenges today, but now, as then, we expect economic dislocation from the global pandemic as well as a philosophical bent toward white-collar enforcement to result in a more aggressive enforcement climate. Former CFTC Commissioner Gary Gensler's leading role in helping to populate agency heads is a harbinger of a more muscular approach to enforcement.[2] This approach will likely include an increased focus on the prosecution of individuals responsible for corporate wrongdoing as pressure at key agencies will once again ratchet up to bring individual prosecutions when possible and appropriate.

Some areas of white-collar enforcement that remained relatively active during the Trump administration are likely to continue as a focus for authorities.

Some areas of white-collar enforcement that remained relatively active during the Trump administration are likely to continue as a focus for authorities. For example, surprisingly to some, the DOJ under President Trump continued to actively pursue FCPA cases and impose significant fines, with the number of new enforcement actions following an upward trend since 2015.[3] The Trump-era DOJ codified and applied the FCPA Corporate Enforcement Policy first piloted under President Obama's administration, and a revised 2020 FCPA Resource Guide provided updated guidance on the FCPA's accounting provisions – all encouraging self-reporting and cooperation (both of which drive much of the FCPA caseload).[4] These policies involved no significant departures from Obama-era interpretation and enforcement of the FCPA, and we expect this will continue.[5] The DOJ's commitment and approach to FCPA investigations is likely to remain steady going forward and, indeed, we can expect that cross-border cooperation between the DOJ and authorities abroad will only continue to increase.[6] Similarly, while we believe the enforcement of sanctions violations and international anti-money laundering investigations will continue to be robust, we expect the Biden administration to take a more multilateral approach to sanctions cooperation and enforcement.[7]

In addition to returning to pre-Trump priorities, the new administration has signaled that it will take an innovative approach in certain areas of its policy priorities. President-elect Biden announced during his campaign that he plans to create an Environmental and Climate Justice Division within the DOJ, signaling a new and historic enforcement approach to climate change and other environmental issues. The appointment of Christopher Schroeder, a professor at Duke Law School who specializes in environmental law and policy, to lead the DOJ transition team signals the administration's commitment to this ESG focus.[8] President-elect Biden has stated that the proposed Environmental and Climate Justice Division will pursue criminal anti-pollution charges against corporations and individual corporate executives, strategically support plaintiff-driven climate litigation against polluters and bring affirmative cases under Title VI of the 1964 Civil Rights Act to address racial discrimination in practices

2 The Federal Reserve, Banking, and Securities Regulators group led by Gensler covers the transition for the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, the Federal Reserve, the National Credit Union Administration, and the Securities and Exchange Commission.

3 Stanford Law School Foreign Corrupt Practices Act Clearinghouse, "DOJ and SEC Enforcement Actions per Year" (2020), available here; see Cleary Gottlieb, "The New DOJ FCPA Corporate Enforcement Policy Highlights the Continued Importance of Anti-Corruption Compliance," (January 9, 2018), available here (noting questions in 2017 as to whether the Trump administration would continue to prioritize FCPA enforcement and the DOJ's subsequent focus on maintaining FCPA enforcement).

4 See Cleary Gottlieb, "DOJ and SEC Release Updated FCPA Resource Guide" (July 9, 2020), available here.

5 *Id.*

6 *Id.*

7 Cleary Gottlieb, "What to Expect from the Biden Administration" (November 9, 2020), available here.

8 Biden-Harris Transition, "Agency Review Teams" (2020), available here; see Duke Law, "Christopher H. Schroeder, Bibliography" (2020), available here.

that affect health or the environment.[9] The SEC has demonstrated a complementary focus on the accuracy of ESG disclosures and compliance policies, which may become a more prominent subject of enforcement investigations in 2021.[10]

Finally, the CFPB, which was dormant under the Trump administration, will reassert its role as a powerful consumer watchdog.[11] Because of the U.S. Supreme Court's decision in *Seila Law LLC v. CFPB* that the CFPB Director is removable by the President at will, the new administration will replace the existing leadership.[12] We expect a Biden-led CFPB to be more assertive in bringing enforcement actions, in particular with respect to pandemic-related claims, which have already seen a sharp increase,[13] and discriminatory actions by financial institutions.[14] As it did in the past, we also anticipate that the CFPB will closely coordinate and collaborate with other law enforcement agencies, including by making referrals to criminal authorities.

Pandemic-Related Financial Statement and Accounting Fraud

The Biden administration's probable increase in focus on financial crimes will reinforce and intensify pandemic and recession-related enforcement trends. The pandemic has had a widespread economic impact across industries and jurisdictions, creating a volatile environment conducive to potential accounting and disclosure violations, including fraud. The DOJ, SEC and other regulators have increasingly prioritized actions related to overly optimistic accounting judgments and estimates, with a particular focus on revenue recognition, channel-stuffing, fair value and impairment considerations, and the use of non-GAAP financial measures.[15]

The SEC has stated on a number of recent occasions the importance of high-quality financial reporting in response to the impacts of COVID-19.[16] With this goal in mind, the SEC has explained that year-end disclosures will receive additional scrutiny and that it is closely monitoring public filings from issuers in industries highly impacted by the pandemic to identify disclosures that appear to be significantly out of step with the rest of the industry.[17] Of course, accounting judgments and disclosures will be reviewed in hindsight, and in the context of an economic downturn companies can expect regulators to look at whether a company appropriately considered what qualifying language should have been included in its risk factors. On December 4, 2020, the SEC announced its first such settlement against the Cheesecake Factory, which agreed to pay $125,000 for its allegedly overly rosy disclosures concerning the impact of the COVID-19 pandemic on its business.[18]

The SEC and other regulatory agencies have also increased their scrutiny of the dissemination of material non-public information (MNPI) and possible insider

9 Biden for President, "The Biden Plan to Secure Environmental Justice and Equitable Economic Opportunity" (2020), available here.

10 See Cleary Gottlieb, "Despite Disagreements, SEC Commissioners Emphasize Need for Clear Disclosure by ESG Funds" (September 24, 2020), available here.

11 See Orla McCaffrey, "Financial Firms Gear Up for Biden and an Emboldened Consumer Watchdog," Wall Street Journal, (October 21, 2020) (quoting a Biden administration spokesman that the former vice president "believes we need to reverse the Trump administration's efforts to weaken the CFPB" and wants to "hold financial institutions accountable for discriminatory practices").

12 *Seila Law LLC v. Consumer Financial Protection Bureau*, 140 S. Ct. 2183 (2020).

13 Consumer Financial Protection Bureau, "Complaint Bulletin: Complaints Mentioning Coronavirus Keywords" (July 2020), available here.

14 Biden for President, "Lift Every Voice: The Biden Plan for Black America" (2020), available here.

15 See Cleary Gottlieb, "From Government Shutdown to COVID-19: SEC Enforcement Division Releases Final Chapter of Jay Clayton-led SEC" (November 9, 2020), available here; Cleary Gottlieb, "SEC Chief Accountant Weighs in on Accounting Issues during the COVID-19 Outbreak" (April 9, 2020), available here.

16 See U.S. Securities and Exchange Commission, "Statement on OCA's Focus on High-Quality Financial Reporting during an Unusual Year and a Discussion of Our Upcoming Priorities" (December 7, 2020), available here; U.S. Securities and Exchange Commission, "SEC Charges the Cheesecake Factory for Misleading COVID-19 Disclosures" (December 4, 2020), available here; U.S. Securities and Exchange Commission, "Statement on the Continued Importance of High-Quality Financial Reporting for Investors in Light of COVID-19" (June 23, 2020), available here; U.S. Securities and Exchange Commission, "Statement on the Importance of High-Quality Financial Reporting in Light of the Significant Impacts of COVID-19" (April 3, 2020), here.

17 In September, the enforcement division announced the first settled action resulting from its new initiative using risk-based data analytics to review quarterly earnings per share reporting and other data points to uncover potential accounting and disclosure violations. See U.S. Securities and Exchange Commission, "SEC Charges Companies, Former Executives as Part of Risk-Based Initiative" (September 28, 2020), available here.

18 U.S. Securities and Exchange Commission, "SEC Charges the Cheesecake Factory for Misleading COVID-19 Disclosures" (December 4, 2020), available here.

trading violations given the heightened risks created by the pandemic as (i) corporate insiders are regularly learning new MNPI that may hold an even greater value than under normal circumstances, (ii) a greater number of people may have access to MNPI and (iii) many of these people are working from home.[19] The SEC's focus on MNPI has extended to stock buyback initiatives. For example, in October 2020, the SEC settled with Andeavor LLC for allegedly failing to ensure it did not have MNPI related to takeover negotiations when repurchasing its own shares.[20]

Massive federal and state stimulus packages will continue to generate fraud investigations, including under the False Claims Act, which also allows for *qui tam* actions by private plaintiffs on behalf of the government. The targets of these investigations have included the gatekeepers for stimulus funds, such as banks issuing Paycheck Protection Program loans.[21] This focus on pandemic-related fraud and the passage of the CARES Act (with its $500 billion corporate relief fund) has led to the establishment of a Special Inspector General for Pandemic Recovery, which promises to be active for years to come given that it is modeled after a similar program that continues to investigate fraud cases stemming from the TARP program more than 12 years after its creation.[22]

Focus on Whistleblower Programs

The SEC's whistleblower program, which relies on individuals to report possible violations of the federal securities laws, has grown in scope and payouts every year since its inception in 2010. In fiscal year 2020, the SEC awarded approximately $175 million to 39 individuals, new highs for both the dollar amount and number of recipients in a given year.[23] On October 22, 2020 (after the end of fiscal year 2020), the SEC issued a $114 million award to a whistleblower, its largest award to date.[24] Domestic and foreign whistleblower tips continue to increase significantly, totaling over 6,900 in fiscal year 2020, as the existence of the program and magnitude of potential awards become more publicly well-known, including to potential whistleblowers.[25] The SEC will continue to leverage the program as a source of new investigations to strengthen its enforcement efforts.

The success of the SEC's whistleblower program may also lead other regulatory agencies to step up similar efforts.

The success of the SEC's whistleblower program may also lead other regulatory agencies to step up similar efforts, particularly those seeking a pipeline of cases after limited enforcement activity over the last four years. For example, the CFTC has also increased its reliance on whistleblowers. More than 40% of the CFTC's orders granting awards to whistleblowers since the program's inception in 2010 were issued in fiscal year 2020, with 16 individuals receiving a total of approximately $20 million.[26] CFTC whistleblower tips also reached a new high of 1,030, a 36% increase from the previous high-water mark.[27]

Key Takeaways

— Boards of directors should be attuned to shifts in enforcement priorities that will accompany the Biden administration and recalibrate risk accordingly.

[19] See Cleary Gottlieb, "Insider Trading Risk during the COVID-19 Outbreak" (March 27, 2020), available here; U.S. Securities and Exchange Commission, "Statement from Stephanie Avakian and Steven Peikin, Co-Directors of the SEC's Division of Enforcement, Regarding Market Integrity" (March 23, 2020), available here.

[20] See Cleary Gottlieb, "SEC Internal Controls Case Demonstrates Agency's Focus on MNPI Issues in the Stock Buyback Context" (October 19, 2020), available here.

[21] See Cleary Gottlieb, "The CARES Act and Mitigating False Claims Act Risk" (April 13, 2020), available here.

[22] *Id.*

[23] U.S. Securities and Exchange Commission, "2020 Annual Report to Congress: Whistleblower Program" (2020), available here.

[24] *Id.* at 2 n.2.

[25] *Id.* at 2.

[26] Commodity Futures Trading Commission, "Whistleblower Program & Customer Education Initiatives: 2020 Annual Report" (October 2020) at 2-3, available here.

[27] *Id.* at 7.

- Financial institutions should expect increased regulatory scrutiny of Wall Street activity, while companies in the oil and gas, mining, automotive, aerospace and industrial sectors should be prepared for potential environmental investigations.

- Issuers need to be particularly attuned to the accuracy of their ESG disclosures.

- Board members should take additional precautions regarding adherence to financial reporting standards and compliance with internal policies and procedures in the course and aftermath of the COVID-19 pandemic, including by maintaining and strengthening their internal whistleblower programs.

- Companies should mitigate heightened insider trading risk through robust and tailored policies and trainings to address information flow and the use of MNPI.

The Privacy Law Plot Continues to Thicken: Compliance Considerations for 2021

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Patchwork and continually changing regulation continues to be the trend in data privacy law, with 2020 adding new legislation to the fray and striking down some existing privacy structures. 2021 will likely be a time of reflection for businesses trying to adjust to impending new requirements in the face of an increasingly remote workforce and customer base.

Boards and management will need to continue to monitor the evolving privacy compliance landscape to ensure that they are mindful of privacy obligations and attendant risks.

Boards and management will need to ensure that their businesses not only adjust to the legislation that entered into force in 2020, but are also preparing for the implementation of additional legislation on the horizon. As always, boards and management will need to continue to monitor the evolving privacy compliance landscape to ensure that they are mindful of privacy obligations and attendant risks when implementing their business objectives and oversight going into 2021.

California Privacy Rights Act (CPRA)

Californians passed the CPRA via ballot initiative in the November 2020 election. Superseding and augmenting the existing California Consumer Privacy Act (CCPA) that itself only came into effect in the beginning of 2020, the CPRA clarifies certain ambiguities in the CCPA and introduces new complexities and uncertainties for businesses to get a handle on before it goes into effect on January 1, 2023. While the CPRA both narrowed and expanded the applicability of the law on businesses, generally the law will apply to those businesses to which the CCPA is applicable. New regulations will still need to be issued to implement the act, resulting in more uncertainty and a pressing need for businesses to stay abreast of the evolution of this law as it moves toward its effective date.

Many obligations under the CCPA will remain. Notable differences between the CCPA and the CPRA include:

— ***Additional Obligations Regarding Sharing of Personal Information***. The CPRA includes new rights and obligations regarding the practice of a business "sharing" (not only selling) personal information, with a broad definition of "sharing" including providing a third party with consumer personal information for the purpose of cross-context behavioral advertising.[1] The CPRA provides consumers with a new right to opt out of the sharing of their data for this purpose, and as a result businesses will have to modify their websites and business practices to allow consumers to exercise this right.

— ***New Rights Relating to Sensitive Personal Information***. The CPRA creates a new concept of "sensitive personal information" (SPI).[2] Consumers may direct businesses collecting SPI to limit use of their SPI to those uses "necessary to perform the services or provide the goods reasonably expected by an average consumer" of such goods or services.

— ***New GDPR-Inspired Rights***. The CPRA gives consumers additional rights that are akin to rights under the EU General Data Protection Regulations (GDPR) – specifically, the right to correct personal information and the right to "data minimization," meaning covered businesses may only collect, use, retain and share a consumer's personal information to the extent that it is "reasonably necessary and proportionate" to either (i) the purpose for which it was collected or processed or (ii) another disclosed purpose that is compatible with the context in which it was collected.

Other key aspects of the CPRA include:

— ***Continued Review of Service Provider Agreements***. The CCPA requires a covered business to impose certain contractual restrictions on service providers that process consumers' personal information on behalf of the business. The CPRA has expanded the required restrictions, including by requiring a business to prohibit its service providers from combining personal information collected from the business with personal information collected through other means, either independently by the service provider or from other businesses.

— ***Enforcement***. The CPRA establishes a "California Privacy Protection Agency," the first agency of its kind in the United States, that will be able to enforce the CCPA and the CPRA beginning July 1, 2023.

[1] Defined as "the targeting of advertising to a consumer based on the consumer's personal information obtained from the consumer's activity across businesses, distinctly-branded websites, applications, or services, other than the business, distinctly-branded website, application, or service with which the consumer intentionally interacts."

[2] Personal Information that reveals a consumer's (1) government identification number; (2) account log-in, financial account, debit card, or credit card number in connection with any required security or access code; (3) precise geolocation (to be defined further in regulation); (4) race, ethnicity, religious or philosophical beliefs, or union membership; (5) contents of mail, email, or texts (unless the business is the intended recipient); or (7) genetic data. It also includes the processing of biometric information to uniquely identify a consumer or personal information collected and analyzed concerning the consumer's health (to the extent not covered by the existing HIPPA exemption), sex life, or sexual orientation.

— ***Forthcoming Regulations***. The CPRA requires adoption of several specific regulations, including rules requiring businesses to perform a GDPR-inspired annual audit to determine if their processing of consumers' personal information presents significant risk to consumers' privacy or security and to submit regular risk assessments with respect to processing of personal information to the California Privacy Protection Agency.

— ***Moratoria on Employee and B2B Data***. Currently, the CCPA does not apply to employee data or personal data collected in a business-to-business relationship. These moratoria have been extended to January 1, 2023.

EU – U.S. Privacy Shield Invalidated and Stricter Conditions to Continued Use of Standard Contractual Clauses Anticipated

In a highly anticipated landmark judgment handed down on July 16, 2020, the Court of Justice of the European Union (the CJEU) in *Data Protection Commissioner v. Facebook Ireland and Maximillian Shrems* (*Schrems II*)[3] invalidated the EU-U.S. Data Protection Shield (Privacy Shield) as a means for legal transfer of personal data from the EU to the United States. Businesses that transfer personal data from the EU to the United States can no longer rely on the Privacy Shield framework to transfer such data in compliance with the GDPR.

While the CJEU's judgment confirmed that the European Commission's "Standard Contractual Clauses" (SCCs) remain a valid mechanism for the transfer of personal data to "third countries" (including, but not limited to, the United States), the *Schrems II* judgment confirmed that primary responsibility for determining their efficacy on a case-by-case basis, by reference to the laws applicable in the recipient country, remains with the data exporter.

Whether or not your business was relying on the Privacy Shield framework, the *Schrems II* judgment gives rise to new legal concerns with respect to the primary methods that remain available to businesses for the transfer of personal data from the EU in compliance with the GDPR.[4]

— ***Continued Reliance on Standard Contractual Clauses***. As noted above, the CJEU made clear that SCCs remain valid; however, whether they amount to an appropriate safeguard in the circumstances of a particular transfer must be determined by the data exporter in collaboration with the data importer. The data controller must ascertain, in collaboration with the data importer, that the laws of the recipient country would not cause the parties to be incapable of complying with the SCCs or take efficient supplementary measures to protect the transferred data. In particular, the existence of laws permitting surveillance of, or access to, personal data by public authorities (where such access goes beyond what is "necessary in a democratic society") will preclude the ability to rely solely on the SCCs as a means to transfer the data in compliance with the GDPR unless technical, contractual or organizational measures (such as encryption or pseudonymisation) are taken to remedy the risk of unauthorized access.

— ***Reliance on Derogations***. The GDPR provides for a number of "derogations" to the general restriction on ex-EU data transfers, as set out in Article 49. These derogations include, for example, (i) obtaining consent of the data subjects; (ii) the transfer being necessary for the exercise, establishment or defense of a legal claim; or (iii) the transfer being necessary for important reasons of public interest. Derogations are generally not intended for use in connection

[3] For additional information, see our July blog post here.

[4] Among other developments since the judgment (blog post available here), on November 11, 2020, the European Data Protection Board published *Recommendations 01/2020 on measures that supplement transfer tools to ensure compliance with the EU level of protection of personal data*, which attempt to provide a step-by-step roadmap to help data exporters transfer personal data outside the EU in a manner consistent with the *Schrems II* judgment. The following day, the European Commission published a new set of standard contractual clauses with a view to incorporate certain contractual measures in light of the judgment. Both the EDPB's recommendations and the European Commission's new set of standard contractual clauses are still subject to comments via public consultation.

with massive or repetitive transfers and should be examined on a case-by-case basis.

— ***Reliance on Binding Corporate Rules (BCRs)***. For transfers of personal data between entities in the same corporate group, businesses can rely on BCRs. However, BCRs take time and a significant investment to put in place, and BCRs must be pre-approved by the competent supervisory authorities.

Class action activity regarding data protection or privacy violations is increasing across jurisdictions.

Other Privacy Legislation

— ***Other U.S. State Laws.*** The trend toward increased state privacy laws continued into 2020 with data privacy bills introduced in at least 30 states and Puerto Rico during 2020. However, the COVID-19 pandemic shifted legislative attention and, aside from California, no other prominent legislation was enacted.

— ***U.S. Federal Law.*** There was no substantial progress toward federal data privacy legislation, although in September, Republican senators introduced new data privacy legislation – the Setting an American Framework to Ensure Data Access, Transparency, and Accountability (SAFE DATA) Act. Whether such legislation becomes a priority of the Biden administration is yet to be seen. However, in light of the COVID-19 pandemic, there is a possibility of renewed attention to federal data privacy law related to health information.

— ***International Laws***. In 2020, data privacy laws in Brazil and Thailand went into effect, and India and South Korea introduced legislative changes in respect of data privacy. This trend will continue into 2021, making clear that boards and management will need to continue to monitor the evolving landscape of these laws on a global basis.

Increased Litigation and Enforcement Risks

Class action activity regarding data protection or privacy violations is increasing across jurisdictions. Data rights groups in the European Union and United Kingdom are seeing a rise in representative or class action-type suits – with class actions filed in the Netherlands against Oracle and Salesforce for alleged GDPR violations, as well in the UK against British Airways and Marriott in connection with personal data breaches for which both parties have incurred fines from the UK Information Commissioner's Office. Also in the UK, in 2021 the Supreme Court is set to hear the final appeal in the *Lloyd v Google* representative action which, if the class is successful, will open the door to representative actions in the UK for damages associated with the "loss of control" of personal data. Currently class actions under the GDPR are limited by member-state laws governing class actions, but this could change in light of a new directive agreed in June 2020 that, if adopted, would create a right of collective class action across the entire EU for data privacy violations.

In the U.S., standing has historically been an issue for plaintiffs bringing privacy-based class actions. However, courts have been increasingly allowing claims brought by plaintiffs that have not suffered actual damages or identity theft by, instead, finding that an increased risk of identity theft establishes standing. In April, the Ninth Circuit in the matter of *In re Facebook, Inc. Internet Tracking Litigation* permitted plaintiffs' claims to continue, finding that violation of privacy constituted a concrete injury for standing purposes. Additionally, plaintiffs' ability to bring class actions that survive removal to federal courts and establish Article III standing under the Illinois Biometric Information Privacy Act (BIPA) was bolstered by the Seventh Circuit in *Bryant et al. v. Compass Group U.S.A. Inc.* Here, the Seventh Circuit found that defendant's failure to provide plaintiff with informed consent to the collection of her biometric data caused plaintiff to suffer a concrete injury and allowed certain of her BIPA claims to proceed in federal court.

Finally, high-profile tech companies are facing these claims at an increasing rate (e.g., Shutterfly and Facebook have defended BIPA class actions), and claims and settlement amounts are making headlines (e.g., in 2020, Facebook agreed to pay $650 million to settle its long-fought BIPA dispute; and in September 2020, a class-action style claim against Google subsidiary YouTube was filed in the UK, seeking damages of approximately £2.5 million, alleging YouTube's violation of UK and EU data protection law). The increased publicity brought by these defendants and these amounts might create the perfect storm for "big ticket" litigation.

Coupled with those cybersecurity enforcement actions and litigation highlighted in Cybersecurity: Another Year of Intrusions and Regulation Punctuated By a Pandemic in this memo, this trend in litigation indicates that failure to comply with privacy and cybersecurity laws will increasingly result in significant financial liability and should continue to be a focus of boards and management as we move into 2021.

Key Takeaways:

- While the CPRA expands the privacy rights afforded by the CCPA, it does not go into effect until 2023. Until then, businesses must continue to comply with the CCPA and its related regulations while also monitoring the developments under the implementing regulations of the CPRA and preparing for CPRA compliance in two years.
- Legislative and enforcement trends indicate that failure to closely monitor data collection, processing and sharing activities and compliance obligations will pose increasing financial risk as this landscape evolves in 2021.

Cybersecurity: Another Year of Intrusions and Regulation Punctuated By a Pandemic

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Cybersecurity, a topic that was already top of mind for boards and corporate stakeholders at the start of the year, was pushed even further to the fore in the wake of the COVID-19 pandemic. The increased prevalence of remote working made it all the more critical for companies to manage cybersecurity risk.[1] In a recent survey of business and technology executives, 96% of respondents said that they will shift their cybersecurity strategy due to COVID-19, and 50% say that they will consider cybersecurity in *every* business decision (up from 25% last year).[2] Boards in turn will take on an increasing role in managing oversight of this high-stakes issue.

Data Breaches

A number of significant data breaches occurred in 2020, driving the conversation on cybersecurity risk:

— In March, Marriott announced that beginning in mid-January, hackers had accessed the personal information of approximately 5.2 million guests, including names, contact details and addresses. This follows the previous high-profile hack of Marriott that occurred in 2018.

— In May, EasyJet announced that hackers had improperly accessed the email addresses and travel details of approximately 9 million customers including over 2,000 customers' credit card numbers and security codes.

— In July, the Twitter accounts of many high-profile figures, including Joe Biden, Bill Gates and Kanye West, were hacked in a bitcoin scam.

1 For additional details, see our March blog post here.

2 PwC Cybersecurity Coming of Age (October 5, 2020).

Regulators in 2020 were increasingly active in bringing cybersecurity enforcement actions against companies that allegedly maintained inadequate cybersecurity protections.

Regulatory Focus on Cybersecurity

In response to continuing significant data breaches, regulators in 2020 were increasingly active in bringing cybersecurity enforcement actions against companies that allegedly maintained inadequate cybersecurity protections or failed to comply with related obligations:

— In July, New York's Department of Financial Services (DFS) brought its first-ever enforcement action for the alleged breach of its cybersecurity regulations, which had been in force as of 2019. DFS alleged that First American Title Insurance Company was aware of a vulnerability in its website that allowed tens of millions of documents containing personal information to be publicly accessed, but, because of a "cascade of errors," First American allegedly did not remedy the vulnerability for six months.

— In August, the U.S. Department of Justice charged Uber's former Chief Security Officer with obstruction of justice and misprision of a felony for allegedly attempting to cover up a 2016 data breach during the course of an investigation by the Federal Trade Commission.[3] The prosecution represents an aggressive step by federal authorities in bringing charges under the obstruction and felony misprision statutes, the latter of which is a relatively rarely used statute in white-collar cases.

— In August, the Office of the Comptroller of the Currency (OCC) assessed an $80 million civil monetary penalty and entered into a cease-and-desist order with the bank subsidiaries of Capital One, following a 2019 cyber-attack. The OCC actions represent the first imposition of a significant penalty on a bank in connection with a data breach or an alleged failure to comply with the OCC's guidelines relating to information security.[4]

— In October, the UK Information Commissioner's Office announced that it was reducing its proposed fines against British Airways and Marriott Hotels for violations of the EU General Data Protection Regulation (GDPR) that occurred in connection with previous data breaches. In 2019, the ICO had announced its intent to fine British Airways and Marriott £183 million and £99 million, respectively, but the final fines were £20 million and £18.4 million. The reduction likely reflects the ICO's consideration of remedial steps that the companies took and the fact that both companies are in industries that were severely impacted by the COVID-19 pandemic.

— In November, the Federal Trade Commission announced a settlement with Zoom Video Communications, Inc. (Zoom) arising out of Zoom's alleged misrepresentations regarding the level of encryption it offered for users' communications (unrelated to the breach Zoom disclosed in April), as well as an allegation that Zoom secretly installed software that bypassed an Apple Safari browser safeguard. In connection with the settlement, Zoom agreed to establish and implement a comprehensive security program that requires it, among other things, to regularly review software updates for security flaws.

Litigation Developments

There were also significant developments in litigation related to cybersecurity in 2020:

— In February, in largely denying Marriott's motion to dismiss the litigation arising out of the 2018 breach of Starwood Hotels & Resorts (which Marriott acquired in 2016), a Maryland federal district court rejected Marriott's standing arguments and held that

3 For additional details, see our September blog post here.

4 For additional details, see our August blog post here.

plaintiffs can establish injury-in-fact based on the non-speculative "imminent threat" of identity theft. The decision is one of a potentially developing trend of companies facing increasing difficulty in obtaining dismissals of data breach litigation at early stages based on the argument that consumers were not injured by exposure of their personal information.

— In May, in class action litigation arising out of the above-referenced 2019 data breach, Capital One was ordered by a Magistrate Judge in federal district court in Virginia to produce to plaintiffs a digital forensic investigation report, finding that such report was not protected from disclosure by the attorney work product doctrine. The court's decision highlights the challenges in maintaining protection over the work product of data incident investigators who have broad retainer agreements and in cases where the product is used for multiple purposes.[5]

— The California Consumer Privacy Act (CCPA), as of 2020, gave California residents a private right of action in the event of data breaches. The first such lawsuits have already been filed, including *Fuentes v. Sunshine Behavioral Health Group, LLC*, an action arising out of an alleged data breach of the personal and medical information of thousands of patients of a behavioral health treatment center, and *Atkinson v. Minted, Inc.*, an action arising out of an alleged data breach of the account information of millions of customers of an online stationery and craft company. CCPA litigation is likely to proliferate, particularly with the passage of enhanced CCPA provisions that were approved by California voters in the November election as discussed in The Privacy Law Plot Continues to Thicken: Compliance Considerations for 2021 in this memo.

Key Takeaways

— Cybersecurity continues to be an essential issue for companies, both in light of the pandemic and the notable data breaches that occurred in 2020.

— Increased regulatory action related to cybersecurity issues portends the continued shift away from regulators viewing hacked companies as only victims and toward potentially holding them responsible for perceived deficiencies in their cybersecurity programs and other implicated internal controls.

— Private litigation arising out of data breaches continues to proliferate, and courts have recently handed down plaintiff-friendly decisions on standing and discovery issues, which may make the cases even more expensive to litigate.

— In 2021, we expect these trends to continue and possibly expand as hackers continue their activities unabated, while the Biden administration may lead to an increased focus on enforcement and potentially federal data security legislation that has eluded lawmakers for years.

[5] For additional details, see our July blog post here.

Taxes: The Rules Continue to Change and Tax Authorities Focus on Enforcement

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In recent years, the international tax system has experienced significant change as tax authorities across the globe have adopted and implemented new rules and procedures to respond to the new economy and perceptions of taxpayers arbitraging differences among jurisdictions.

While this process has been partially delayed by special temporary tax measures enacted by governments in response to COVID-19, once these measures expire, tax authorities and policymakers can be expected to rapidly resume forceful enforcement initiatives and the introduction of further substantive law changes. We expect to see, in particular, an increased focus on how to tax companies engaging in digital transactions. While many of the rules enacted so far 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 and the UK have introduced a new mandatory disclosure regime, known as DAC6, requiring intermediaries (including tax advisers, accountants, lawyers and banks) that establish or advise on certain kinds of "cross-border arrangements" to provide extensive information about those arrangements to local tax authorities. Following Brexit, the UK rules now only apply to a limited extent, with a focus on arrangements that undermine financial account information reporting obligations and arrangements that obscure beneficial ownership.

While the first reports are not due until early 2021 in most jurisdictions (other than Germany, Austria and Finland, where reporting obligations commenced in July 2020), the period covered looks back all the way to June 2018. As intermediaries start to make reports, taxpayers can expect enhanced information sharing among tax authorities and wide-ranging follow-up information requests.

Taxpayers can expect enhanced information sharing among tax authorities and wide-ranging follow-up information requests.

We expect DAC6 to result in a significant increase in audits (including multijurisdictional joint audits) and in assertions of tax underpayments by tax authorities. 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 or are otherwise at risk.

Reshaping the Global Tax System for the Digital Economy

Various jurisdictions have recently introduced unilateral rules targeting digital transactions and structures.

In the UK, a digital services tax (DST) took effect in April 2020. It applies 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 a 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 was introduced in Italy, effective as of January 1, 2020.

Looking to the future, the October 2020 Organization for Economic Co-operation and Development (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. This program may result in governments enacting additional new rules.

Companies offering digital services should be prepared for drastic changes to their worldwide tax exposure and filing obligations as these and other measures take effect in the coming years.

Other Significant Changes to Tax Systems

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

The EU anti-tax avoidance directive (referred to as ATAD) took effect in 2019 and includes extensive anti-hybrid rules modelled after the OECD's base erosion and profit-shifting (BEPS) recommendations. ATAD also includes changes to Controlled Foreign Corporation (CFC) rules and a harmonization of the rules across the EU. The

EU, the United States and the OECD have also enacted or proposed various measures intended to ensure that multinational companies pay a minimum rate of tax on global income.

In connection with the transposition of ATAD into EU Member States' national laws, as well as the drive to raise revenues to cover pandemic-related aid packages and to address recent tax-related scandals (such as German cum/ex schemes), we expect increased significant legislative activity (for example, Germany has recently started to overhaul its substance requirements and withholding tax system). 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 they should evaluate their current tax strategies and intercompany transactions and structures accordingly.

Changing Priorities and Increased Tax Litigation Expected in the United States

Over the past few years, the U.S. Department of the Treasury and the IRS have been focused on providing administrative guidance implementing the tax reform law enacted in 2017 (referred to as the "TCJA" and the "2017 Tax Reform"). This guidance (in the form of Treasury Regulations, FAQs, new IRS forms and information publications, and other substantive and procedural releases) has been voluminous, complex and often controversial. While Treasury finalized an enormous amount of this guidance before the end of 2020, there are some regulatory projects that were only recently released in proposed form and could not be finalized before year-end.

The Biden administration can take significant actions in the tax area without legislation.

Whether we will see any significant tax legislation in 2021 is unclear at this point and will depend in large part on the politics in the U.S. Congress. Whether we will see any significant tax legislation in 2021 is unclear at this point and will depend in large part on the politics in the U.S. Congress and what the Biden administration wants to focus on, particularly given what now appears to be a very narrow Democratic control of the Senate. The Biden administration could, however, take significant actions in the tax area without involving Congress, including by adopting new regulatory rules and establishing new enforcement priorities and policies.

Indeed, tax litigation is an area of increasing focus in the United States. There has been a significant increase in the number of court cases challenging the legal validity of Treasury regulations and other forms of IRS guidance, as well as IRS enforcement actions, and we expect this will continue for at least the next few years, if not decades. The challenges have included assertions that the guidance or actions are invalid because they are substantively contrary to the underlying statutory rules and because Treasury and the IRS procedurally did not comply with the U.S. Administrative Procedures Act (APA) or other applicable rules. Taxpayers have had some significant and sometimes surprising success, while the IRS has also had its share of successes. One result of this litigation is that Treasury and the IRS are focusing significant attention and efforts on shoring up the substantive and procedural support for all of their rule-making and enforcement actions.

One particularly significant tax case was argued in the U.S. Supreme Court in early December 2020, and we expect to see a decision in the first half of 2021. *CIC Services LLC v. IRS* involves the ability of a taxpayer to challenge whether an IRS Notice establishing an information-reporting requirement (enforced through a tax penalty due in the event of non-compliance) is valid before the IRS has sought to impose the non-compliance penalty. The U.S. Anti-Injunction Act and the Declaratory Judgment Act generally prohibit courts from enjoining the collection of any tax before the IRS has attempted to collect the tax (referred to as a "pre-enforcement challenge"). But the scope of these prohibitions and how they interrelate with taxpayers' rights under the APA are being tested through numerous lawsuits. In *CIC Services*, the plaintiff is asserting a violation of the APA's procedural requirement that rules go through a public "notice and comment" process before being finalized; other cases are asserting that various Treasury regulations are inconsistent with the underlying Internal Revenue Code provision or are substantively "arbitrary and capricious" in violation of the APA.

The Supreme Court's decision may have an impact on the questions raised in the other cases, particularly whether taxpayers have any ability to challenge substantive tax regulations or IRS notices pre-enforcement.

This case is distinguishable from many of the other cases because it involves a rule requiring only the reporting of information to the IRS – not a rule that requires the payment of taxes. Nevertheless, the Supreme Court's decision may have an impact on the questions raised in the other cases, particularly whether taxpayers have any ability to challenge substantive tax regulations or IRS notices pre-enforcement. This is a very important issue to taxpayers for whom a decision as to whether to undertake a particular transaction is entirely dependent upon whether a substantive tax regulation will or will not apply. It is an equally important issue to Treasury and the IRS, which do not want to be inundated with pre-enforcement challenges.

Key Takeaways

— Taxpayers operating in Europe and the UK should be aware of increased information reporting and sharing in relation to their cross-border activity. There is likely to be a consequential increase in audit and enforcement activity, including criminal investigations.

— Companies offering digital services should prepare for the possibility of new nexus and profit allocation rules that require them to pay taxes where they have significant profit-making, consumer-facing activities. All multinational companies should be prepared for further tax reforms focusing on measures such as substance and minimum levels of taxation.

— In the United States, it remains uncertain whether we will see any significant tax legislation in 2021 and whether the Biden-led Treasury Department and IRS will pursue significant changes through administrative guidance and enforcement actions. Tax litigation will also be an area of focus and interest in 2021, as we await the Supreme Court's decision in the *CIC Services* case challenging the validity of an IRS rule and observe its impact on the many similar cases pending in the lower courts.

U.S. and EU Antitrust: Expect Robust Enforcement in 2021

U.S. Antitrust: Developments and Outlook

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Antitrust was front-page news in 2020: regulators sued Google and Facebook in some of the biggest antitrust enforcement actions in recent decades. Robust antitrust enforcement can be expected to continue under a Biden administration.

Robust antitrust enforcement can be expected to continue under a Biden administration.

Big Tech Lawsuits

In October, the U.S. Department of Justice and 11 states sued Google, alleging its conduct relating to search and search ads violated Section 2 of the Sherman Act. The DOJ alleged that Google achieved its lead in online search, where Google accounts for nearly 90% of all U.S. queries, through exclusionary agreements requiring Google to be the default search engine on devices, and then used those revenues to reinforce its monopoly. The DOJ alleged Google's practices have foreclosed other search engines from meaningfully competing in the United States, harmed consumers by reducing privacy and suppressed competition in advertising. In addition to an injunction against these practices, the DOJ seeks unspecified structural relief. In December, two separate state lawsuits were filed against Google. First, Texas and nine other states filed a suit alleging that Google manipulated digital advertising markets in violation of antitrust laws. The complaint alleges that Google entered into an agreement with Facebook to limit competition in return for special treatment in Google-run ad auctions. A few days later, Colorado and 37 other states sued Google, alleging it leveraged its monopoly in search to limit consumer choice and foreclose competition from specialized search engines. Google has strongly denied all the claims against it and is vigorously litigating in defense of these cases. Three additional states later joined the suit.

In December, the Federal Trade Commission and 48 states sued Facebook, accusing it of abusing its monopoly in personal social networking to swallow up smaller competitors. The FTC alleges that Facebook targeted potential competitive threats to its dominance with its acquisitions of Instagram in 2012 and WhatsApp in 2014, though both deals were cleared by the FTC at the time. The complaint also alleges that Facebook imposed anticompetitive conditions on third-party developers' access to its application programming interfaces. The FTC seeks remedies that could include a mandated divestiture of Instagram and WhatsApp.

Other investigations are ongoing and may result in additional lawsuits against "Big Tech" platforms like Apple and Amazon. Notably, after a year-and-a-half investigation, a Democratic-led House panel recently concluded that Google, Facebook, Apple and Amazon all wield monopoly power and urged greater antitrust enforcement. A potential flood of private suits following any government action is another source of concern for these companies – numerous such suits have already been filed, and more are likely.

Tech-focused enforcement is not limited to these four household names. In April 2019, the FTC launched a major antitrust case against Surescripts, a leader in the e-prescriptions market. The FTC alleged that the company used anticompetitive agreements to maintain its monopoly in the routing of prescriptions to pharmacies and the market for determining eligibility for prescription coverage and ultimately denying patients the benefits of competition. The FTC's case survived a motion to dismiss and is in discovery. In November, the DOJ sued to block Visa's $5.3 billion acquisition of Plaid Inc., an innovative fintech firm. According to the DOJ, as a monopolist in online debit services, Visa is attempting to acquire a nascent competitor developing a lower-cost option for online debit payments. As a leading data aggregator, Plaid planned to leverage its connections to build a payments network that would disrupt Visa's collection of processing fees. Despite the lack of apparent overlaps between the companies, the complaint relied heavily on Visa's own emails and other internal documents, which DOJ argued revealed the company's plans to roll back Plaid's development of a cheaper alternative debit service.

In December, the FTC also issued orders under Section 6(b) of the Federal Trade Commission Act to nine social media and streaming companies ordering them to provide data on how they gather and use personal information and their advertising practices, including how those affect children and teens.

Beyond tech, state regulators continued to take an active role in antitrust. Most notably, 14 states filed a challenge to the T-Mobile and Sprint merger, even though it had received DOJ and FCC clearance. This unusual suit was publicly opposed by DOJ and ultimately defeated in early 2020.

Stepped-up merger and conduct enforcement should be expected from the DOJ, while the current aggressive levels of FTC enforcement will likely continue.

Enforcement in the Biden Administration

Looking forward, stepped-up merger and conduct enforcement should be expected from the DOJ, while the current aggressive levels of FTC enforcement will likely continue, with perhaps a slight uptick and a particular focus on pharmaceutical mergers. However, a major swing toward progressive antitrust enforcement is unlikely.

Similarly, legislative changes will likely be incremental rather than radical. While the Democrats have won control of the Senate, that control is marginal (depending on the Vice President breaking ties), and is far from a filibuster-proof majority. Thus, support from moderate Democrats and Republicans will be necessary to pass legislation. Legislation that is more likely to garner such support includes increasing agency funding, addressing recent adverse court decisions involving the FTC's jurisdiction and remedial authority and other marginal changes. Sweeping proposals such as those considered in the House Judiciary Majority Staff Report on the technology industry mentioned above are not likely to advance (though some of the more modest proposals directed at the tech industry may garner bipartisan support).

By historical standards, DOJ merger enforcement levels have been relatively low under Assistant Attorney General Makan Delrahim, with the notable exception of a set of high-profile cases such as the unsuccessful challenge to AT&T's acquisition of Time-Warner. That will likely change. Even with marginal control of Congress, any Biden nominee for AAG will probably have to come from the mainstream antitrust tradition of the Democratic party, but that still leaves room for more aggressive merger enforcement. Expect current cases to continue, and mergers to receive more probing scrutiny, with enforcement levels possibly similar to those of the recent FTC. Criminal enforcement may also increase, though the decline in cartel cases we have observed is not limited to the U.S., and so may not result from administration policy. It is also reasonably likely that the Biden DOJ will reverse or step back from the strongly pro-IP "New Madison" approach to IP/antitrust issues advanced by AAG Delrahim, rebalancing toward antitrust enforcement in the IP context. On the other hand, new leadership at the DOJ may continue the aggressive "statement of interest/amicus" program AAG Delrahim developed, which resulted in historically high levels of DOJ court filings (though probably with somewhat different content).

The FTC's current activity levels do not leave huge amounts of room (or resources) for drastic increases.

The FTC has been very aggressive in recent years, including in 2020 breaking a record for merger enforcement actions that had stood since 2000. While there will be pressure to be even more aggressive, the FTC's current activity levels do not leave huge amounts of room (or resources) for drastic increases. Also, as with the DOJ, any chairman President Biden might appoint, and the Bureau directors that chairman will select, will likely come from the mainstream of the Democratic antitrust community, which also suggests that FTC enforcement will not change radically. We do expect increasing scrutiny of pharmaceutical transactions, as the current Democratic commissioners' objections to FTC merger decisions have disproportionately focused on that industry, and perhaps more skepticism of vertical mergers. There's an open question as to how long it will take the FTC to switch to Democratic control. It is technically possible for Republicans to retain voting control of the agency until 2023. We do not believe that will occur, but it may take time – perhaps well into the middle of 2021 – for Democrats to take control of the FTC. However, even if Republicans remain in control of the FTC for a transition period, the FTC's independence and existing policy priorities should mean that the FTC will sustain its current high level of antitrust enforcement.

Potential HSR Rule Changes

In September 2020, the FTC published two documents related to potential Hart-Scott-Rodino rule (HSR Rule) changes: (i) a Notice of Proposed Rulemaking (NPRM) and (ii) Advance Notice of Proposed Rulemaking (ANPRM).

While these rules have not yet been adopted, and the timeline for adoption is unclear, if implemented, they may significantly increase the burden of the HSR Rules, particularly for investment firms. The NPRM, as drafted, would expand the definition of "person" to attempt to capture information about different investment funds that are under common management. It would also add a new exemption for acquisitions of less than 10% of the voting securities of an issuer provided that the acquirer is not a competitor, does not own more than 1% of any competitor, is not a major supplier or customer of the company and is not an officer/director/principal/agent of the company. While this would seem to be a beneficial new exemption in addition to the existing "investment only" and "institutional investor" exemptions, in practice the new proposed exemption may be difficult to use. Moreover, the ANPRM suggests that the FTC is rethinking its approach to these exemptions on a going forward basis.

As 2021 continues, it will be important to watch these potential changes and consider their impact, especially in the context of corporate investments.

Key Takeaways

There is little indication that antitrust enforcement will abate under a Biden administration. In pursuing actions against "Big Tech," federal and state regulators have shown unprecedented willingness to challenge already consummated deals as well as the acquisition of nascent competitors. In other sectors, enforcement by both DOJ and the FTC can be expected to be even more aggressive as well, particularly in the pharmaceutical space, though Biden appointees will likely come from the mainstream of Democratic antitrust community.

EU Antitrust: Developments and Outlook

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Despite the COVID-19 pandemic, 2020 was another active year for antitrust enforcement in Europe, with continued robust enforcement expected for the year to come.

European Commission Vice President Margrethe Vestager, having just completed her first year in her new role as Commissioner responsible for the Commission's Digital Agenda and the first year of her second five-year term as Competition Commissioner, has fully embraced Commission President Ursula von der Leyen's call to further strengthen the Commission's antitrust enforcement efforts. This has been particularly true in new and emerging markets that the Commission views as shaping European economies and society.

Big Tech and Abuse of Dominance Investigations

After blockbuster fines against Google (in the *Shopping*, *Android* and *AdSense* cases) and an e-commerce sector inquiry that led to various Big Tech investigations in Vice President Vestager's first term as Competition Commissioner, the Commission's focus on Big Tech has continued in 2020 and will continue into 2021.

The Commission's Directorate General for Competition now has a number of significant ongoing investigations in the sector, several of which involve novel issues or theories of harm. These include:

— ***Amazon Marketplace***. Following an investigation initiated almost two years ago in the wake of the Commission's e-commerce sector inquiry, the Commission in November 2020 issued Amazon a statement of objections, alleging the misuse of its Marketplace's independent sellers' data. Specifically, applying a novel theory of harm, the Commission is alleging that Amazon is misusing large quantities of non-public and sensitive business data of third-party sellers to the benefit of its own retail activities and thus leveraging its dominance in the market for the provision of marketplace services into various retail markets. These data inform strategic decisions, including product launches and targeted discounts, and allow it to focus its own offers on best-selling products (while other retailers have no such advantage).

— ***Amazon – Buy Box***. When issuing its statement of objections in the *Marketplace* investigation, the Commission also formally opened a separate investigation into Amazon's business practices that might artificially favor its own retail offers and offers of marketplace sellers that use Amazon's logistics and delivery services. In particular, the Commission is examining the manner in which Amazon selects sellers that appear in the "Buy Box," Amazon's direct purchase feature through which the bulk of Marketplace transactions are conducted. The Commission is concerned that Amazon may be leveraging its dominant position in marketplace services across to the logistics markets or the retail markets in which it is active.

— ***Apple – App Store Practices***. Earlier in 2020, and following complaints by Spotify and an e-book distributor, the Commission opened three formal investigations targeting Apple's App Store rules applicable to music streaming, e-books/audiobooks and apps that compete with Apple offerings. All three investigations appear to be focused on the same theory of harm, namely that Apple-imposed contract terms disadvantage app developers that compete with Apple's own apps. In particular, the Commission is concerned with Apple forcing rival app developers to use Apple's own in-app purchase system, through which it charges a 30% commission, and with Apple preventing those developers from informing users of alternative purchasing possibilities for their apps.

— ***Apple Pay***. At the same time, the Commission also opened a separate investigation into Apple's practices regarding Apple Pay. The investigation is focused on whether Apple is foreclosing rival providers of mobile payments from offering their solutions to users of iOS devices. In particular, the Commission is reviewing (i) "Apple's terms, conditions, and other measures" related to the use of Apple Pay for purchases made on merchant apps and websites accessed from iOS devices; and (ii) the alleged favouring of Apple Pay by making it the only solution with access to so-called "tap and go" technology embedded in iOS mobile devices.

Commission is also pursuing a sector inquiry of the Internet of Things (IoT) space and advancing planning for a new *ex ante* regulatory instrument for platforms acting as so-called digital gatekeepers.

While proceeding with these investigations, the Commission in parallel is also pursuing a sector inquiry of the Internet of Things (IoT) space and advancing planning for a new *ex ante* regulatory instrument for platforms acting as so-called digital gatekeepers:

— ***IoT sector inquiry***. In July 2020, the Commission kicked off a sector inquiry into the nascent IoT space. In doing so, it expressed concern that the IoT sector, as it grows, presents so-called "tipping risks" that might leave certain players with an unfair advantage. In that context, the ongoing inquiry is focusing on potential restrictions on data access and interoperability, as well as certain forms of favoring and practices linked to the use of proprietary standards. The sector inquiry covers products such as wearable devices (e.g., smartwatches or fitness trackers) and connected consumer devices used in the smart home context, such as refrigerators, washing machines, smart TVs, smart speakers and lighting systems. The sector inquiry is also collecting information related to services available via smart devices, such as music and video streaming services, and the voice assistants used to access them. Based on the findings of the sector inquiry, the Commission may later initiate more targeted antitrust investigations, as it did with its e-commerce investigation.

— ***Digital Markets Act***. In December 2020, the Commission also released a legislative proposal that would create *ex ante* regulatory enforcement capabilities targeted at platforms that act as "gatekeepers" in the digital sector and thus have a disproportionate impact on the functioning of the internal market. The rules, if passed, would address issues such as interoperability, one-sided data access or favoring, and would apply to companies providing specific pre-defined "core platform services." The new regime would be administered by the Commission, although it remains unclear whether by the Directorate General for Competition or the Directorate General for Communications Networks, Content and Technology. It would also give the Commission powers to impose fines and remedies in the event of noncompliance. The proposal will flow through the European legislative process and is on a path that could see it adopted in or around 2023.

National Competition Authorities in Europe too have focused (and are expected to continue to focus) their enforcement efforts on Big Tech. Most notably, this has included multiple competition authorities' investigations into conduct by Amazon, the German Federal Cartel Office's investigation of Facebook's data practices as well as legislative proposals, such as in Germany and the UK, targeted at Big Tech companies.

Merger Control

With respect to merger control, boards should expect continued vigorous enforcement in Europe. In recent years, this has entailed more resources devoted to complex cases, along with longer pre-notification periods, a greater use of sophisticated quantitative tools and economic analyses, more requests for a greater range of internal documents and more wide-reaching remedies in complex cases.

With respect to merger control, boards should expect continued vigorous enforcement in Europe.

If anything, the European General Court overturning the Commission's prohibition of the UK's Three/O2 mobile telephony transaction in May 2020 will only make complex merger control review more demanding and resource-intensive in complex cases in the years to come, as Commission case teams work harder to insulate future decisions from judicial scrutiny.

In 2020, the Commission also outlined a few specific initiatives in the merger control field:

— ***Referrals***. As part of an effort to close the enforcement gap for so-called "killer acquisitions" and other transactions involving nascent targets with no or limited revenues, Vice President Vestager suggested that the Commission change its approach to referrals from National Competition Authorities in Europe, to encourage referrals, even when relevant national thresholds are not met. The Commission expects this new policy could come into effect by mid-2021 and, while it remains to be seen how it will be implemented in practice, it could lead to significant legal uncertainty if the Commission were suddenly, through this loophole, able to review transactions that do not trigger review thresholds anywhere in Europe.

— ***Market Definition***. Separately, the Commission is also reviewing its 1997 Market Definition Notice to assess whether the Notice needs to be updated to better capture cases in digital markets, as well as mergers in markets where competition takes place globally. It expects to publish the results of its evaluation in 2021.

Restrictive Practices

With the Vertical Block Exemption Regulation set to expire in May 2022, the Commission in September 2020 published a report on its views of the functioning of the Regulation and accompanying Vertical Guidelines. While it largely concluded that the Regulation and Guidelines had worked effectively for the past (almost) 10 years, it also noted there is a need for targeted updates to both documents as a result of the growth of online sales and new market players (such as online platforms).

Specific areas for improvement identified by the Commission include:

— tackling diverging interpretations by National Competition Authorities in Europe,

— providing further guidance on the assessment of retail parity clauses and restrictions on the use of price comparison websites, and

— when possible, reducing the burden on the businesses associated with self-assessment.

The Commission intends to publish a draft new Regulation and Guidelines in the course of 2021 for public consultation.

With regard to cartel enforcement, notwithstanding the drop in immunity and leniency applications in recent years, boards should continue to expect the Commission's rigorous pursuit of cartel activity. In particular, purchaser-side cartels have been a focus for the Commission in the last year, with the Commission fining three ethylene purchasers a total of €260 million for cartel conduct in July 2020, and with a number of other purchasing cartel investigations ongoing.

Green Agenda

Throughout 2020, President von der Leyen and others on the Commission have said on several occasions that they expect competition policy to be one pillar supporting the European Green Deal. While acknowledging that competition policy cannot replace environmental laws and regulation, or green investments, the Commission does believe there is room for EU competition law to complement the proposed Green Deal legislative package.[1]

The Commission has suggested it is considering whether horizontal and vertical agreements pursuing Green Deal objectives should benefit from special treatment under the antitrust rules.

In a March 2020 speech, Commissioner Vestager signaled, for example, that State aid rules could be reviewed to better take into account sustainable objectives. Similarly, the Commission has suggested it is considering whether horizontal and vertical agreements pursuing Green Deal objectives should benefit from special treatment under the antitrust rules, or whether merger control rules should take into account sustainability objectives as relevant merger specific effects.

The Commission, in October 2020, called for contributions and views from all business sectors on ways in which the competition rules might further the Green Deal, with a conference planned to take place in early 2021 to bring together the different perspectives on this topic. The topic raises the somewhat

[1] For more information on the Green Deal and other EU environmental and sustainability developments, please see Progress Since Paris: Sustainable Policy in Europe in 2020 and Beyond, in this memo.

controversial question whether harm to the climate or the environment should be included in the notion of "consumer welfare" that drives current competition law enforcement.

Brexit

The Brexit transition period ended on December 31, 2020, and EU competition law as such has ceased to apply in the UK. In practice, this means that mergers not notified before the end of 2020 are no longer subject to the EU one-stop-shop principle, and merging companies could be faced with parallel reviews in the EU and UK. Similarly in antitrust enforcement, the Commission no longer has jurisdiction to apply Articles 101 and 102 TFEU to practices (not already under investigation) having an effect in the UK.

However, UK businesses could continue to be investigated and potentially fined by the Commission for infringements that relate to the remainder of the EU, in the same way as companies based in countries outside the EU have been to date.

Outlook on Antitrust Enforcement

Despite the COVID-19 crisis and its impact on the European economy, the pandemic had minimal impact on EU antitrust enforcement as the Commission has continued to advance its cases in a timely manner. In 2021, boards should expect a continuation of the vigorous enforcement and keep an eye on the various, ongoing policy debates, which could greatly influence European antitrust rules in the years to come.

Developments in U.S. Sanctions and Foreign Investment Regulatory Regimes

Economic Sanctions: Developments and Considerations

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The new year comes in the midst of an evolving landscape for economic sanctions, including the transition away from a U.S. administration that has relied on tightening economic sanctions as a key component of a number of foreign policy initiatives. In 2021, boards of directors should be aware of the ongoing implementation of new China-related sanctions, sanctions risks relating to ransomware attacks and the potential sanctions implications of foreign-policy shifts by the incoming Biden administration.

The new year comes in the midst of an evolving landscape for economic sanctions, including the transition away from a U.S. administration that has relied on tightening economic sanctions as a key component of a number of foreign policy initiatives.

China-Related Sanctions

The latter half of 2020 witnessed a flurry of new sanctions relating to China and Hong Kong. In July, President Trump signed into law the Hong Kong Autonomy Act (HKAA), which authorizes blocking sanctions against individuals and entities determined to "materially contribute" to the erosion of Hong Kong's autonomy. The HKAA further authorizes secondary sanctions, including the imposition of blocking sanctions, against foreign financial institutions that knowingly conduct a significant transaction with foreign persons sanctioned under this authority.

In parallel with the HKAA, President Trump issued Executive Order 13936 eliminating differential treatment for Hong Kong. Among a number of other changes to U.S. policy toward Hong Kong, the executive order authorizes the imposition of sanctions on parties engaged in a number of activities, including developing, adopting or implementing the Law of the People's Republic of China on Safeguarding National Security in the Hong Kong Administrative Region. It also authorizes the imposition of sanctions on parties engaged in actions relating to the undermining of democracy or autonomy, censorship or serious human rights abuses in Hong Kong. To date, direct U.S. sanctions on China have been narrow and targeted at specific parties.

In addition, in November 2020 President Trump issued Executive Order 13959, which following an initial grace period, prohibits U.S. persons from engaging in transactions in publicly traded securities (debt or equity) issued by companies that the U.S. government designates as tied to the Chinese military, as well as in any securities linked (in an undefined manner) to those targeted Chinese securities. Beginning January 11, 2021, transactions by U.S. persons in listed securities of designated entities, or derivatives or securities "designed to provide economic exposure" to such listed securities, are prohibited unless made to divest, in whole or in part, securities held by U.S. persons as of that date (in which case they are permitted until November 11, 2021). The executive order raises a number of yet unanswered questions regarding scope and implementation. Boards of companies with exposure to any of the listed entities – which include a number of multinational Chinese state-owned enterprises and companies listed on stock exchanges around the world – should continue to monitor developments and future guidance.

Sanctions Considerations Associated With Ransomware Attacks

As the number of ransomware attacks grows, boards, and risk, crisis and cybersecurity committees in particular, should be aware of the sanctions risks associated with making or facilitating cyber-ransom payments. In September 2020, the U.S. Department of the Treasury, Office of Foreign Assets Control (OFAC) issued an advisory highlighting the issue and confirming that OFAC may pursue enforcement actions against ransomware payments that violate U.S. sanctions, including payments within U.S. jurisdiction involving sanctioned countries/territories (Crimea, Cuba, Iran, North Korea and Syria) or parties.

The OFAC advisory further recommends the development of adequate risk-based compliance programs and the reporting of ransomware attacks and suspicious activity to authorities. Boards should thus ensure that cyber-incident response plans include consideration of potential legal liabilities in any risk assessment for engaging with an attacker.

Boards also should consider the advantages and implications of engaging with government authorities both before and after making a payment to a potentially sanctioned ransomware attacker. While companies are not affirmatively obligated to report potential sanctions violations to the government, law enforcement agencies may be able to provide support, including information potentially relevant to an attacker's identity. Although engagement with authorities may delay payment and result in prolonged business disruptions, early engagement with the U.S. government and a good faith effort to confirm whether an attacker is a sanctions target could reduce the likelihood of an enforcement action if it is later determined that the attacker was sanctioned.

Sanctions Outlook

Boards should anticipate the possibility of significant changes in sanctions policy under the incoming Biden administration, most notably with respect to China. While sanctions aimed at individual Chinese military and political leaders have more political than economic impact, there are three areas that could have significant economic impact:

— Additional Xinjiang-focused sanctions, which could impose difficult and burdensome diligence requirements on Chinese supply chains;

— Furthering restrictions on the use of Chinese products and suppliers in information and communications technology in the United States; and

— The new administration's treatment of new U.S. trading restrictions on Chinese military-linked companies, which, depending on the clarifying guidance, could disrupt non-U.S. investment markets as well by targeting indirect transactions involving affected securities.

In other jurisdictions, a new nuclear deal with Iran may roll back secondary sanctions targeting transactions outside U.S. jurisdiction. While enforcement of existing Russia sanctions continued under the Trump administration, it is possible that the Alexei Navalny poisoning and a scheduled post-election evaluation could lead to expanded sanctions. Cuba policy may revert to the slightly more liberal approach that we saw under the Obama administration, but statutory restrictions limit the possibility of fundamental change. Finally, Venezuelan sanctions policy has generally been unsuccessful, but in the absence of meaningful change or alternatives (neither of which is in evidence), inertia may result in changes being limited to the margins.

CFIUS Reforms Fully Implemented and Expanded

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In 2021, boards of directors will continue to face a complicated landscape in reviews of foreign investment by the Committee on Foreign Investment in the United States (CFIUS), particularly in light of some key developments during 2020.

In February 2020, regulations became effective implementing most of the provisions of the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA), which updated the statute authorizing CFIUS review of foreign investment.[1] The regulations largely tracked the September 2019 proposed regulations to implement FIRRMA's expansion of CFIUS jurisdiction. FIRRMA and the final regulations codified existing CFIUS practice as it has evolved in recent years, particularly with respect to a focus on U.S. businesses involving critical technologies, critical infrastructure and sensitive personal data, and added a limited mandatory filing regime.

[1] For additional details on the regulations, see our January Alert Memo here.

We expect the process of identifying emerging and foundational technologies will continue in 2021 under the Biden administration.

Since the final regulations became effective, there have been a number of key developments.

On October 15, 2020, the U.S. Department of the Treasury final rule (the Critical Technology Rule)[2] went into effect, significantly changing the scope of the CFIUS mandatory notification requirement for foreign investments in U.S. critical technology businesses and expanding it to investments in all industries. The Critical Technology Rule eliminates the then-existing limitation of mandatory notifications to targets active in specified industries and instead focuses on whether the target develops, tests or manufactures technologies that would require a license for export – whether or not the technologies are in fact exported or sold to third parties (e.g., proprietary manufacturing technologies) – to the jurisdiction of the investor and any entity in its chain of ownership, effectively creating different mandatory notification requirements for different countries.

In addition, during 2020, the U.S. Department of Commerce, Bureau of Industry and Security (BIS) took steps in furtherance of the incremental and deliberative process of identifying "emerging and foundational" technologies pursuant to the Export Control Reform Act of 2018.[3] In particular, BIS identified a number of emerging technologies and issued an advance notice of proposed rulemaking requesting public comment on the definition of, and criteria for identifying, foundational technologies that are essential to U.S. national security and should be subject to more stringent export controls. The identified emerging technologies are, and technologies designated as emerging or foundational in the future will be, considered critical technologies for purposes of the CFIUS mandatory notification requirement. The steps taken by BIS during 2020 appear to signal that BIS intends to focus on proposing new controls in multilateral fora, such as the Wassenaar Arrangement and the Australia Group, rather than rapidly imposing new unilateral controls. We expect the process of identifying emerging and foundational technologies will continue in 2021 under the Biden administration.

Further, effective May 1, 2020, CFIUS now assesses tiered filing fees for notifications based on the value of the notified transaction, ranging from no fee for transactions valued at less than $500,000 to a fee of $300,000 for transactions valued at greater than $750 million. Payment must be received by Treasury before CFIUS accepts a notification for review. Submission of a short-form declaration – either in response to CFIUS's new mandatory notification requirements or voluntarily – will not require payment of a filing fee.[4]

We expect that Chinese investments into the United States will remain subject to the highest level of CFIUS scrutiny.

We do not expect significant changes to CFIUS under the Biden administration. Instead, CFIUS will continue to review transactions involving foreign investors to evaluate the impact such transactions could have on U.S. national security. CFIUS largely is staffed and the process is led by career civil servants and the professional national security community, not political appointees, so change in administration does not typically lead to significant change in approach. Broad themes of CFIUS concern, including technology transfer in the semiconductor space, network security and cybersecurity and access to personal data, predated the Trump administration and will continue. Also, although

2 For additional details on the Critical Technology Rule, see our September Alert Memo here.

3 For additional details on these developments, see our August Alert Memo here and our October Alert Memo here.

4 Parties may now choose to submit an abbreviated declaration for any transaction, although they may not receive a clearance providing a safe harbor from future CFIUS review in response.

the current trade war between the United States and China may subside under the Biden administration, we expect that Chinese investments into the United States will remain subject to the highest level of CFIUS scrutiny.

In 2021, boards should continue to identify the advisability or requirement to file a notification with CFIUS early in a transaction. To the extent a transaction does not trigger a mandatory notification, boards also should continue to assess the benefits and risks of voluntarily filing with CFIUS and consider structuring investments and acquisitions to mitigate CFIUS scrutiny. Further, boards should be aware that CFIUS continues to devote significant resources to identifying and investigating transactions that are not voluntarily notified. Finally, boards should continue to bear in mind CFIUS risk as a potential constraint on strategic exits for both existing and new investments.

Global Foreign Direct Investment Review Landscape Expands and Evolves

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In 2021, boards of directors will face an expanding and evolving global foreign direct investment (FDI) landscape requiring that multinational transactions undergo multijurisdictional FDI reviews alongside multijurisdictional merger control reviews.

The jurisdictional thresholds, review timelines and other aspects of FDI reviews vary, sometimes significantly, by country. FDI review analyses are often also subjective and driven by factors of interest to a particular country. For example, some FDI review regimes, such as the Investment Canada Act, take economic considerations into account, whereas others, such as the Committee on Foreign Investment in United States (CFIUS), do not and focus only on national security or national interest. National security reviews typically, but not always, focus on investments in companies that develop and manufacture sensitive export controlled products, companies that supply products used in defense applications, companies active in critical infrastructure and companies that collect and maintain sensitive data.

Boards of directors will face an expanding and evolving global foreign direct investment (FDI) landscape requiring that multinational transactions undergo multijurisdictional FDI reviews alongside multijurisdictional merger control reviews.

Some recent FDI-related developments can be attributed to the COVID-19 pandemic, such as Australia's Foreign Investment Review Board lowering the monetary threshold for FDI review to zero (thereby subjecting all foreign investment to review), India requiring government approval for investments from China and other neighboring countries and the focus on foreign investments in the healthcare/medical sectors and essential supply chains. Other developments, particularly in Europe, occurred independent of the pandemic and, much like CFIUS, tightened restrictions focused on protecting national interest and national security. On the other hand, developments in countries such as China and the UAE[5] are intended to relax existing foreign investment restrictions and encourage foreign investment in previously restricted sectors.

Below are examples of key European FDI-related developments during 2020, which occurred in parallel with significant reforms to the CFIUS regime in the United States:

— **European Union**. On October 11, 2020, Regulation (EU) 2019/452 took full effect.[6] The regulation does not provide the European Commission with the ability to veto investments, but instead sets forth a common framework for FDI reviews to be undertaken by individual EU member states and seeks to increase cooperation among member states.

— **France**. Under new rules that extended and clarified the scope of the French FDI review regime, which entered into force in April 2020,[7] transactions subject to foreign investment control in France include acquisitions by non-French investors of a controlling interest in (or all or part of a line of business of) a French entity operating in certain sensitive sectors, including defense, critical infrastructure, protection of public health, media and key technologies, such as biotechnologies. In addition, direct or indirect acquisitions by a non-EU/EEA investor of at least 25% of the voting rights in such an entity are subject to FDI review. In response to the pandemic, the French government lowered the threshold for foreign investments in French-listed companies active in sensitive sectors from 25% to 10% for non-EU/EEA investors until December 31, 2020.

— **Germany**. During 2020, Germany updated its FDI review regime for the third time since 2017.[8] The latest changes resulted in a stricter FDI regime by, for example, expanding the scope of transactions subject to a mandatory notification in the healthcare sector and requiring FDI clearance before transactions can be closed. The German government can intervene

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

6 For additional details, see our October Alert Memo here.

7 For additional details on the French FDI rules, see our March blog post here.

8 For additional details, see our June blog post here.

if a non-EU/EFTA investor directly or indirectly acquires at least 10% of a German entity active in certain sensitive sectors, (e.g., critical infrastructure, key technologies and healthcare), 25% of any other German entity, and, in both scenarios, the transaction is likely to affect the public order or security of Germany, of another EU Member State, or certain projects of EU interest. The German government also can intervene if any foreign investor, directly or indirectly, acquires at least 10% of a German entity active in the defense or cryptography sectors and the transaction endangers essential security interests of Germany. Further revisions of the German FDI review to align with the EU regulation are currently contemplated by the German government. These changes will specifically address advanced technologies.

— **United Kingdom**. On November 11, 2020, the UK government proposed a new national security screening regime that would allow the government to intervene in "potentially hostile" foreign investments that threaten UK national security while "ensuring the UK remains a global champion of free trade and an attractive place to invest."[9] If approved by the UK Parliament without changes, the UK would have a mandatory and suspensory CFIUS-like regime. We expect the new regime will come into force in the first half of 2021, assuming it receives parliamentary approval. The sectors expected to fall within the mandatory notification regime include advanced technologies such as artificial intelligence and quantum computing, critical suppliers to the UK government, satellite and space and critical national infrastructure (military, defense, energy and communications).

The global FDI review landscape likely will continue to expand and evolve during 2021. As a result, boards should ensure that multinational transactions are undergoing multijurisdictional FDI review analyses before closing, and even earlier on in a transaction involving sensitive countries or industries. Such reviews often can be undertaken in parallel with multijurisdictional merger control reviews.

9 For additional details, see our November Alert Memo here.

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