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Selected Issues for Boards of Directors in 2023

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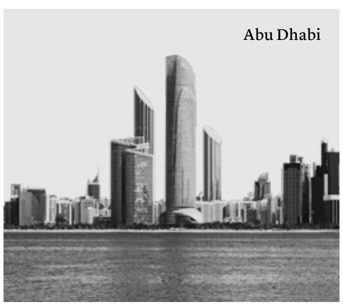
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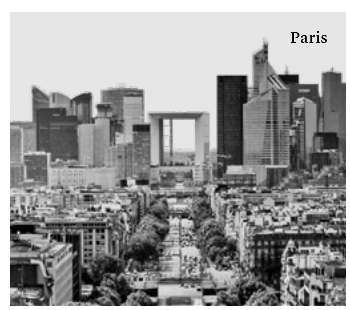
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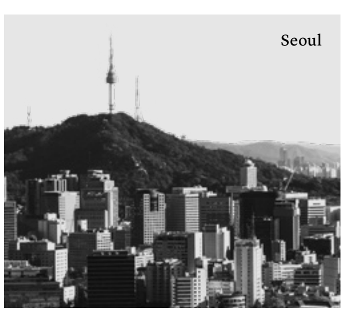
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Selected Issues for Boards of Directors in 2023

It's that time of year again! We have once again asked our colleagues from around our firm to boil down the issues in their fields that boards of directors and senior management of public companies will be facing in the coming year. In the following pages, we present the results for 2023 – focused updates on 18 topics that will surely feature at the top of board agendas throughout the year.

The concerns and practices of public companies are evolving rapidly, driven in part by changing expectations on the part of institutional investors and other stakeholders, in part by cultural and political changes and in part by volatile economic conditions as we emerge from the pandemic. We explore this evolution from several different angles with respect to ESG and sustainability, transaction activity and shareholder and activist engagements.

Other topics stem from the agendas of regulators. 2022 was a notable year for developments in securities regulation, tax, antitrust, sanctions, cybersecurity and privacy and enforcement agency agendas. As Congress remains mired in political skirmishes, we expect 2023 to again be a big year for regulatory rulemaking. Already this year the Federal Trade Commission released proposed rules to ban non-compete provisions from employment contracts – see our Alert on the proposal here. Similarly, European regulatory developments are continuing to drive board agendas, in areas like tax, competition and sustainability. In all of these areas, enforcement risk is on the rise and board oversight and thoughtful considerations of board structure are more critical than ever.

We hope you will find these materials helpful as you (and we) confront the challenges of 2023.

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The editors would like to thank Laura Daugherty, Wolete Moko and Jake Baynum for their invaluable contributions and appreciate their dedication and time in putting together this year's memo.

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Public Companies and Politics: How to Co-Exist

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A number of U.S. public companies have recently found themselves in a surprising place: trapped in visible and charged debates with politicians over internal corporate and investment policies.[1] And when those policies strike different chords across the political spectrum, it increasingly brings boards of directors into new realms of controversy. Can this trap be avoided or has corporate policy forever become entangled in a continuation of politics by other means? Will public companies be forced to declare red or blue allegiances to match the polarized political environment of red and blue states? And will investors follow suit?

For companies that want to keep away from both the political debate and the allegiance question, the path is challenging but should start with fiduciary duty basics: develop policies under a clearly articulable rationale that enhances shareholder value.

For companies that want to keep away from both the political debate and the allegiance question, the path is challenging but should start with fiduciary duty basics: develop policies under a clearly articulable rationale that enhances shareholder value. Doing so removes the central argument cited by some observers against, for example, ESG-oriented policies: that they support a cause rather than a business objective and thereby undermine the classic corporate purpose.

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[1] For example, BlackRock has drawn scrutiny from politicians both on the left and the right. The New York City Comptroller sent the firm a letter urging it to push its portfolio companies to reduce their carbon emissions, while Republican-led states have withdrawn more than $1 billion in assets under management in protest of the firm's green investing policies. Disney has also recently drawn retaliation from the State of Florida for its opposition to Florida's so-called "don't say gay" law, which recently resulted in a books and records demand from a shareholder. Further, Citigroup and Amazon have become the targets of a bill proposed by Senator Marco Rubio in response to their commitments to pay travel costs for their employees to access abortion services.

How Did We Get Here?

In the classic Milton Friedman view, business activities should be undertaken only if they contribute to the profits of a business within the bounds of law and ethical custom.[2] Some well-known advocates for ESG have claimed to take the same approach, arguing that addressing material ESG issues is good business practice and essential to a company's long-term financial performance.[3] In the latter half of the last decade, as "stakeholder capitalism" gained traction within corporate governance circles and "corporate purpose" was discussed in broader terms, some constituencies on the left began to put pressure on companies to be the vehicles for political or social action that dysfunctional governments seemed unable to take.[4] Over time, the underdeveloped definitions and norms embedded in those concepts, while initially embraced by activists on the left, created room for many alternative voices, including politicians on both sides of the aisle.

Where Are We Headed Next?

There are three general directions that public companies could head toward:

— First, corporate America could evolve to mirror the political landscape. In the same way that some states are known as red, blue or battleground states, so too could we find ourselves with companies actively publicizing themselves as red, blue and battleground (or "centrist") companies that pursue management styles and policies reflective of their political imprint. In turn, customers, employees, investors and others could decide which companies to deal with based on their own political allegiances.

— Second, companies could attempt to adhere to the classical Friedman doctrine and refuse to take stances on any political or social issues that do not directly impact their businesses. The appeal of this approach is readily apparent, and it may even work for some companies over certain periods of time. But the shape of today's political and social discourse frequently leaves a lot of room to argue that facially neutral policies have societal or political implications, and many investors (particularly younger ones) have been increasingly focused on these implications in the past several years.

— Third, and we think more tenable over the long run, is a return to the basics of fiduciary duties in a way that is also responsive to the current realities. The Friedman doctrine that companies should pursue profit and leave political and social issues to governments can be a starting point, but the practical director or executive will also be sensitive to the wishes of their customers, employees and business partners. If a company sells a product to a customer base that has demonstrated strong views on a particular issue and whose purchasing habits will be affected by corporate policies, then even Milton Friedman would say that the company should shape its corporate policies accordingly and make this clear to all affected parties.

While this third approach is far from guaranteed to spare companies from political backlash, it remains the most promising way forward in exceedingly difficult terrain. And companies that prepare for these situations—and carefully articulate the rationale of any decisions in advance—will have the highest chances of avoiding the worst of the resulting political and marketplace fallout.

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2 Milton Friedman, "The Social Responsibility Of Business Is to Increase Its Profits," N.Y. Times Magazine (Sept. 13, 1970), available here.

3 *See, e.g.*, State Street Global Advisors, CEO's Letter on 2020 Proxy Voting Agenda, available here (arguing that ESG is "a matter of value, not values").

4 *See, e.g.*, Cleary Gottlieb Steen & Hamilton LLP, "The Purposes of a Corporation and the Role of the Board," available here. As we stated in that article, we reiterate here that we do not use the term "dysfunction" as an aspersion on any political party or philosophy, but rather to describe a generalized inability of elected officials of all philosophies to engage in consistent dialogue and compromise that leads to the passage of thoughtful legislation designed to address the many existing issues faced by the country.

Some encouragement can be drawn from the past. Today's corporate and political landscape has many novel features, but the fundamental contours of public companies as political citizens are not unfamiliar. Many legislative and regulatory requirements, for example, have a political or social aspect that are outside companies' core competencies. Think about Foreign Corrupt Practices Act compliance, conflict minerals disclosure, pay-versus-performance disclosure and, more recently, proposals for mandatory climate-related disclosure—all of which require companies to develop an expertise that has some political valence while still maintaining their competitive position in the marketplace. These are the experiences that companies should draw on when navigating today's world.

Preparation

During periods of relative calm there are steps companies can take to better position themselves if and when the storm of political or social issues arrives. The ultimate goal in these circumstances is to ground the company's response in its longstanding business fundamentals and bona fide business objectives.

Perform an Assessment

Boards and executives should start by taking stock of the company's core constituencies and surrounding context. Are the company's most important customers concentrated in a particular region or social group? Do they trend toward any political positions that are relevant to the business? The same questions should be asked of the company's employees, suppliers, customers, investor base and other important business partners. The answers should be used to answer one question: what is in the best long-term interests of the company?

It is also advisable to think carefully about the company's context, industry and peers. Certain issues might be more salient to an oil and gas company than to a financial institution and vice versa. Companies possessing a unique relationship with any politicians (or any local political constituencies) should give special consideration to how that relationship should play a role in their actions. Boards and executives should also take another look at the company's historical record so that it can be readily drawn on in a crunch. Nuanced familiarity with the company's reputation in the marketplace and in the public square will help corporate leaders understand the outer limits of possible responses and build upon the company's existing goodwill.

Develop Guidelines

The results of this assessment will empower boards and executives to focus on potential areas of risk bespoke to the company.

We suggest consolidating the results of the assessment phase into a set of guidelines or principles that the company can leverage going forward. The guidelines should lay out the business priorities fundamental to the company's continued success in enough detail to be useful, while still permitting flexibility for new circumstances. For example, does the company have an established track record with respect to certain risks or opportunities that are specific to the company? What steps must be taken (or avoided) in order to ensure the protection of the company's customer base, brand or other important assets?

Boards and executives should start by taking stock of the company's core constituencies and surrounding context . . . to answer one question: what is in the best long-term interests of the company?

Execution

In the current environment, public companies must be conscious of politics as they think about increasing profits. We suggest:

— Justifying each decision by its contribution to the long term success and health of the business; and

— Communicating the profit rationale clearly to the public, and thereby creating an objective basis for each corporate action, potentially avoiding political scrutiny.

This approach gives companies the flexibility to carry out the sustainable activities that are most important to their constituencies. A good set of internal guidelines will help companies to identify these activities. While companies can no longer avoid facing political issues, in this way the Friedman doctrine lives on: focusing on the success of the business remains the best way for companies to convince their critics that they take their social responsibility seriously.

M&A in 2023: A Year of Cautious Optimism?

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Consensus opinion coming into 2022 was that high M&A volume would continue, albeit not quite at the record-setting pace of 2021. The market had other plans. Volume decreased much more sharply from the 2021 high than was commonly expected. While overall deal volume was generally in line with averages from 2017-2020, 2022 was a tale of two halves—there was a marked drop from H1 to H2, with Q4 representing the lowest Q4 global deal volume in the past six years.[1] Significant stock market volatility wrought havoc on valuations. Higher interest rates and a retreat by large banks from the leveraged loan market chilled leveraged buyout financing. Macroeconomic and geopolitical uncertainty turned confidence to caution. Valuation disconnects scuttled deals as sellers continued to expect 2021 multiples. Regulatory scrutiny made execution more complex. Entering 2023, many of these headwinds continue.

Yet, 2022 was still a strong year for dealmaking. And opportunities still abound.

With several significant macroeconomic variables in the balance, there is less consensus on the outlook for 2023. Will this year be in line with five year averages? Is there room for rebound from there or will we see significant further drop off? Only time will tell, but we expect forecasts to vary by sector, with outlook as a whole significantly affected by how quickly inflation stabilizes and the timing and depth of potential recessions in the U.S., EU and China.

The structural drivers that fueled a record 2021 and buoyed M&A last year remain largely intact.

1 Data taken from Bloomberg.

Furthermore, the structural drivers that fueled a record 2021 and buoyed M&A last year remain largely intact. The disruptions induced or accelerated by COVID-19 and its aftermath will continue to drive consolidation in a number of industries. Cash-rich corporates continue to look for opportunities to position themselves strategically for the long term. And although the fundraising environment is facing additional headwinds, private equity buyers who spent more time tending to their portfolios in 2022 will look to deploy their still substantial dry powder opportunistically as valuations reset. The onset of a recessionary environment will provide acquirors with strong balance sheets or capital to deploy with even more fertile ground for deal-making.

The onset of a recessionary environment will provide acquirors with strong balance sheets or capital to deploy with even more fertile ground for deal-making.

Our sense from boards, senior management teams, private equity professionals and other dealmakers is that M&A is very much on this year's agenda. What follows are some key themes we expect may play out in 2023, as well as some lessons from 2022 that they should bear in mind.

Muddy Waters, Many Fish. Amidst the stream of murky macroeconomic events, we expect dealmakers to wield an expanded toolkit to catch passing opportunities.

— Corporate carveouts, particularly in the form of tax-free spin-offs, maintained a steady pace last year despite overall M&A deal volume fluctuations. We expect this to continue in 2023. Portfolio reshaping will remain a driving force for dealmaking, as corporates look for opportunities to separate high-growth from low-growth assets and achieve multiple re-ratings, and spin-offs avoid valuation disconnects between buyers and sellers. Leveraged spins can also provide an attractive opportunity for the parent company to de-lever or put cash on the balance sheet.

— As acquisition financing costs are likely to continue to increase at least in the near term, we expect to see private equity sponsors, who very much need to put dry powder to work, continue to innovate in the absence of affordable financing for typical leveraged buyouts. In 2023, we expect to see private equity firms increase equity checks, turn to founder-based strategies and smaller deals (as larger PE funds invade the realm of venture firms), rely on the direct lending market, focus on strengthening portfolio companies through add-on acquisitions and other strategies, and consider minority investments or targets with portable debt structures (which can reduce the need for acquisition financing and avoid repayment of legacy lower cost debt). The latter trend, paired with demand for corporate carve-outs, may also lead to an increase in sponsored spin-offs.

— In private transactions, we expect to see an increase in seller financing and use of earn-outs to bridge financing and valuation gaps.

— Other creative deal structures, including joint ventures and partnerships between strategics and between strategics and private equity firms or their portfolio companies, will also provide opportunities to diversify balance sheets, share costs of R&D and unlock synergies.

— We also expect the large number of high growth, low revenue public companies that emerged from de-SPAC transactions, as well as depressed valuations in the tech sector, to continue to spur take-private activity.

Antitrust the Process. As we predicted at this time last year, the recent trend of increased scrutiny of transactions from competition regulators, particularly in the U.S. and Europe, continued in 2022. But in the U.S., substantial shifts in announced antitrust policy and bold public statements from antitrust enforcers have not yet been matched by a surge in actual enforcement, and the agencies suffered unprecedented setbacks in court. For further discussion of these antitrust developments, *see* 2023 Update: U.S. Antitrust Sets Sail Into Uncharted Seas. Despite the fact U.S. enforcement statistics have not quite matched the rhetoric to date, merger review in 2023 will continue to create complexities in transaction planning and execution. Deals raising horizontal or vertical issues will continue to get done, but will require thoughtful planning.

— U.S. antitrust agencies (particularly the Department of Justice) are likely to continue challenging the adequacy of merger remedies, placing an onus on parties to address issues proactively and "fix it first" or be prepared to "litigate the fix."

— U.S. agencies have also expressed some hostility to private equity firms in general, complicating some private equity transactions, particularly with respect to portfolio company "add-on" acquisitions. In particular, in the context of antitrust remedies, the agencies have challenged private equity firms as divestiture buyers, which will require these buyers to demonstrate their experience and expertise in the relevant industry and have a concrete plan for the target business (which will likely be viewed more favorably by a court if it shows investment in the business relative to the standalone plan).

— Although for the most part the agencies' bark has been worse than their bite, the rhetoric has injected a measure of wariness into the market, particularly on behalf of sellers. In cases where regulatory remedies are likely, we expect to see increasing prevalence of regulatory reverse break-up fees and ticking fees in order to incentivize buyers to obtain timely clearance and avoid the need for sellers to prove damages.

"Fool me once, shame on you…" Between the COVID broken deal cases and the drama to emerge from last year's market dislocations, sellers have now had two vividly recent opportunities to consider the importance of conditionality and deal remedies when a buyer finds remorse. We may not be through the turbulence yet, so they are advised to give careful consideration to deal protections in negotiations this year.

Outlook for Activism in 2023

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Shareholder activism continued to rise in 2022, and is poised to bubble over in 2023. As we turn the page on 2022, the overall macroeconomic and geopolitical picture portends continued market volatility and recessionary-like conditions, and activists of all stripes will look to capitalize on valuation re-sets and broader disruption to push their agendas at companies at home and abroad. While we expect many of the activism trends from recent years to continue, that does not mean activism in 2023 will necessarily reflect business as usual. A number of recent developments will likely cause meaningful shifts to the activism landscape and playbook, which companies should be prepared to navigate. Some of these key developments and likely forces of change in 2023 are discussed below.

More New Faces

Continuing a multi-year trend, 2022 saw a broad range of new entrants to the activism field, bringing with them new aims, strategies and tactics. While the most prominent activists (Elliott, Icahn and the like) are as active as ever, there has been a notable rise in the number of campaigns initiated by first-time activists. Many of these actors are fusing the types of strategic and financial goals traditionally espoused by activists with ESG and corporate governance aims. Some have also demonstrated more aggressiveness and unpredictability as they seek to establish a track record and garner notoriety they can leverage into greater fundraising success. Companies should continue to be aware of the expanding roster of activists and their tactics as they refresh their activism defense playbook in the new year.

The adoption of the universal proxy rules—which came into effect on September 1, 2022—represents the most important development in shareholder voting in a generation and is already reshaping the activist playbook.

Universal Proxy Reshapes the Playing Field

The adoption of the universal proxy rules—which came into effect on September 1, 2022—represents the most important development in shareholder voting in a generation and is already reshaping the activist playbook. Proxy advisory firms and shareholders can now more easily pick and choose among company and dissident director nominees in contested elections. We expect this will make elections more personal, with greater focus on, and scrutiny of, individual director candidates. Companies should keep this in mind when making board composition and refreshment decisions; rather than focusing on just the collective strength of their boards, companies should also carefully consider the vulnerabilities of individual directors and proactively address those issues. Companies should also recalibrate how they market their directors to investors to thoughtfully highlight the skills each director brings to the table and tie their respective skillsets to the company's business model and broader objectives.

The ability of activists to use the notice-and-access solicitation method could allow single-issue and gadfly players, for whom a full mailing may be prohibitively costly, to more easily run ESG and other statement campaigns against companies. We would not be surprised to see "withhold" campaigns morphing into targeted director replacement campaigns where activists seek to oust and replace individual directors on ESG or human capital grounds. As such, companies should continue to proactively engage with their stakeholders on these issues so as to preempt (or at least be in a better position to respond to) these types of campaigns.

In the wake of the universal proxy rules, hundreds of U.S. public companies have amended their advance notice bylaws to implement the new rules and modernize other elements of their bylaws. These next generation advance notice bylaws are designed to ensure boards and shareholders have access to the full set of information necessary to make an informed decision and help protect against the potential abuse of the universal proxy regime. While activists and their advisors have been quick to criticize the latest bylaw enhancements, the mainstream form of these bylaws adopted on a clear day and based on an appropriate record are likely to pass judicial muster and unlikely to draw the ire of institutional investors and proxy advisor firms. We recommend that companies continue to evaluate their takeover defenses holistically and ensure they are tailored to the new threat environment.

Implications of Interlocking Directorate Enforcement

Activists may also find their directors under the microscope as a result of the DOJ's stated intention to ramp up enforcement of the Clayton Act's prohibition on interlocking directorates. This long-standing statutory provision, which bans competitive companies from having overlapping directors and officers in an effort to prevent collusion, has not been a primary focus of the U.S. antitrust agencies in the past. This appears to be changing. In October 2022, seven directors from five companies resigned in response to an interlocking directorate probe from the DOJ, which also announced that its Antitrust Division would be "undertaking an extensive review of interlocking directorates across the entire economy and will enforce the law."

Activist-nominated directors—particularly activist insider nominees—will need to be more closely assessed for antitrust and interlocking directorate concerns. Of particular concern for activists will be the "agency" or "deputization" theory of liability—even if a single individual does not sit on the boards of competitors, the

DOJ may find an interlocking directorate when different individuals deemed to be representing the interests of the same firm sit on the boards of competitors. Under this theory, the ability of activists to place representatives on multiple boards in the same industry may be hampered.

Will the SEC Reform 13D?

The SEC's proposal to reform the 13D beneficial ownership reporting rules, together with rules regarding securities-based swaps reporting, would, if adopted, represent a sea change in the disclosure of cash-settled derivatives and other means often used by activists to clandestinely accumulate their positions. The more expansive definition of a "group" for purposes of beneficial ownership disclosure would also more closely regulate the ability of activists to tacitly coordinate with each other on campaigns without alerting the market.

If effected, these changes would give companies and the market more timely notice of emerging activist accumulations. Companies should continue to monitor regulatory developments on this front and be prepared to incorporate any 13D reforms into their activism preparedness planning and shelf rights plan language.

Pass-Through Voting Accelerates

In 2022, some of the largest asset managers rolled out programs designed to give certain of their investors greater say over how their shares are voted. Vanguard announced it would test a pilot program in 2023 in which investors in several equity index funds would have options on how their shares are voted. Similarly, BlackRock and State Street have begun giving institutional investors input on the voting of their shares, and Charles Schwab is testing a program for polling investors on their preferences to inform proxy voting decisions.

We believe pass-through voting is here to stay as political pressure on the Big 3 intensifies and ESG-oriented investors increasingly second guess the ESG priorities of asset managers' stewardship groups .

We believe pass-through voting is here to stay as political pressure on the Big 3 intensifies and ESG-oriented investors increasingly second guess the ESG priorities of asset managers' stewardship groups. This trend will make it more important than ever for companies to engage deeply with their shareholder base and understand which institution will be the one exercising voting authority.

Navigating the ESG Crossfire Hurricane

While ESG is here to stay, the controversy surrounding it likely is as well. 2022 was rife with political backlash against ESG and so-called "woke capitalism." Anti-ESG activists emerged, targeting several large-cap companies for their human capital policies, engagement with political issues, and purported failure to focus on maximizing shareholder value.[1] While the wave of anti-ESG activism will likely continue into 2023, we expect that shareholder support for such proposals will remain low, while support for pro-ESG proposals will likely persist. In any event, companies should be prepared to contend with activists on both sides of ESG issues.

We recommend companies monitor and proactively assess their ESG profiles, shareholder engagement strategies and defensive preparedness measures in light of these developments. Activists will certainly change up their playbooks in reaction to the shifting landscape in 2023, and companies would be well advised to do the same.

[1] For further discussion, *see* Public Companies and Politics: How to Co-Exist.

Prepared for Climate? A Director's Readiness Guide

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In March 2022, the U.S. Securities and Exchange Commission (SEC) issued for public comment a rule proposal regarding certain climate-related disclosures that reporting companies would need to include in their registration statements and annual reports filed with the SEC. Although a majority of commenters generally expressed support for the proposed rule, many supporting parties, neutral parties and opposing parties alike requested changes (often significant ones) be made for the final rule.[1]

The most prevalent areas of requested changes include:

— ***Materiality*** – Adjusting the materiality threshold or definition to better fit existing notions of materiality under SEC disclosure rules.

— ***Framework Consistency*** – Better leveraging existing disclosure frameworks, including International Sustainability Standards Board (ISSB) standards, to create a more uniform disclosure framework across jurisdictions.

— ***Compliance*** – Allowing for a longer implementation timeline.

— ***Scope 3 Emissions*** – Lessening the requirements for Scope 3 disclosures, which companies argue come at high cost without proportionate benefits for investors.

— ***Safe Harbors*** – Enhancing safe harbor provisions beyond just Scope 3 emissions disclosures, including allowing disclosures be furnished rather than filed.

— ***Regulation S-X*** – Fully removing the proposed amendments to Regulation S-X, or, at least, altering the 5% financial impact threshold for each line item.

[1] Commonwealth Climate and Law Initiative, "Review of public comments to US Securities and Exchange Commission regarding the proposed rule for climate change disclosures" (September 5, 2022), available here.

— ***Principles-Based Rules*** – Aligning the proposed climate rules with the trend toward a more principles-based approach that the SEC had taken in recent years with other rule simplification amendments, as opposed to the more prescriptive nature of the proposed rules.

Although the final rule may demonstrate the SEC's responsiveness to some of these requested changes, public company directors should start now (to the extent they have not already done so) to prepare a concrete plan for how to satisfy their oversight responsibilities with respect to the proposed climate disclosure rules once they are finalized — which we expect will be in early 2023. Below are some key action steps that boards should consider as part of such a plan.

First Step: Process

☐ ***Determine Division of Labor among Board Members/Committees***

— Before diving into the substance, have a game plan as to how the board should approach its oversight responsibilities.

— Given the nature of the proposed rule requirements, a natural choice may be to delegate these new responsibilities to the audit committee, if there is not already a delegation for ESG and climate/sustainability-related matters to another committee.

— However, the proposed rules will require substantial additional work and many audit committees already juggle too many responsibilities. It may make sense for a different committee(s) (or the full board) to share some of the burden, particularly with respect to those requirements that do not fall within the financial statements.

☐ ***Identify the Right Resources within the Company***

— Work with management to identify the right individuals to whom the board or committee(s) should have regular access in order to receive the appropriate information on climate-related data and disclosures.

— Although a CEO or CFO may be well-positioned to speak on substantive climate matters, other senior personnel, including sustainability officers may be better-situated.

☐ ***Consider Engaging External Experts***

— Consider whether it would be appropriate to engage third party consultants and advisors who can assist the board in its oversight responsibilities, as climate-related metrics, greenhouse gas (GHG) emissions and other topics in the scope of the SEC proposed rules are all specialized substantive areas; supplement particularly where the board is less-equipped with relevant expertise.

☐ ***Schedule Board Trainings***

— Since directors sign and take liability on the disclosures included in annual reports on Form 10-K and Form 20-F, make sure to have a working knowledge of the requirements of the proposed rules and the kinds of substantive climate-related information that must be disclosed.

— Trainings could cover the disclosure itself, the substantive data behind the disclosure, and/or the implementation of processes that boards should oversee in connection with data collection, verification, audit and disclosure.

Second Step: Substance

☐ ***Identify Appropriate Governance Enhancements***

— Review (i) board committee charters to ensure they reflect any decisions made regarding the division of delegated responsibilities with respect to ESG and climate (including climate initiatives and strategies, climate risk oversight and management, climate metrics and targets, climate-related data gathering and climate disclosures) and (ii) corporate guidelines and policies to ensure they are aligned with any new or existing processes for executing on these areas.

— Ensure management and reporting teams are sufficiently robust to handle additional reporting work and consider whether additional personnel may be needed.

— Review management reporting channels for climate-related matters to ensure the board has an understanding of information flow and can identify any areas for improvement.

☐ ***Review Internal Audit & Controls Processes***

— Confirm that the company's internal audit function is preparing for compliance under the new rules. While there may be some time before compliance deadlines of final rules, financial disclosers may nonetheless cover current or prior periods. Some work streams will require additional lead time and should begin now in case the final rules provide a short compliance deadline (*e.g.*, some companies may not have processes to gather the required GHG emissions data, or the existing processes may not be adequate to measure up to SEC disclosure standards).

— Identify the current status of the internal audit function with respect to climate, and have management regularly report back on developments leading up to the compliance deadline once the timing is known.

☐ ***Review Impacts on Disclosure Controls & Internal Controls over Financial Reporting***

— Review and consider whether updates to the company's disclosure controls and procedures (DCP) and internal controls over financial reporting (ICFR) are necessary to fold in the new climate-related information required to be disclosed under the proposed rules.

— Items to consider for DCP include identifying (and training, if needed) responsible parties on processes (existing or newly implemented) for (i) gathering the data, (ii) verifying the data and preparing auditable data backup files, (iii) analyzing the data against the materiality thresholds under the rules and (iv) preparing the disclosure.

— Items to consider for ICFR, particularly with respect to the proposed Regulation S-X rules, include how the company should be calculating climate risk metrics and transition plan impacts on the company's financial statement line items (especially if the 1% threshold remains in the final rule).

☐ ***Engage with Company Auditors***

— In connection with the proposed Regulation S-X rules, reach out early to the company's independent auditing firm to understand how they are preparing to audit the new climate-related disclosures in the financial statements.

— Confirm what auditors will need from the company in order to give a clean audit report, and whether they need the company's processes to be finalized at an earlier date to do test runs prior to the compliance deadline.

— Consider if and how the board's oversight role of the auditors may need adjustments as the board and the auditing firm navigate these rules for the first time, and understand whether the new climate rules will result in negotiating changes to auditor fees for their services.

— Some firms may also be preparing to offer attestation report services for GHG emissions. If the company's auditor is doing so, confirm whether this results in any conflict of interest or independence issues.

☐ ***Review Company Targets & Use of Credits***

— To the extent the company has already published targets, consider (i) whether management has a plan (with or without interim milestones) for achieving such targets and (ii) how management is thinking about the use of credits, including ensuring the quality of the credits and accounting for the increasing cost of credits over time, if the plan is to use credits.

— Determine whether the responses to such questions are ones that the company wants to be disclosing publicly (particularly if the answer to the first question is "no"), and, if needed, identify the risks and most opportune time to walk back those targets.

— To the extent the company has not already published targets but wants to do so, consider whether now is the right time in light of the forthcoming final rules and any impact on the substance of any published targets.

☐ ***Identify the Board's Role with Respect to Attestation Report Provider***

— Determine the scope and nature of the board's role with respect to oversight of the attestation report provider for GHG emissions disclosure, including whether the board or a committee should oversee the selection and retention.

— Establish criteria for evaluating and selecting a provider and a plan for how to best oversee them and their work.

— Ensure management understands what information the provider needs to perform its review and give a clean report and how much lead time such processes may take.

☐ ***Consider Having a Climate Expert on the Board***

— Determine whether the board would like to identify any director as a "climate expert" to be disclosed in the SEC reports. There is no requirement to name one, and the proposed rules do *not* include a safe harbor for a board's climate expert equivalent to the one available for a board's financial expert (and it is unclear whether this was an inadvertent or intentional oversight on the SEC's part).

— Separately, update D&O questionnaires or otherwise collect information about any relevant expertise on the board for purposes of facilitating oversight responsibilities, even if the individual is not officially deemed a "climate expert" for purposes of the proposed rule requirement.

☐ ***Engagement with Key Stakeholders***

— Understand the company's investor relations strategy with respect to its climate disclosures and coordinate with management on relevant messaging and the overall strategy.

— Consider how the disclosure in the company's SEC filings may be different from what was previously disclosed in a sustainability or ESG report published on the company's website.

— Consider whether any directors will engage with stakeholders directly on climate-related issues.

Turning a Corner on Corporate Governance: The SEC's Disclosure Agenda

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In 2022, public companies witnessed a new kind of corporate governance activism. New rules and regulations from the Securities and Exchange Commission (the SEC) use the lever of mandated disclosure to push for corporate governance actions, and in some cases what amounts to reforms. The SEC's broad foray into governance represents an expansion of historically more limited SEC rules in the governance space, mostly focused on audit committee and auditor independence and more general disclosure of board structures and oversight. Many commentors note that investors were well able to push companies historically for disclosure on governance matters and that the proposed SEC disclosure mandates may impinge on decisions and policies that boards should be able to define and/or compel board structure and composition to move in directions that are not best suited to the effective functioning of the board.

The SEC rules have long mandated disclosure related to board organization and description of committee responsibilities. Until recently, rulemaking spurred by the Sarbanes-Oxley Act of 2002 (the SOX) had been the most specific of this type of governance mandate, with requirements that members of a company's audit committee be financially literate and that companies disclose whether audit committee members include a "financial expert" (and if not, why not). Recent similar "disclose or explain" mandates have included explanation of whether public companies have policies prohibiting officers and directors from hedging against company stock.[1] In these cases, the disclose or explain rules often push companies to adopt what the SEC rule makers view as the desired governance action, rather than be forced to explain why they do not. While not an outright prohibition on taking the "or explain" route, conformity to peers and the risk that investors and proxy advisory firms may question those companies that take an outlier "explain" approach pushes companies toward the preferred outcome for regulators.

[1] *See* our January 2019 alert memo on this topic for more information, available here.

While the use of disclose or explain rules has been mostly limited to relatively cabined requirements outside of the audit committee context in recent memory, at the end of 2021 and throughout 2022 the SEC significantly increased rulemaking that, if fully adopted, would represent a significant push by the SEC to regulate corporate boards, their composition and their areas of responsibility and focus. The SEC's regulatory agenda for 2023 hints at additional governance-related rules that would continue this trend.

10b5-1 Trading Plans

Starting in late 2021, the SEC's proposed rulemaking on the use of Rule 10b5-1 trading plans by companies, directors and executive officers kicked off the regulation of what had previously been the domain of market practice-based corporate governance.[2] The proposed rules would have gone so far as to impose mandated blackout periods for corporate use of the Rule 10b5-1 safe harbor. In a significant addendum to the rule's prior requirement that trading plans be adopted only when a participant was not in possession of material non-public information, the proposed rule also regulated the exact length of blackout periods and what modifications and terminations would be permitted. The proposed rule also required disclosure of insider trading policies and specific trading plans by insiders, a significant expansion of the information currently required.

The required disclosure of material terms of insiders' plans and the requirement for companies to file their insider trading policies (or explain why they don't have one) are both significant examples of how the SEC is mandating its view of good corporate behavior in a prescriptive manner, with few exceptions.

The SEC finalized the changes to Rule 10b5-1 trading plans in December 2022, and while corporate plans were excluded from the rulemaking on the new blackout periods, the required disclosure of material terms of insiders' plans and the requirement for companies to file their insider trading policies (or explain why they don't have one) are both significant examples of how the SEC is mandating its view of good corporate behavior in a prescriptive manner, with few exceptions.

Whereas companies previously could tailor plans and policies to accommodate a range of procedures within the broader restrictions of the rule, the SEC has now mandated specific timing and policies around plans and suggested areas for insider trading policy coverage, implicitly compelling specific governance practices. Companies and insiders can always trade outside the Rule 10b5-1 safe harbor while not in possession of material non-public information, but given the prevalence of the plans and the specific financial planning needs insiders often have with respect to future sales, coupled with enforcement risk, the new rules will likely result in a shift to compliance with the new rule for insider 10b5-1 plans and, over time, greater conformity across company insider trading policies.

Whether the disclosure of insider trading plans and related policies was high on investors' priorities is debatable – investors have successfully advocated for disclosure in other governance areas, including board and employee diversity and cybersecurity and board oversight; however, the SEC clearly believes that insider trading plans are a focus for investors' review. With respect to the explanation of the exhibit for insider trading policies, the SEC goes so far as to say "Specific disclosures concerning registrants' insider trading policies and procedures would benefit investors by enabling them to assess registrants' corporate governance practices and to evaluate the extent to

2 *See* our December 2021 alert memo on this topic for more information, available here.

which those policies and procedures protect investors from the misuse of material nonpublic information."[3]

Cybersecurity and Climate

The governance rules began to quickly stack up with the March 2022 cybersecurity proposal and the climate proposal, each of which mandates disclosure of board expertise, board structure and board risk analysis, and goes well beyond disclosure requirements.

The cybersecurity proposal, among other changes, would expand Regulation S-K to require both domestic and foreign private issuers to disclose instances of material cybersecurity incidents, and would amend Forms 10-K and 20-F to require annual disclosure regarding a company's procedures for identifying and managing cybersecurity risks, including board oversight of cybersecurity risks and management's role, and relevant expertise, in assessing and managing cybersecurity risks and implementing related policies and procedures and identification of any director that qualifies as having "cybersecurity expertise."[4] The SEC acknowledges certain pitfalls of implementing additional expertise requirements, such as the availability of directors with such expertise and related liability concerns and has tried to address those concerns in its proposal,[5] but even if directors that qualify having cybersecurity expertise are available, being named as an expert could still lead to a decrease in the willingness of qualified directors to serve in those roles.

Since its publication in March 2022, the climate proposal has been the source of significant commentor attention. The SEC reiterated its perceived need for involvement in climate disclosure, saying "Investors need information about climate-related risks—and it is squarely within the Commission's authority to require such disclosure in the public interest and for the protection of investors—because climate-related risks have present financial consequences that investors in public companies consider in making investment and voting decisions."[6]

The climate proposal covers, among other things, disclosure requirements for the notes to companies' audited financial statements and disclosure of greenhouse gas emissions (along with a third-party attestation report), and like the cybersecurity proposal, significant disclosure related to governance. The rule would require disclosure under Regulation S-K on climate-related governance practices, risk management of a company's climate-related activities and the impacts of those activities, and any climate targets or goals. With respect to a company's climate-related governance practices, companies would be required to disclose whether any board member has expertise in climate-related risks, in addition to the board's role

3 SEC Release No. 33-11138, Final Rule: Insider Trading Arrangements and Related Disclosures, available here. The SEC adopting release makes a similar argument that description of insider trading policies, could improve investor confidence, although again investors have not broadly been requesting this information through engagement with companies. "While not every individual component of an insider trading policy is necessarily material on its own, together, a comprehensive description of an insider trading policy can help investors to assess the thoroughness and seriousness with which the issuer addresses the prohibition of trading on the basis of material nonpublic information by its officers, directors and employees. More detailed disclosure about these policies and procedures could therefore improve investor confidence, and in turn, potentially contribute to market liquidity and capital formation."

4 *See* our April alert memo on this topic for more information, available here.

5 SEC Release No. 33-11038, "Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure" (March 9, 2022), available here. "Further, if many registrants move to add a board member or staff to their management team with cybersecurity expertise, or a chief information security officer at the same time, the costs to registrants associated with adding such individuals may increase if demand for cybersecurity expertise increases. This is especially true to the extent that certain relevant certifications or degrees are seen as important designations of cybersecurity expertise and there are a limited pool of individuals holding such certifications." In addition, the proposal notes that, like audit committee financial experts, a director with cybersecurity expertise would not be deemed an "expert" for purpose of Section 11 of the Securities Act of 1933, as amended (which designation creates additional liability) and that the disclosure of expertise "would not impose on such person any duties, obligations, or liability that are greater than the duties, obligations, and lability imposed on such person as a member of the board of directors in the absence of such designation or identification."

6 SEC Release No. 33-11042, "The Enhancement and Standardization of Climate-Related Disclosures for Investors" (March 21, 2022), available here.

in oversight and management's role in assessment and management of climate-related risks.[7] Interestingly, there was significant overlap between the cybersecurity proposal and the climate proposal in terms of the specific disclosure requirements, perhaps indicating a new SEC rulemaking template for governance disclosures.

Market Reaction

In comment letters on the proposals, public companies and other commentors raised concern as to the level of detail the new rules would require as to the workings of public company boards, and that disclosure mandates will cause a race to load up boards with subject matter experts, regardless of whether the board as a whole deems it the best approach for the governance of the company. Concerns raised include whether boards will grow too large and unwieldly in order to accommodate all the skill sets and expertise necessary to satisfy investors looking to tick boxes in governance checklists based on SEC disclosure rules and whether non-experts will unduly defer or feel constrained in their exercise of fiduciary duties and oversight obligations by the presence of rules-defined "experts." Where the SOX audit committee expertise serves a specific financial statement oversight function, it is not clear that cyber or climate experts on the board are necessary to augment the insight and expertise of other board members or to effectively manage and oversee management's efforts and expertise in these areas.

Is SEC rulemaking necessary?

There is a strong case for the existing effectiveness of market practice in corporate governance. Investors have been pushing companies for disclosure of cybersecurity oversight, climate strategy and board diversity with significant effect over the last few years without the SEC mandating disclosure. The SEC points to the need for consistent disclosure,[8] but rulemaking regularly leads to rote boilerplate disclosure intended to meet the technical requirements of the rule and incur as little liability risk as possible and does not necessarily lead to better, more probing descriptions than are provided by companies responding to the demands of their shareholders.[9]

The SEC points to the need for consistent disclosure, but rulemaking regularly leads to rote boilerplate disclosure intended to meet the technical requirements of the rule and incur as little liability risk as possible and does not necessarily lead to better, more probing descriptions than are provided by companies responding to the demands of their shareholders.

Similarly, the stock exchanges, which have for years been the bodies dictating independence requirements and definitions for directors, have entered the arena with respect to board diversity. NASDAQ introduced a disclose or explain requirement that companies disclose a board diversity matrix, and companies must explain if they do not have board members with certain diversity characteristics. While the NYSE has not put in place a similar rule, many NYSE companies are including a board diversity matrix in order to meet their peers' disclosure in this area and satisfy investor demands. The SEC has added "board diversity" to

7 *See* our April alert memos on this topic for more information, available here.

8 *Supra* notes 5, 6. Both the climate and cybersecurity proposals repeatedly highlight the need for consistency in disclosure. "The disclosure of this information would provide consistent, comparable, and reliable—and therefore decision-useful—information to investors to enable them to make informed judgments about the impact of climate-related risks on current and potential investment." "Consistent, comparable, and decision-useful disclosures regarding a registrant's cybersecurity risk management, strategy, and governance practices, as well as a registrant's response to material cybersecurity incidents, would allow investors to understand such risks and incidents, evaluate a registrant's risk management and governance practices regarding those risks, and better inform their investment and voting decisions."

9 *See* our September alert memo on this topic for more information, available here.

its regulatory agenda for the second half of 2023, but in light of existing disclosure, the NASDAQ rule and investor-led insight published in SEC-filed reports or on company websites, it seems any action by the SEC now would only codify what the market is already doing for disclosure and would most likely unnecessarily tie companies to extensive sets of disclosure rules that push companies into strict lanes of behavior and disclosure, instead of allowing for adaptability to specific company governance needs.

It is important to remember that even in disclose or explain mandates, the governance regimes are not required and that boards should strongly consider what is the right approach for their board, how they fulfill their oversight mandate and how they consider risk and their company's long-term strategy.

The cybersecurity and climate rules are widely expected to be adopted in the first half of 2023. While the proposed rules do not require boards to include directors with specific expertise, if adopted as they were proposed, many companies will feel strongly compelled by the disclose or explain mandates to include directors with expertise in these areas or fit existing director expertise into these buckets in order to meet peer company disclosure. Even if the rules are not finalized with the same level of detail in which they were proposed, the SEC has made clear its intention to step into the realm of governance activists in a way previously unseen. It is not clear that there is a strong investor driven regulatory mandate for these disclosures since investors have not been shy about asking for, and getting, the governance disclosure and engagement they want. The SEC has faced growing calls from Republican politicians to stop regulating ESG factors and a new Republican-led House of Representatives has promised significant oversight hearings.[10]

Key Takeaway

We should expect boards to have to grapple with multiple governance-related disclosure mandates in 2023. It will be important to consider what skills and experience sets will best serve a board's strategy and oversight needs and how boards can best organize themselves to address the coming disclosure mandates.[11] It is important to remember that even in disclose or explain mandates, the governance regimes are not required and that boards should strongly consider what is the right approach for their board, how they fulfill their oversight mandate and how they consider risk and their company's long-term strategy. SEC disclosure rules will force companies to think about the right structure and risks related to hot button issues, but ultimately it should remain up to the board to decide the most effective governance structures and policies, and maintain the flexibility it needs in order to fulfill its oversight duties.

[10] *See* Letter to SEC on ESG Rule, available here.

[11] For further discussion, *see* Prepared for Climate? A Director's Readiness Guide and Practical Steps for Increased Board Effectiveness.

Practical Steps for Increased Board Effectiveness

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Over the past year, public companies have faced an onslaught of external pressures, including an uncertain economy, an ongoing pandemic with changing rules and best practices and increasing demands from various stakeholders. The coming year looks to continue the trend with a volatile market and economic/political conditions, increasing regulatory demands and shareholders looking for active engagement. How prepared a company is to handle these external factors depends in no small part on the strength of its board of directors. An effective board is critical for company success, even in the absence of such difficulties. Increasingly, companies and their shareholders are focusing on selecting, evaluating and maintaining an effective board.

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Entering 2023, here are key issues companies and boards should consider to enhance board effectiveness.

Identifying Needs Through Meaningful Board Evaluations

Nearly all major public company boards conduct annual board evaluations, but not every company is able to glean clear, actionable feedback from those evaluations. Standard written board evaluations may be an efficient way to comply with annual obligations to self-assess, but they may not elicit enough information to provide meaningful insights into board effectiveness and provide a path forward to increased board efficacy. Some companies are turning to alternative evaluation formats to better assess how their boards can improve.

Next Steps:

— Consider the various formats for conducting a board evaluation (including written questionnaires, one-on-one interviews, group discussions (led by a member of the board or by a third party)) and determine whether an alternative format may elicit more or different feedback from the board.

— Board evaluations can alternate from year to year. For example, a board can opt for one-on-one interviews once every two or three years in order to more deeply explore certain themes or topics.

— Consider using advisors to assist in structuring an evaluation process that can provide more meaningful feedback. Also, depending on the particular dynamics and personalities on the board, an advisor may be best placed to facilitate the interview or discussion, as well as guide potential follow-up.

— Consider seeking feedback from senior executives as part of the board evaluation process. Senior executives may have insight on additional skills or expertise that would be helpful to have on the board.

— Board evaluations should seek feedback not only on an individual's performance as a director but also on the performance of the board as a whole, as well as its committees.

One question we often hear is "how do I get my board on board with board refreshment?" In order to be successful in achieving a refreshed and more effective board, it is critical for board refreshment to be led by the board and particularly by key directors, which can be a long-term process.

Enhancing the Diversity of Skills and Backgrounds Through Board Refreshment

Diversity continues to be a focus of stakeholders, including at the board level. Increasing board diversity can be accomplished through either (i) expanding the board to add directors with diverse skills and backgrounds or (ii) a more comprehensive board refreshment process. For some companies, the latter option may be more appealing as a way to promote and enhance board effectiveness, as well as potentially deal with lingering issues, shareholder pressure or directors with longer tenure than desired. Management, however, may find it difficult to initiate a board refreshment process. One question we often hear is "how do I get my board *on board* with board refreshment?" In order to be successful in achieving a refreshed and more effective board, it is critical for board refreshment to be led by the board and particularly by key directors, which can be a long-term process.

Next Steps:

— Consider linking a board refreshment process with the company's long term strategic plan so board skills are aligned with where the company views its business in the future.

— Identify areas in which new directors with a diverse skillset and background can strengthen the board and contribute to a more effective board. Present a board skills matrix to showcase where there may be gaps in expertise. Be specific in what skills and backgrounds could enhance the effectiveness of the board, focusing on what can be gained in terms of diversity in background and expertise by a comprehensive board refreshment process. Elicit feedback from board members on what additional skills they would value in new directors.

— Avoid focusing on which directors may be a target for replacement in a comprehensive board refreshment process when initially discussing the concept with the board. Focus on the benefits to board diversity and effectiveness rather than on potential impacts to individual directors.

— Enlist support from the chairs of the board and nominating and governance committees, and prepare over time for them to lead conversations with individual directors.

— Plan for a long runway—the board refreshment process is oftentimes a multiyear process involving a comprehensive evaluation of the current board and multiple director searches.

As companies prepare for their upcoming board election cycle, they should consider the importance of using enhanced disclosure to highlight the attributes of an effective board.

Highlighting Board Effectiveness to Stakeholders

As companies prepare for their upcoming board election cycle, they should consider the importance of using enhanced disclosure to highlight the attributes of an effective board. Particularly given stakeholders' focus on board diversity and the new rules on universal proxy cards, not to mention potential SEC rules relating to climate and cybersecurity, disclosure of director skills, expertise and qualifications is particularly important.

Next Steps:

— Evaluate which directors have received lower support from shareholders in previous annual votes. For those directors who have received less support, consider how to enhance disclosure in the proxy statement to highlight those directors' skills and qualifications, including what unique contributions each director has made to the board in order to generate more shareholder support.

— Directors should be encouraged to take a fresh look at their biographies and qualifications and consider emphasizing skills, qualifications and expertise that contribute to the business and strategy of the company.

— Narrowing the expertise set of each director to their deepest skill sets, rather than trying to fill the skills matrix with checks, may highlight the value of each director and indicate a cohesive and well-balanced board.

— Consider whether other forms of affirmative outreach are warranted for directors, including posting personal videos to allow shareholders to get to know the directors and their contribution to the board.

Delaware Extends Exculpation from Personal Liability to Senior Officers

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The Delaware legislature recently amended Delaware's General Corporation Law (DGCL) to allow corporations to limit the personal liability of corporate officers for money damages for breaches of their fiduciary duty of care.[1] Prior to this amendment, Delaware only allowed for such "exculpation clauses"—which must be set forth in the certificate of incorporation—for corporate directors. This disparity resulted in increased litigation against officers for alleged breaches of duties of care when such claims against directors were not available.

The change in Delaware law is a much needed corrective that permits corporations to treat corporate officers and directors similarly.

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What the Amendment Permits

Corporate officers and directors owe fiduciary duties of care and loyalty to the corporation and its shareholders. Previously, DGCL Section 102(b)(7) permitted corporations to exculpate directors from claims for breaches of their duty of care, but did not permit any exculpation of corporate officers. Claims against officers for breaches of their duty of care have become especially common in the context of M&A transactions. The new amendment now allows for the exculpation of officers, with some specific limitations. (As a matter of policy, Delaware law still does not permit exculpation of claims against directors or officers for breaches of the duty of loyalty.)

[1] This amendment is effective as of August 1, 2022 and is not retroactive.

The amended Section 102(b)(7) applies only to certain senior officers—specifically, an individual who: (i) is or was president, chief executive officer, chief financial officer, chief legal officer, controller, treasurer or chief accounting officer; (ii) is or was a "named executive officer" identified in the corporation's SEC filings; or (iii) has, by written agreement with the corporation, consented to be identified as an officer for purposes of accepting service of process.[2]

Mirroring the previous scope of exculpation for directors, the amendment does not permit exculpation of officers from liability for: (i) breaches of duty of loyalty; (ii) acts or omissions not in good faith or involving intentional misconduct or knowing violations of law; or (iii) any transaction from which a director or officer derives an improper personal benefit.[3] And as with directors, while Section 102(b)(7) allows for exculpation of officers for monetary liability, it does not permit exculpation for equitable relief, which means officers (as was already the case with directors) may still be held liable for injunctive or rescissory relief in connection with a breach of fiduciary duty of care.

Finally, the amendment does not permit exculpation of officers for claims brought by or in the right of the corporation, including claims brought derivatively by the corporation against officers for breaches of the duty of care, or brought by stockholders derivatively on behalf of the corporation where demand on the board is properly excused. Director exculpation is not subject to this same limitation.[4]

Requirements to Implement

Extending exculpation for duty of care claims to corporate officers under DGCL Section 102(b)(7) is not self-executing. Corporations will need to amend their charters to include such a provision if they wish to provide such exculpation, and any amendments of this nature will require shareholder approval. These kinds of proposals will require preliminary proxy statements, which corporations should consider in their annual meeting timeline. We think that adopting such a provision makes good sense. It corrects an imbalance that plaintiffs' lawyers have been exploiting to bring often frivolous claims against officers that could not be maintained against directors, only to increase the settlement value of those lawsuits. Adoption of a charter amendment will enable officers to avoid such liability to shareholder plaintiffs when acting in good faith, and for the early dismissal of such claims, while still preserving the ability of the company or shareholders to bring claims for breaches of the duty of loyalty or derivatively where appropriate.

Proxy Advisors' Response

Some companies have, since the passage of the amendment, successfully amended their charters and ISS and Glass Lewis have generally supported these measures.

Companies seeking to court the proxy advisors' approval of officer exculpation proposals should avoid bundling these proposals with any other charter amendments proposed for adoption at the same meeting, given the advisors' past criticism of bundled voting as not giving shareholders a proper opportunity to weigh in on each amendment.

In its recently issued 2023 policy update, ISS indicated it will make recommendations on officer exculpation charter amendments on a case-by-case basis, "consider[ing] the stated rationale for the proposed change" and the extent to which the charter amendment would: (i) "[e]liminate directors' and officers' liability for monetary damages for violating the duty of care;" (ii) "[e]liminate directors' and officers' liability for

[2] *See* § 102(b)(7).

[3] *See* § 102(b)(7)(i)-(iv). Section 102(b)(7) also does not permit exculpation of liability for directors under Section 174 for unlawful dividends or stock repurchases. *Id.*

[4] *See* § 102(b)(7)(v).

monetary damages for violating the duty of loyalty"; and (iii) "expand coverage beyond legal expenses to include liability for violations of fiduciary duties that are more serious than acts of mere carelessness."[5] ISS appears to be focused on exculpation provisions that would extend to the duty of loyalty, but this is not permitted by the DGCL.

Meanwhile, Glass Lewis appears poised to take a stricter approach. In its 2023 policy update, it indicates that it will generally recommend that shareholders vote against officer exculpation proposals that eliminate monetary liability for breach of duty of care unless the board has a "compelling rationale" and the provision is "reasonable."[6]

Companies seeking to court the proxy advisors' approval of officer exculpation proposals should avoid bundling these proposals with any other charter amendments proposed for adoption at the same meeting, given the advisors' past criticism of bundled voting as not giving shareholders a proper opportunity to weigh in on each amendment.

Shareholder Challenges to Officer Exculpation Provisions

In two recent cases currently pending before the Delaware Court of Chancery, *Electrical Workers Pension Fund, Local 103, I.B.E.W. v. Fox Corp.*[7] and *Sbroglio v. Snap, Inc.*[8], certain classes of shareholders challenged Fox Corporation's and Snap, Inc.'s attempts to amend their charters to include an exculpation provision for their top officers. In both cases, plaintiff shareholders were part of a class of shareholders that the corporation excluded from voting on the charter amendment. Plaintiff shareholders did not challenge the substance of the amendments or the corporations' right to propose the changes but instead challenged them on the grounds that they violated section 242 of the DGCL, which gives holders of individual stock classes a right to vote on charter amendments if the amendment would "alter or change the powers, preferences, or special rights of the shares."[9]

While *Fox* and *Snap* may have an impact on the process for adopting such provisions in the future and the classes of shareholders that are entitled to vote, the lawsuits do not challenge the legality or appropriateness of a corporation to propose such changes in the first place and should ultimately not impact a corporation's decision whether to do so.

With the amendment of DGCL Section 102(b)(7), Delaware corporations should seriously consider amending their corporate charters to allow for officer exculpation for breaches of fiduciary duty of care.

Takeaways

With the amendment of DGCL Section 102(b)(7), Delaware corporations should seriously consider amending their corporate charters to allow for officer exculpation for breaches of fiduciary duty of care. Doing so will allow corporations to provide to their officers nearly the same level of protection that they provide to their directors from claims for breaches of the duty of care. This is especially important as the number of nuisance suits naming officers for breaches of their duties of care is on the rise, and its adoption should be a factor in ensuring the corporation is retaining top talent. Corporations seeking such charter amendments will need to be prepared to articulate these benefits to their shareholders and the proxy advisors.

5 *Proxy Voting Guidelines, Benchmark Policy Changes for 2023: U.S., Canada, Brazil, and Americas Regional*, ISS (Nov. 30, 2022), available here.

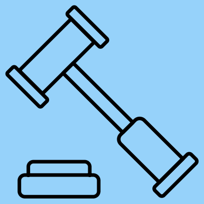
6 *2023 Policy Guidelines*, Glass Lewis, available here.

7 C.A. No. 2022-1007 (Del. Ch. Nov. 4, 2022).

8 C.A. No. 2022-1032. (Del. Ch. Nov. 16, 2022); *see also Dembrowski v. Snap, Inc.*, C.A. No. 2022-1042 (Del. Ch. Nov. 17, 2022) (consolidated with the *Sbroglio* case).

9 DGCL § 242(b)(2).

Accelerated Pace and Increased Regulatory Expectations in Enforcement and Compliance Investigations



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The Securities and Exchange Commission (SEC) and Department of Justice (DOJ) ramped up their enforcement efforts in 2022, often in highly coordinated actions, including with other regulatory agencies such as the Commodity Futures Trading Commission (CFTC), Department of the Treasury's Office of Foreign Assets Control (OFAC) and Department of the Treasury's Financial Crimes Enforcement Network (FinCEN). The DOJ also announced major policy changes regarding corporate criminal enforcement and took steps to convey its seriousness in pursuing actions against individual wrongdoers, recidivists and companies that fail to maintain effective compliance programs. The SEC was particularly active, setting its record for civil penalties and continuing its enforcement focus on insider trading, digital assets and Environment, Social and Governance (ESG) disclosures.

The SEC

The SEC reported 760 enforcement actions filed in 2022, a 9% uptick from 2021.[1] With a record $4.2 billion in civil penalties in its 2022 fiscal year, the SEC realized its goal to see penalties "recalibrated" upward across the board.[2] Several blockbuster corporate settlements showcased the SEC's continued focus on traditional areas such as investment advisers, broker-dealers and issuer accounting and disclosure, as well as its priority to ensure individual accountability. Finally, in light of significant volatility in digital asset markets, including the collapse of the digital asset trading platform FTX, the SEC continues to pursue an aggressive litigation and investigation posture towards all actors in the industry, including platforms, lenders and digital asset issuers.

Financial institutions (and any others subject to the recordkeeping provisions of the federal securities laws) should pay particular attention to their policies regarding the use and monitoring of employee communications.

Off-Channel Communications

Last year, the SEC assessed over $1.2 billion in penalties for violations of recordkeeping requirements relating to the use of "off-channel" communications such as text messages and messaging apps by employees of some of the largest banks, broker dealers and investment advisers.[3] The SEC's sweep of the market has expanded to hedge funds and private equity firms and will certainly continue into next year. Financial institutions (and any others subject to the recordkeeping provisions of the federal securities laws) should pay particular attention to their policies regarding the use and monitoring of employee communications, especially in light of new app-based messaging practices on employees' personal devices and messaging systems with the capacity to permanently delete conversations and message threads, whether selectively or automatically.

Digital Assets

Having doubled the size of the Enforcement Division's Cyber Unit (renamed the Crypto Assets and Cyber Unit),[4] the SEC signaled its commitment to ramp up enforcement in the digital asset space, all against the backdrop of parallel regulatory and legislative efforts to establish a workable regulatory framework for this nascent industry. The SEC continues to assume the role of "cop on the beat" with respect to digital assets, pursuing a broad range of actions that includes charges of unregistered securities offerings, fraud, insider trading and disclosure violations. This includes auditors responsible for evaluating the financials of firms in the crypto industry. In the wake of FTX's collapse, these investigations and litigated actions will inevitably continue into next year, with SEC Chair Gary Gensler signaling that the "roadway is getting shorter" for non-compliant crypto issuers and exchanges to register with the agency.[5] Litigation to follow in 2023 includes the SEC's first digital asset insider trading case against a former employee of a digital asset trading platform and alleged co-conspirators who allegedly traded on non-public information about digital asset listings on that platform, as well as a potential decision on summary judgment motions in the SEC's case against Ripple Labs Inc. and two of its executives, which is seen as a bellwether for when digital assets are considered securities.

1 Press Release, "SEC Announces Enforcement Results for FY22" (November 15, 2022), available here.

2 Press Release, "SEC Announces Enforcement Results for FY22" (November 15, 2022), available here.

3 Press Release, "SEC Charges 16 Wall Street Firms with Widespread Recordkeeping Failures" (September 27, 2022), available here.

4 Press Release, "SEC Nearly Doubles Size of Enforcement's Crypto Assets and Cyber Unit" (May 3, 2022), available here.

5 Ephrat Livni & Matthew Goldstein, "Even After FTX, S.E.C. Chair Sees No Need for New Crypto Laws" (December 22, 2022), available here.

ESG

The SEC continues to pursue actions against regulated entities for allegedly misleading disclosures and omissions related to ESG issues. In May 2022, the SEC and BNY Mellon Investment Adviser, Inc. settled claims that the investment advisor misled investors about its consideration of ESG principles in making investment decisions for certain mutual funds it managed. The SEC's Climate and ESG Task Force will remain focused in 2023 on applying time-tested theories concerning materiality, accuracy of disclosures and fiduciary duty in the ESG context.

[The DOJ's] focus is to empower compliance personnel to adopt measures that lead to increased prevention, detection and mitigation of misconduct, including greater cooperation with authorities and higher likelihood of self-reporting.

The DOJ

The DOJ continued to provide additional detail regarding new policy initiatives previewed in 2021[6] and anticipated the rollout of even more policies to come in 2023. New appointments at the Department signal the Biden Administration's focus on enhancing corporate compliance programs both through enforcement actions and policy guidance.[7] On multiple occasions, the DOJ stated that its focus is to empower compliance personnel to adopt measures that lead to increased prevention, detection and mitigation of misconduct, including greater cooperation with authorities and higher likelihood of self-reporting.[8] Prosecutors across all DOJ units have been urged to adopt policies that will further incentivize self-reporting and cooperation.

Corporate Enforcement Policies

In September, the DOJ released a memorandum providing guidance to prosecutors in several key corporate criminal enforcement areas.[9] Individual accountability will be paramount to how the DOJ expects corporations and their counsel to conduct investigations. In order to obtain cooperation credit, the DOJ has made clear that it expects companies to identify everyone involved in the relevant conduct and to make timely and complete disclosures regarding those individuals. Companies with a history of misconduct, regardless of the criminal or civil nature of such misconduct, will need to be prepared to address that history and distinguish it from the conduct at issue. Timely voluntary self-disclosure will be rewarded, and the DOJ has committed to providing further guidance on the benefits of self-reporting in the coming months, in addition to guidance on the use of personal devices and third party messaging applications and compensation clawback provisions that will be relevant to cooperation in DOJ investigations.

FCPA

The DOJ has reinvigorated the corporate monitorship program, which was relatively dormant during the Trump administration.[10] In 2022, the DOJ reached four Foreign Corrupt Practices Act (FCPA) resolutions, with Stericycle Inc., Glencore plc, GOL Airlines S.A. and ABB Ltd. Both Stericycle and Glencore agreed

6 Deputy Attorney General Memorandum, "Corporate Crime Advisory Group and Initial Revisions to Corporate Criminal Enforcement Policies" (October 28, 2021), available here. *See also* our November 2021 alert memo available here.

7 *See, e.g.*, Dylan Toker, "Hewlett Packard Enterprise Executive to Lead Justice Department's Fraud Section" (June 7, 2022), available here; Dylan Toker, "Justice Department Recruits AB InBev Data Expert to White-Collar Crime Force" (September 8, 2022), available here.

8 *See, e.g.*, Speech, "Assistant Attorney General Kenneth A. Polite Jr. Delivers Remarks at NYU Law's Program on Corporate Compliance and Enforcement" (March 25, 2022), available here.

9 Deputy Attorney General Memorandum, "Further Revisions to Corporate Criminal Enforcement Policies Following Discussions with Corporate Crime Advisory Group" (September 15, 2022), available here. *See also* our September alert memo available here.

10 In an effort at increased transparency, the DOJ last year also released a consolidated list of monitors from the past ten years. *See* DOJ Corporate Enforcement, Compliance and Policy Unit, "List of Independent Compliance Monitors for Active and Previous Fraud Section Monitorships" (last updated December 13, 2022), available here.

to the imposition of corporate monitors. As part of a coordinated resolution between the DOJ and CFTC, Glencore had one compliance monitor imposed as part of its settlement regarding FCPA violations and a separate compliance monitor with respect to market manipulation violations.[11] In what will likely be an increasingly common feature of resolutions going forward, both the Glencore and GOL Airlines resolutions required "compliance certifications" attesting to the strength of the companies' compliance programs. The DOJ also declined to prosecute JLT Group Holdings for violations of the FCPA in light of voluntary self-reporting by the company regarding bribe payments to Ecuadorian government officials. The DOJ still sought disgorgement from JLT Group and, consistent with its stated priorities, prosecuted five individuals involved in the misconduct.

Digital Assets

Several major events in the digital asset space, including the collapse of the trading platform FTX and the algorithmic stablecoin Terra, have led to increased investigations and litigation by the DOJ. Consistent with its focus on individual accountability, the DOJ has also sought to prosecute actors in this space for alleged insider trading,[12] market manipulation and money laundering, among other criminal allegations.[13] Unlike the SEC, the DOJ has been able to pursue actions without needing to prove that the underlying digital assets are securities. With the indictment of FTX leaders including CEO Sam Bankman-Fried in December 2022, it is clear that this space will continue to be active in 2023 and will be characterized by heavily coordinated investigative activity and litigation by the SEC, CFTC and DOJ.

Boards of directors should be prepared for investigations and enforcement actions designed to implement policy goals announced by the agencies throughout the past year.

Key Takeaways

Boards of directors should be prepared for investigations and enforcement actions designed to implement policy goals announced by the agencies throughout the past year.

— Investigations will proceed at an accelerated pace, and prosecutors and regulators will expect facts regarding any culpable individuals to be front-loaded. Failure of companies under investigation to cooperate expeditiously may result in reduced cooperation credit.

— The DOJ will be particularly focused on whether executives and high-ranking employees have compensation clawbacks in their contracts that encourage compliance with DOJ investigations.

— All companies subject to any recordkeeping provisions of the federal securities laws should establish robust policies and employee training and guidance regarding use of personal communication channels, use of workplace devices and document retention, especially where, as a practical matter, a substantial amount of business is conducted using such channels.

[11] Press Release, "Glencore Entered Guilty Pleas To Foreign Bribery And Market Manipulation Conspiracies (March 24, 2022), available here.

[12] Press Release, "Three Charged In First Ever Cryptocurrency Insider Trading Tipping Scheme" (July 21, 2022), available here. *See also* our August blog post available here.

[13] Press Release, "FTX Founder Indicted for Fraud, Money Laundering, and Campaign Finance Offenses" (December 13, 2022), available here.

— All companies should evaluate their risk exposure to digital assets and the disclosures and representations to counterparties and the public regarding accounting for those assets.

— Companies—particularly those in the oil and gas, mining, automotive, aerospace and industrial sectors—should continue to devote resources to their internal monitoring and compliance protocols for ESG targets and anti-corruption in light of the Biden administration's targeted focus on these topics.

SEC Parties Like Its 2010: Adopts Long-Awaited Executive Compensation Regulations Under Dodd-Frank

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2022 saw a flurry of activity to implement rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, a statute passed in reaction to the financial crisis of 2008 but for which enacting guidance had long been absent.

Two significant rules adopted this year in the area of executive compensation are the so-called "pay vs. performance" rules (PVP Rules)[1] and rules on mandatory clawback of incentive compensation (the Clawback Rules).[2] This memo focuses on insights and considerations that have arisen since the passage of the rules and highlights some practical takeaways for boards and management teams as we collectively work through compliance with rules that, in many cases, have created significant unanswered questions.

PVP Rules

As a refresher, the PVP Rules apply to U.S. public companies subject to SEC reporting (other than foreign private issuers (FPIs), most registered investment companies and emerging growth companies) and generally will require disclosure in proxy or information statements in which disclosure under Item 402 of Regulation S-K is required with respect to any fiscal year ending on or after December 16, 2022.

[1] *See* our September Alert Memo on these rules available here.

[2] *See* our November Alert Memo on these rules available here.

It can be time-consuming to determine methodologies and track and value equity-based awards and pension benefits for purposes of determining compensation "actually paid" under the PVP Rules. We recommend early engagement of appropriate advisors, such as valuation and actuarial experts.

PVP Key Takeaways and Questions

— It can be time-consuming to determine methodologies and track and value equity-based awards and pension benefits for purposes of determining compensation "actually paid" under the PVP Rules. We recommend early engagement of appropriate advisors, such as valuation and actuarial experts. Even if this work will be done internally, setting up a process early that can be applied consistently will be helpful in complying with the rules. Because the PVP Rules require disclosure of valuation assumptions at later stages of the vesting cycle for equity-based awards, and these assumptions may differ from those used in determining grant-date fair value, companies may face a tension between complying with the rules and disclosing confidential or sensitive information (*i.e.*, internal projections not otherwise required to be disclosed may be relevant for valuation assumptions but premature or competitively harmful).

— The PVP Rules will require focus on peer group evaluation and selection and discipline, given that changing groups year-over-year will likely increase the disclosure burden under the rules.

— The selection of a "Company Selected Measure" on which compensation is based will imply its importance to the company's strategic objectives and compensation philosophy. Care must be taken to ensure conformity with selecting this measure and non-compensation-related disclosure of how this metric fits within the company's operational goals.

— Compensation committees will need to decide the form and content of the PVP disclosures and ensure consistency between those disclosures and discussion of performance both within the compensation discussion and analysis (CD&A) in the proxy and elsewhere in the company's public filings. In terms of practicalities, we believe most issuers will opt for graphic disclosure (as it will be the easiest way to present the information in a clear and concise manner), will choose to present this new disclosure outside of the CD&A and will resist the temptation to add supplemental disclosure in excess of what is plainly required by the PVP Rules, unless of course there is a significant disconnect in pay-versus-performance caused by external factors not readily discernible from the minimum required disclosures.

— While we expect companies will take time to digest the initial response from proxy advisory firms and institutional shareholders to PVP disclosures to better understand the impact of these disclosures before making any significant changes to their compensation philosophy and programs, it is never too early for compensation committees to begin to analyze their current compensation program designs, including use of financial performance measures and operational, strategic and ESG goals, and to assess whether any changes to program designs may be warranted.

— We do not expect companies to include non-financial measures, such as operational, strategic or ESG goals, in their list of performance measures unless such non-financial measures are significant determinants of compensation, and we would caution against doing so without a compelling narrative linking the company's achievement of such non-financial goals and the compensation paid to the named executive officers.

— While the PVP Rules require various disclosures relating to total shareholder return (TSR) (both the company's absolute TSR and the TSR of its peer group), the rules are ambiguous regarding use of relative TSR as the "Company Selected Measure," even when that metric is a predominant financial measure in a company's compensation program, and whether such company must select an alternate financial performance measure (assuming there are additional financial performance measures in the list of financial performance measures to choose from) in lieu of relative TSR, since absolute TSR is already disclosed. While we believe relative TSR should be an appropriate "Company Selected Measure," companies should proceed with caution until we have received clarification from the SEC.

Issuers that do not adopt a clawback policy compliant with the Clawback Rules or who fail to enforce their policy are subject to delisting on their applicable exchange.

Clawback Rules

The Clawback Rules remain at this time a bit inchoate, insofar as they require the listing exchanges to adopt clawback listing standards further enacting the Clawback Rules prior to the end of February 2023 (which listing standards must go into effect no later than November 28, 2023, with issuers required to implement policies within 60 days thereafter). Unlike the PVP Rules, the Clawback Rules will also apply to FPIs.

Generally, the Clawback Rules require most issuers to implement "no fault" clawback policies that apply in the event of certain restatements of the issuer's financial reporting for accounting purposes, which policies would require the issuer to pursue recovery of any erroneously paid incentive compensation that is earned, vested or granted to any of the issuer's current or former executive officers during the three completed fiscal years prior to the date of the accounting restatement. An issuer must also file a copy of its clawback policy as an exhibit to its annual report and disclose details regarding the incentive compensation subject to recovery and any excess amounts that remain outstanding for at least 180 days. Issuers that do not adopt a clawback policy compliant with the Clawback Rules or who fail to enforce their policy are subject to delisting on their applicable exchange.

The Clawback Rules are simultaneously broader and narrower in scope than many existing clawback policies that have been adopted by issuers both in anticipation of the Dodd-Frank rules and investor pressure. On the one hand, most financial restatements (including certain so-called "little r" restatements that are not inherently material) will implicate the Clawback Rules, and current and former executive officers may be subject to the Clawback Rules regardless of whether they have engaged in any misconduct. In addition, the Clawback Rules significantly restrict the board's use of discretion, including in areas such as: whether a clawback will be required, the amount of compensation subject to clawback, how to factor in extenuating concerns like adverse tax impact of clawback and similar considerations. On the other hand, the type of misconduct covered by the rules remains limited to deemed overpayment of incentive compensation tied to financial restatements, and does not include other misconduct that may result in financial or reputational harm to the company (*e.g.*, policy violations, criminal conduct), which is commonly included in existing clawback policies.

Clawback Takeaways and Next Steps

— Most public companies have already adopted clawback policies in response to shareholder feedback or the views of institutional proxy advisory firms who consider clawback policies in their proxy voting guidelines. However, a large number of those clawback policies were influenced by the clawback provisions under Section 304 of the Sarbanes-Oxley Act, which generally require misconduct and are limited to clawback in the event of a "Big R" restatement. As a result, we anticipate that many companies will need to revise existing clawback policies to address the broader scope of the Clawback Rules, but may choose to retain multiple policies (or a policy-within-a-policy) that will require clawback in compliance with the Clawback Rules, but will also permit clawback in other circumstances currently covered by their issuer's policies and/or to non-executive officers, in the discretion of the issuer's board of directors.

Issuers should review their compensation committee charters and other applicable governance documents to ensure the compensation committee will be empowered to act on the Clawback Rules once the listing standards are adopted.

— Although we do not expect the listing exchange implementing standards to substantially differ from the Clawback Rules, in light of ongoing interpretive uncertainty in the rules, we are advising most issuers to defer adoption of changes to their existing policies until such standards (and any further guidance) are released. That does not mean boards and compensation committees should defer all action until the listing standards are released. Issuers should review their compensation committee charters and other applicable governance documents to ensure the compensation committee will be empowered to act on the Clawback Rules once the listing standards are adopted. In addition, careful deliberation and consideration should be given to whether existing clawback policies will be retained to the extent they are broader than the Clawback Rules require, mindful that there will likely be substantial institutional shareholder and proxy advisory firm pressure to retain these policies. For this reason we expect many companies to adopt a segregated Dodd-Frank clawback policy that effectively tracks the minimum requirements of the statutory language and applicable listing standards, leaving any clawbacks broader in scope to separate or supplemental policies.

We recommend that FPIs begin the analysis of who would qualify as an executive officer for purposes of the Clawback Rules now, particularly because it is likely judgment calls will need to be made in this process.

— In addition to the above considerations, FPIs will have additional work to do. The individuals covered by the Clawback Rules generally track the definition of "executive officer" under Section 16 of the Exchange Act, to which FPIs are not subject. As a result, we recommend that FPIs begin the analysis of who would qualify as an executive officer for purposes of the Clawback Rules now, particularly because it is likely judgment calls will need to be made in this process. The definition of executive officer is based on a "facts and circumstances" analysis, informed by the issuer's reporting lines and structure and focused on the degree of policy-making authority of the applicable individuals, which will vary based on their responsibilities within the organization. It is likely that there may be some overlap between the members of the issuer's "administrative, supervisory or management bodies"[3] required to be disclosed in an FPI's annual report on Form 20-F, but the disclosure requirements in Form 20-F defer to home country practice rather than the functional test utilized in Section 16, which FPIs will need to consider when implementing the Clawback Rules.

— Compliance with the Clawback Rules will require more fulsome internal controls and procedures, including documentation and decision-making processes for determinations regarding compensation (*e.g.*, preparing materials for compensation committee meetings including significant detail regarding the role of financial/non-financial metrics considered by the committee when making compensation decisions). Issuers will need to clearly delineate what items

[3] *See* Form 20-F Item 6(B).

of compensation may be subject to the Clawback Rules and evaluate whether elements of an issuer's compensation design may be inadvertently swept up in the incentive-based compensation covered by the Clawback Rules due to being awarded partially in recognition of prior achievement of financial reporting measures, even if the compensation itself is not subject to further achievement of financial goals.

— Issuers should review their compensation disclosure for upcoming proxy statements with the Clawback Rules in mind, given the inherent tension between, on the one hand, demonstrating an alignment between their executives' compensation and the issuer's financial performance, which will remain a focus of shareholders and proxy advisory firms, and on the other, linking elements of compensation that the committee did not intended to be "incentive compensation" within the meaning of the Clawback Rules (*i.e.*, base salary increases) but that might be deemed to be performance-based if the disclosure would suggest it is contingent or related to attainment of financial performance metrics.

Issuers should be mindful that significant questions remain about how to reconcile potential tension between the Clawback Rules and other applicable law, including state and local laws that broadly protect "wages" against forfeiture or clawback and limitations in the tax rules for recovery of taxes paid on amounts that are ultimately clawed back.

— Issuers should begin reviewing their current compensation programs and arrangements to evaluate whether and how current contracts will need to be modified to address the Clawback Rules and to assess the feasibility of recovery in the event of a clawback. This review should include ensuring awards and contracts with executive officers include clawback language that could be revised unilaterally by the issuer to permit recovery as required under the Clawback Rules, or that at least reference any clawback policies adopted by the issuer. In addition, for go-forward annual equity or bonus awards, issuers should consider whether to require executives to execute, as a condition to their receipt, an acknowledgement agreeing that such awards, as well as any previously awarded compensation that falls within the scope of the Clawback Rules, will be subject to the Clawback Rules (carefully specifying whether and to what extent such compensation will also be within the scope of any supplemental clawback policy issuer has in effect) and allowing for broad recovery and offset rights in favor of the issuer. In conducting these reviews, issuers should be mindful that significant questions remain about how to reconcile potential tension between the Clawback Rules and other applicable law, including state and local laws that broadly protect "wages" against forfeiture or clawback and limitations in the tax rules for recovery of taxes paid on amounts that are ultimately clawed back.

— The Clawback Rules generally prohibit a company from indemnifying or otherwise economically protecting executive officers from the Clawback Rules and their implications. Affected companies may wish to review their employment and executive agreements and plans, as well as indemnification policies, to ensure that they comply with this aspect of the rules.

— Compensations committees will want to consider the impact of the Clawback Rules on compensation design. We expect many committees to turn to their compensation consultants and advisors to assist in modifying compensation programs with an eye toward enforcement of the Clawback Rules and potential mitigation of the reach of new clawback policies on executives' compensation. The desire and ability of compensation committees to make any such changes to plan design will be limited by the countervailing interests of shareholders and proxy advisory firms. Potential areas for consideration may include:

- Using operational, strategic or ESG measures as opposed to financial performance measures and/or moving away from a reliance on stock price or TSR as a financial performance measure given the difficulty in determining the impact of a restatement on incentive compensation earned based on achievement of stock price and TSR.

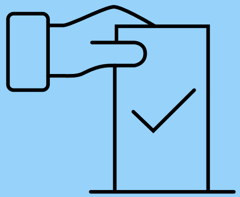
- Moving from awards with multiple year performance periods to incentive compensation that contains a "banking" element (*e.g.*, awards where performance is measured at one-year performance periods subject to a requirement of continued employment through the end of the aggregate number of performance periods) to limit the scope of the award that may be covered by the issuer's clawback policy if a lookback period encompasses only a portion of the performance period.

- Similarly, compensation plan design may evolve to assist in the recovery of compensation in the event of a restatement by requiring deferral of earned incentive compensation through the date it is no longer covered by the lookback period, longer stock ownership periods following settlement of equity awards or similar steps to extend the period of time before earned incentive compensation becomes payable to covered executives in order to facilitate recovery of such amounts in the event of a restatement.

While the Clawback Rules do not empower the SEC to directly compel issuers to pursue recovery pursuant to the issuer's clawback policy, they are also likely to result in an increase in shareholder derivative suits in connection with restatements, in particular around questions of whether a restatement was required, the calculation of erroneously awarded compensation and where the issuer determines not to pursue recovery due to its impracticability.

— While the Clawback Rules do not empower the SEC to directly compel issuers to pursue recovery pursuant to the issuer's clawback policy, they are also likely to result in an increase in shareholder derivative suits in connection with restatements, in particular around questions of whether a restatement was required, the calculation of erroneously awarded compensation and where the issuer determines not to pursue recovery due to its impracticability. In addition, executives subject to the rule may also pursue actions against their employers in connection with the loss of earned incentive compensation as a result of the application of the issuer's clawback policy. For its part, the SEC is likely to scrutinize issuers' disclosures about compensation clawback calculations, efforts, and the timing of restatement decisions. Boards and compensation committees should be braced for this potential development.

The DOL Finalizes Yet Another Rule on ESG and Proxy Voting and Proposes Significant Amendments to the QPAM Exemption



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The Department of Labor has been busy with various regulatory initiatives during 2022 and this trend is likely to continue into 2023. This high-level overview of a couple of noteworthy DOL regulatory initiatives should be useful for boards and management teams alike. The first is a proposed amendment to a popular "prohibited transaction" exemption, which, if passed, will have a significant impact on many financial contracts, including existing loan and ISDA contracts. The second is a final regulation governing ERISA plan investments, which could alter how plan investors consider ESG as part of their investment strategy and manage their investments in public companies.

The DOL's Proposed Amendment to the QPAM Exemption

ERISA plan sponsors and service providers frequently rely on Prohibited Transaction Exemption 84-14 (the QPAM Exemption) in connection with transactions involving ERISA plan assets. By way of background, absent an applicable exemption, ERISA prohibits certain direct and indirect transactions (*e.g.*, purchase/sale, extension of credit, provision of services) between ERISA plans and "parties in interest" with respect to such plans. Given the breadth of the term "party in interest," ERISA plan sponsors and service providers frequently confirm the applicability of an exemption (*e.g.*, the QPAM Exemption) instead of attempting to confirm that there is no "party in interest" relationship.

In July of 2022, the DOL proposed an amendment to the QPAM Exemption (the Proposal) that includes a number of key changes, which would fundamentally alter the way in which ERISA plan sponsors and service providers rely upon this exemption.[1] One of the proposed changes would require review, and likely amendment, of nearly every agreement involving ERISA plan assets and referencing (or relying upon) the QPAM Exemption (including ISDAs, investment management agreements

[1] 87 Fed. Reg. 45204 (July 27 2002).

and loan agreements). After publication of the Proposal, the DOL received numerous comments from service providers and industry groups raising concerns regarding the impact of the Proposal and related issues. As a result, the DOL held a public hearing in November 2022 and opened a second comment period, which closed.

ERISA plan sponsors and financial institutions that provide services to ERISA plans should consider surveying key agreements to get a better understanding of the potential impact of the Proposal from a resource/cost perspective.

QPAM Exemption Key Takeaways

At this time, it is difficult to predict with certainty what the final amendment will look like but it is unlikely that the DOL will abandon this initiative altogether. Further, the Proposal includes a relatively short timeframe for implementation of any required changes. Accordingly, ERISA plan sponsors and financial institutions that provide services to ERISA plans should consider surveying key agreements to get a better understanding of the potential impact of the Proposal from a resource/cost perspective. Depending on the substance of the final amendment, we may see less reliance on the QPAM Exemption across a broad range of transactions, which may require consideration of the applicability of other potential exemptions and could have a chilling effect on the willingness of service providers to enter into contracts with ERISA plans. Compliance with the Proposal, if adopted, is likely to be costly to ERISA plan sponsors and service providers alike and the increased risk and cost of relying on the QPAM Exemption or alternative prohibited transaction exemptions could result in financial institutions and asset managers charging ERISA plans higher fees for investment management services and financial transactions.

ESG and Proxy Voting

In November of 2022, the DOL released its final rule (the Final Rule)[2] clarifying the application of ERISA's fiduciary duties to the selection of investments and investment courses of action.[3]

The Final Rule reaffirms a bedrock principle under ERISA's duties of prudence and loyalty – when selecting investments and/or investment courses of action, plan fiduciaries must focus on the relevant risk-return factors and may not subordinate the interests of participants and beneficiaries to objectives unrelated to the provision of benefits under the plan (*e.g.*, by reducing investment returns and/or increasing investment risks). Through the years, the DOL has issued quite a bit of guidance regarding the consideration of ESG factors and the exercise of shareholder rights. While the foregoing principle has remained constant, the DOL's guidance has varied as to the degree to which ESG factors may be considered and the responsibilities of fiduciaries in connection with the exercise of shareholder rights.[4] With the Final Rule, the DOL intends to "remove the chilling effect created by the prior administration on considering environmental, social and governance factors in investments"[5] and the Final Rule may make it easier for ERISA plan sponsors and their fiduciary committees to select investments (and/or investment options) with a nexus to ESG factors.

[2] 87 Fed. Reg. 73866 (December 1, 2022).

[3] *See* our December alert memo for our summary of the Final Rule, available here.

[4] *See* Interpretive Bulletin, 94-1, 59 FR 32606 (June 23, 1994); Interpretive Bulletin, 94-2, 59 FR 38860 (July 29, 1994); Interpretive Bulletin 2008-01, 73 FR 61734 (October 17, 2008); Interpretive Bulletin 2008-02, 73 FR 61731 (October 17, 2008); Interpretive Bulletin 2015-01, 80 FR 65135 (October 26, 2015); Interpretive Bulletin 2016-01, 81 FR 95879 (December 29, 2016); Field Assistance Bulletin 2018-01, 85 FR 72846 (November 13, 2020); 85 FR 81658 (December 16, 2020) (the 2020 Final Rule); and Executive Order (E.O.) 13990, "Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis" (January 20, 2021).

[5] DOL news release: "US Department of Labor Announces Final Rule to Remove Barriers to Considering Environmental, Social, Governance Factors in Plan Investments" (November 22, 2022), available here.

As part of the Final Rule, the DOL:

- **Clarified that fiduciaries may, without violating their duties of loyalty and prudence, take into consideration participants' non-financial preferences when constructing a menu of investment options for participant directed (*i.e.*, 401(k)) plans;**
- **Reemphasized that an ERISA fiduciary's duties extend to the management of shareholder rights, including with respect to proxy voting; and**
- **Affirmed the duty to prudently select and monitor proxy voting advisory firms (and any other related service providers) — an ERISA fiduciary may not adopt a practice of rubber stamping decisions made by any such service providers and such fiduciary must independently determine that the proxy voting guidelines utilized by such service providers are consistent with its fiduciary duties under ERISA.**

ESG and Proxy Voting Key Takeaways

While the Final Rule does not mandate the consideration of investments with a nexus to ESG factors (or provide blanket approval thereof), as part of routine ongoing monitoring and selection of plan investments, ERISA plan sponsors and their fiduciaries may want to consider such investments and, in the case of participant-directed plans (*i.e.*, 401(k) plans), whether participants would prefer an investment line-up that includes such investments. In addition, any changes incorporated into an ERISA plan's investment policies in response to the 2020 Final Rule should be revisited to ensure harmony with the Final Rule.

In addition, ERISA plan sponsors and their fiduciary committees should consider reviewing arrangements with proxy voting firms to ensure that the retention of such firm and such firm's voting policies and procedures are consistent with ERISA's fiduciary duties. In addition, an ERISA plan sponsor's fiduciary committee should include, as part of its routine monitoring, a review of the services provided and votes taken by such firm and an analysis of whether such actions are consistent with applicable proxy voting policies and procedures.

In Conclusion

ERISA plan sponsors and fiduciaries should continue to monitor these and other DOL initiatives over the coming year.

Sustainability in the EU: From Theory to Action

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2022 has been a pivotal year for sustainability policy worldwide. In the EU, where sustainability regulation enjoys broad popular and institutional support, sustainability policy shifted from theory to action.

The European Commission has now defined the detailed contours of its sustainability framework – through the Taxonomy Regulation (TR), Sustainable Finance Disclosure Regulation (SFDR), Corporate Sustainability Reporting Directive (CSRD) and Corporate Sustainability Due Diligence Directive (CS3D) – and laid out the related disclosure templates and other implementing rules. Regulators will now shift their attention to supervision and enforcement. We briefly outline below the developments that will most affect companies that do business in the EU in 2023 – distinguishing between implementation challenges and possible future developments.

Defining and Aligning with ESG

Implementing EU Taxonomy Disclosures

The 2020 Taxonomy Regulation provided a first framework definition of "green" (*i.e.*, environmentally sustainable) economic activities, to encourage sustainable investments and combat greenwashing.[1] The subsequent implementing acts set out sector-specific sustainability criteria for a number of "high impact" activities that are seen as key for the green transition

[1] The EU Taxonomy Regulation is available here. For our analysis of the Taxonomy framework, *see* our November 2020 alert memo available here.

(*i.e.*, from transport and energy generation, to industrial manufacturing and raw material extraction).[2] Activities that fall under these criteria are called "Taxonomy-eligible." The Taxonomy Regulation requires companies to disclose, for the first year, only the *percentage* of Taxonomy-eligible activities that they carry out each year.

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Starting in 2023 (with respect to the 2022 financial year), large non-financial issuers of EU-listed securities will be required to disclose their "Taxonomy-alignment," *i.e.*, the *degree* to which those "high impact" activities and investments are environmentally sustainable. The requirement will gradually extend to other types of companies: large financial sector firms (in 2024), all large EU firms (in 2026), and finally also EU-listed SMEs (in 2027).

The KPIs for measuring Taxonomy-alignment are specific to the type of company and sector.[3] For non-financial sector companies, they will concern the percentage of the company's (i) turnover, (ii) capex and (iii) opex associated with Taxonomy-eligible activities.

Preparing for Taxonomy-alignment disclosures presents challenges. Securing access to sufficient, reliable ESG data remains complicated. KPIs for financial institutions – banks' "green asset ratio" (GAR) for instance – were criticized for being both difficult to apply, and insufficiently representative of a bank's effective financing of green versus brown activities. By way of example: credit granted in favor of smaller non-listed firms (that are not themselves in-scope of Taxonomy-alignment reporting obligations) may not count towards a bank's GAR. Logically, this will result in a more favorable ratio for institutions whose lending activities focus on larger corporates.

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Possible future Taxonomy Scenarios

This year, the Commission will work on sectoral environmental sustainability thresholds for the EU's four remaining "green" objectives (pollution control, water use and marine resources, biodiversity and circular economy).[4] Their structure will presumably mimic what was done in 2022 for climate change mitigation and adaptation – which included the debated "green" classification of nuclear energy and natural gas.[5]

[2] The sector-specific sustainability criteria issued so far can be consulted through the "Taxonomy Compass" digital tool, available here.

[3] The Taxonomy "delegated acts" laying out the various Article 8 KPIs are available here.

[4] As required under Paragraph 5 of Articles 12, 13, 14 and 15 of the Taxonomy Regulation.

[5] For an analysis of the nuclear & gas "Complementary Delegated Act," *see* our February alert memo available here.

The Commission is also considering whether to extend the Taxonomy beyond just "green" to cover (i) "amber" activities, having an intermediate impact on environmental sustainability (such as nuclear and natural gas, but also grey and blue hydrogen) and (ii) "red" activities (such as coal-generated energy), having a detrimental impact. A separate category may also emerge for low environmental impact activities (such as professional services), which do not have the potential to significantly benefit nor harm the environment.[6]

On the "Social" end, the EU intends to protect the rights of (i) employees (focusing on decent work and workers' rights), (ii) consumers (with a focus on healthy, safe and durable products, and on favoring products that improve citizens' access to primary needs like quality food, water, housing and education), and (iii) communities affected by corporate activities (such as to promote broader equality and inclusive growth). As "Governance," the Taxonomy is likely to look at both the good conduct of companies (*e.g.*, board diversity and worker representation) and those of public affairs (anti-bribery and corruption, but also responsible lobbying, and transparent and non-aggressive tax planning).

Lastly, 2023 will see the development of a Taxonomy with respect to human rights and good governance (the "S" and "G" of "ESG"). On the "Social" end, the EU intends to protect the rights of (i) employees (focusing on decent work and workers' rights), (ii) consumers (with a focus on healthy, safe and durable products, and on favoring products that improve citizens' access to primary needs like quality food, water, housing and education), and (iii) communities affected by corporate activities (such as to promote broader equality and inclusive growth). As "Governance," the Taxonomy is likely to look at both the good conduct of companies (*e.g.*, board diversity and worker representation) and those of public affairs (anti-bribery and corruption, but also responsible lobbying, and transparent and non-aggressive tax planning).[7]

Disclosing on ESG

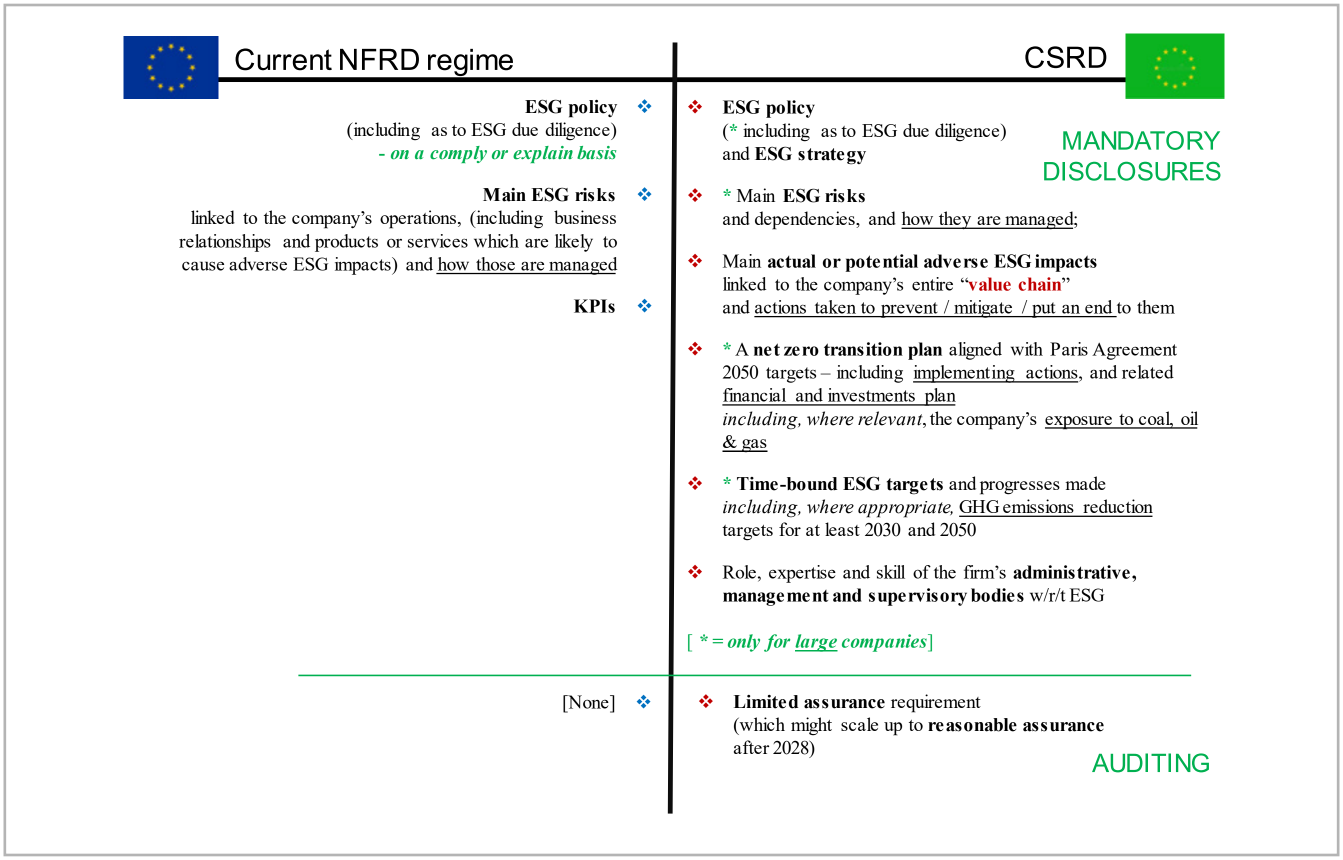
Delivering Transparency on Sustainability Risks & Impacts

On November 28, 2022, the EU approved the text of its much awaited "Corporate Sustainability Reporting Directive" (CSRD).[8] The CSRD will have a phased-in application, starting (in 2025) with the 2024 FY reports of large financial sector companies and listed issuers. The regime represents a profound overhaul of the "Non-Financial Reporting Directive" (NFRD) rules that have applied since 2017 to European "public interest entities."

6 The "Extended Environmental Taxonomy Report" (March 2022) of the Platform for Sustainable Finance is available here. *See* our April alert memo available here.

7 The Platform's "Report on a Social Taxonomy" (February 2022) of the Platform for Sustainable Finance is available here. *See* our March alert memo available here.

8 The official text of the CSRD (as published in the EU Official Journal in December 2022) is available here. For an analysis of the original Commission proposal, *see* our May 2021 alert memo available here.



The CSRD extends EU reporting rules beyond EU companies and will also apply (starting in 2029) to the parent companies of multinational groups headquartered outside of the EU where these generate over €150 million of consolidated revenues within the Union.

Importantly, the CSRD extends EU reporting rules beyond EU companies and will also apply (starting in 2029) to the parent companies of multinational groups headquartered outside of the EU where these generate over €150 million of consolidated revenues within the Union.[9]

Another area of attention in the months to come relates to CSRD implementing rules and standards. Last November, the EU Financial Reporting Advisory Group (EFRAG) delivered a first set of draft sustainability reporting rules which the Commission is set to approve by June of this year. These rules set out the details of what and how companies should report under the new regime.[10] An additional set of sector-specific standards will be formulated by EFRAG in the course of 2023.

Similar considerations apply to asset managers' disclosures under the Sustainable Finance Disclosure Regulation's (SFDR) new implementing rules, which have become applicable since January 1, 2023. While the Commission, the EU financial market supervisor (ESMA) and national regulators have released multiple set of Q&As and guidance in response to queries by regulators and market participants over the course of

9 A recent interview of one of Cleary's Associates concerning the final version of the Directive – and in particular, its enlarged "extra-territorial scope" – is available here.

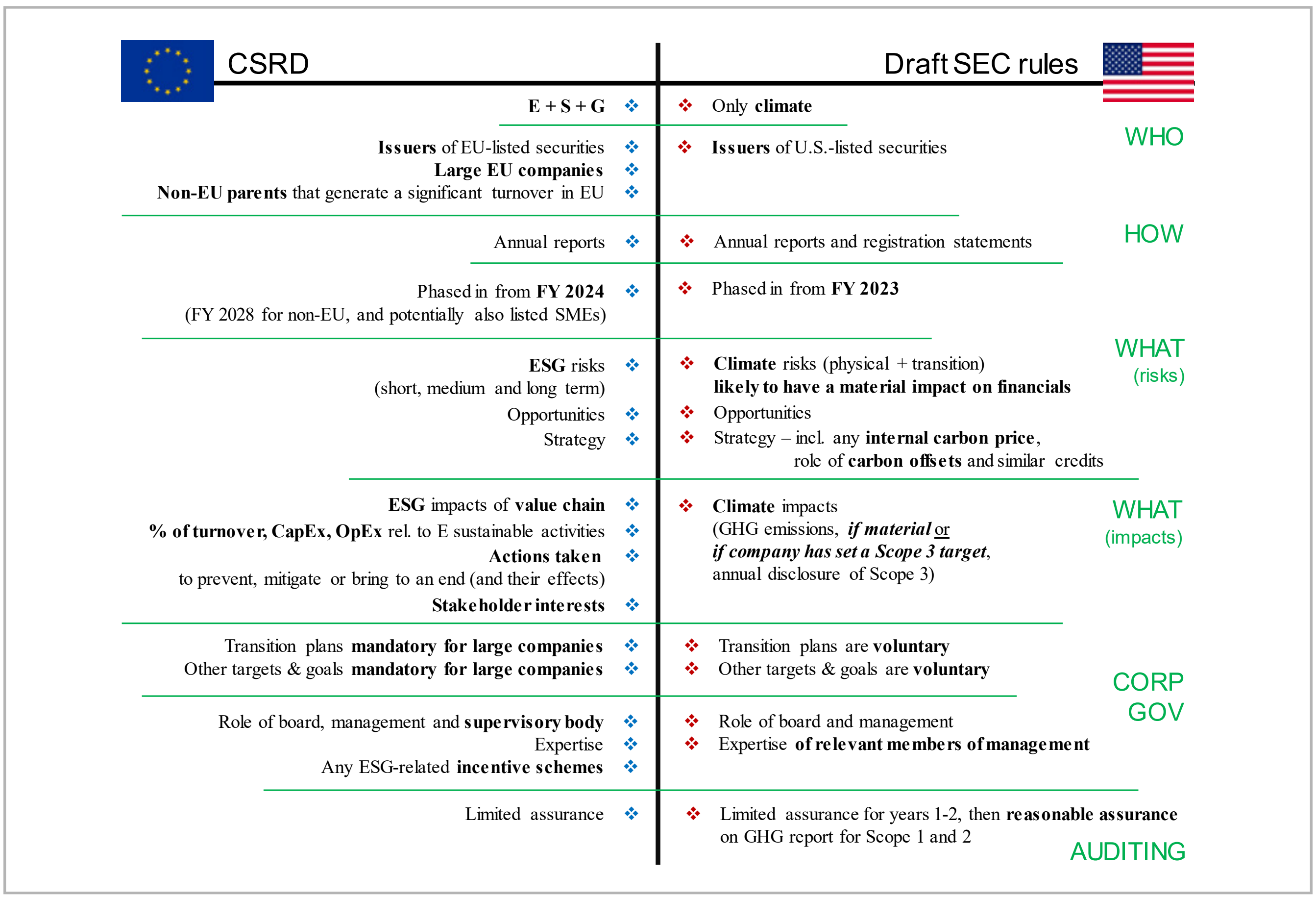
10 EFRAG's draft standards (as transmitted to the Commission for approval) are available here.

the past months, a certain lack of regulatory clarity remains.

Future Evolutions of ESG Disclosure Rules

While the EU took a head-start on ESG disclosure rules in 2021, other regulators and international bodies, including the U.S. Securities and Exchange Commission (SEC) have worked to catch up. Assuming that the SEC publishes final climate-related disclosure rules early this year, many companies operating on both sides of the Atlantic Ocean will potentially need to begin preparing for compliance with both EU and U.S. rules.[11]

For one thing, EU rules cover a wider spectrum, given their focus on E+S+G – as opposed to only climate change – and on "double materiality" *(i.e.*, risks & impacts) – as opposed to only "financial materiality" (*i.e.*, the financial risks that the company faces as a result of climate change). It is therefore somewhat uncertain whether and in what measure the EU's anticipated "equivalence decisions" will bring any relief to U.S. issuers that are due to report under both frameworks.



[11] For further discussion, *see* Prepared for Climate? A Director's Readiness Guide and our April 2022 alert memos available here.

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2023 will then see the emergence of the reporting standards of the ISSB. Although voluntary in nature, these are being drafted in coordination with global regulators (including EFRAG) and it is expected that they will set a common baseline that may generally guide and shape global market practice and (potentially) also supervisory enforcement.[12]

A second development for 2023 will certainly be a marked growth in supervisory and enforcement action in the ESG disclosure space. ESMA in particular, has indicated that it considers common enforcement in the area of sustainability disclosures as a priority for 2023, and aims to ensure effective and harmonized action by national competent authorities, particularly with respect to greenwashing.[13] Supervisory and enforcement actions could leverage on similar actions carried out in other jurisdictions, causing spill-over effects for multinational firms.

Lastly, the Commission is considering whether to regulate the activities of ESG rating and data providers.[14] Rulemaking in this space could follow the principles used to regulate credit rating agencies (that is, seeking to ensure methodological integrity rather than regulate content). Increasing the reliability of ESG-related data would certainly be welcome by both issuers and investors, since this data is a key element underpinning the accuracy and credibility of sustainability disclosures generally.

[12] The ISSB committed to an "early 2023" release date, in a press release made at COP27 and available here.

[13] *See* ESMA's enforcement priority statement of October 28, 2022 (available here) and its most recent annual work programme (available here).

[14] The Commission's first summary report on its public consultation on the ESG ratings market (August 2022) is available here.

Acting on ESG

Creating an Accountability Regime for Negative ESG Impacts

Finally, the EU set off to create harmonized, EU-wide duties for companies to prevent, mitigate and remediate any material negative impacts of their activities on the environment and human rights. Some EU Member States – notably France and Germany – in fact already have similar regimes in place of their own. [15]

Under the CS3D, companies will be expected to monitor and act upon any material negative ESG impacts of their activities, as well as (potentially) the activities of their subsidiaries, business partners, suppliers, and other "established business relationship," both upstream and downstream, direct and indirect.

It has now been almost one year since the publication of the Commission's proposal for a "Corporate Sustainability Due Diligence Directive" (CS3D).[16] Under the CS3D, companies will be expected to monitor and act upon any material negative ESG impacts of their activities, as well as (potentially) the activities of their subsidiaries, business partners, suppliers, and other "established business relationship," both upstream and downstream, direct and indirect: a surprisingly wide net captured by the concept of "value chain."

[15] France approved its landmark Corporate Duty of Vigilance Law (*Loi de Vigilance*) in 2017. For Germany, the Supply Chain Act, passed in 2021, entered in force at the start of this year. For a comparative analysis of national supply chain due diligence regimes, *see* our January 2021 alert memo available here. For an analysis of the German Supply Chain Act, *see* our January 2022 blog post available here.

[16] The latest available draft of the CS3D (the EU Council's "general approach" of December 1, 2022, is available here. For a commentary of the Commission's original CS3D proposal of February 2022, *see* our March alert memo available here.

Companies in scope of the CS3D will be required to adopt adequate corporate governance arrangements and internal policies. This is expected to include publicly accessible "grievance mechanisms" and stakeholder consultations on remedies. Similarly to the CSRD, large non-EU companies operating in Europe might be caught by the rules.

In parallel, the Commission issued two other ESG supply chain due diligence-related proposals that, unlike the CS3D, would operate as blanket bans on the circulation of affected goods.

The first is a "Deforestation Regulation" that (if approved) would block all EU imports and sales of cattle, cocoa, coffee, palm oil, soya and wood, plus certain derived products (such as chocolate, furniture, leather, printed paper products, swine, sheep, goats and poultry meat, maize and rubber), requiring distributors to ensure that their supply chains are entirely deforestation-free.[17]

The second and most recent is the so-called "Forced Labour Ban," affecting any product whose fabrication (including the fabrication of individual components) has involved, at any point, forced labour.[18] The proposal was drafted in the context of rising international pressure to address the supply and sale of products made with forced labour – marked in particular by the issuance of the U.S. "Uyghur Forced Labour Prevention Act," in December 2021.[19]

Some Take-aways

Regulatory pressure on ESG matters is rising in the EU, leading companies to rethink fundamental aspects of their governance, supply chain, disclosure, compliance and risk management strategies.

In parallel, activists and NGOs are relying on laws and regulations (such as the French Corporate Duty of Vigilance Law) to push companies to not only increase disclosures on ESG, but also to reshape their business strategies, with the aim of forcing a stronger and faster alignment with the goals of the Paris agreement.

In 2023, as the ESG framework continues to expand and deepen, companies will need to navigate increasingly complex and sometimes contradictory requirements, under an increasing threat of litigation and enforcement, creating new and unique challenge for management and board members .

Therefore in 2023, as the ESG framework continues to expand and deepen, companies will need to navigate increasingly complex and sometimes contradictory requirements, under an increasing threat of litigation and enforcement, creating new and unique challenge for management and board members.

[17] The Deforestation Regulation proposal of November 2021 is available here.

[18] The Labour Ban proposal of September 2022 is available here.

[19] The "Uyghur Forced Labour Prevention Act" is available here. Unlike its American counterpart, the EU ban is not focused on a specific area of provenance of goods and their components, nor does it reverse the burden of proof on importers.

Voluntary Carbon Markets: An Overview of U.S. Regulatory Developments

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The development of transparent, sound and efficient voluntary carbon markets is of vital importance to the growing number of companies using carbon credits to help meet their emissions reduction and net zero goals and to comply with growing disclosure and related regulatory mandates.

As the importance of the voluntary carbon markets to global decarbonization goals grows, so too does U.S. regulatory and legal interest in this area, and the importance to public companies and their boards. We briefly explain the voluntary carbon markets before discussing related Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC) regulatory developments and the potential impact of the Inflation Reduction Act on these markets in the U.S. The development of transparent, sound and efficient voluntary carbon markets is of vital importance to the growing number of companies using carbon credits to help meet their emissions reduction and net zero goals and to comply with growing disclosure and related regulatory mandates.

Voluntary Carbon Markets: A Primer

Voluntary carbon markets allow carbon emitters to purchase credits that are awarded to projects that remove or reduce atmospheric carbon. These credits offset their emissions in furtherance of a voluntary commitment to reduce "net" emissions.[1] These markets can be distinguished from "compliance" carbon markets, which is the term for systems where a government or regulator issues a carbon allowance that participants must not exceed unless they can purchase additional compliance allowances from

[1] *Voluntary Carbon Markets: How They Work, How They're Priced and Who's Involved*, SP Global (June 10, 2021), available here.

another participant under the cap-and-trade program.[2] Each credit typically corresponds to one metric ton of reduced, avoided or removed carbon dioxide or equivalent greenhouse gas.

The importance of the voluntary carbon markets is growing. According to the Taskforce on Scaling Voluntary Carbon Markets, voluntary carbon markets need to grow by more than 15-fold by 2030 in order to support the investment required to deliver the Paris Agreement's goal of limiting the global average temperature increase to below 1.5°C above pre-industrial levels.[3]

CFTC and SEC Interest in the Carbon Markets

CFTC

The CFTC has shown an increasing interest in carbon. This focus largely began in September 2020 when the CFTC's Climate-Related Market Risk Subcommittee issued a report titled *Managing Climate Risk in the U.S. Financial System*.[4] The report concludes that climate change poses a major risk to the stability of the U.S. financial system and, in turn, the American economy, and presents fifty-three recommendations to mitigate the risks that climate change poses to the financial markets.[5] In response, in March 2021, then CFTC Acting Chairperson Rostin Behnam established the Climate Risk Unit. The goal of the CFTC's Climate Risk Unit is to "[focus] on the role of derivatives in understanding, pricing, and addressing climate-related risk and transitioning to a low-carbon economy."[6]

In June 2022, the CFTC issued a Request for Information (RFI) on Climate-Related Financial Risk. The RFI sought responses on questions specific to data, scenario analysis and stress testing, risk management, disclosure, product innovation, voluntary carbon markets, digital assets, greenwashing, financially vulnerable communities, and public-private partnerships and engagement. The CFTC indicated that it intends to use the responses to promote responsible innovation, ensure the financial integrity of all transactions subject to the Commodity Exchange Act, avoid systemic risk, inform the CFTC's response to the recommendations of the Treasury Department's Financial Stability Oversight Council 2021 *Report on Climate-Related Financial Risk* and inform the ongoing work of its Climate Risk Unit.[7]

One key issue that has materialized in the comments in response to the RFI is whether the CFTC should establish a broader regulatory framework for the voluntary carbon markets, including the spot markets.[8] The outcome of this debate is one area to watch as CFTC regulation of the voluntary carbon markets evolves.

SEC

In March 2022, the SEC proposed sweeping climate risk related disclosure and reporting rules.[9] Although the issuance of the final rules has been delayed given

[2] *Voluntary Carbon Markets: Analysis of Regulatory Oversight in the US*, ISDA (June 2022) at 3, available here.

[3] *Taskforce on Scaling Voluntary Carbon Markets*, TSVCM (January 2022) at 4, available here.

[4] Press Release, *CFTC's Climate-Related Market Risk Subcommittee Releases Report*, Commodity Futures Trading Comm'n (Sept. 9, 2020), available here (press release); *see also* Rostin Behnam et al., *Managing Climate Risk in the U.S. Financial System: Report of the Climate-Related Market Risk Subcommittee, Market Risk Advisory Committee of the U.S. Commodity Futures Trading Commission*, Commodity Futures Trading Comm'n (2020), available here (full report).

[5] *CFTC's Climate-Related Market Risk Subcommittee Releases Report*, *supra* n. 4.

[6] Press Release, *CFTC Acting Chairman Behnam Establishes New Climate Risk Unit*, Commodity Futures Trading Comm'n (March 17, 2021), available here.

[7] *See* Press Release, *CFTC Releases Request for Information on Climate-Related Financial Risk*, Commodity Future Trading Comm'n (June 2, 2022), available here.

[8] *Compare Letter from Walt Lukken to Sec'y Christopher Kirkpatrick*, Commodity Futures Trading Comm'n (October 7, 2022) at 10, available here (discouraging the CFTC from establishing a registry); *with Letter from Cory A. Booker et al., to Chairman Rostin Behnam*, Commodity Future Trading Comm'n (October 13, 2022) at 2, available here (recommending that the CFTC create a registry for carbon offsets, offset brokers and offset registries).

[9] For additional information on the SEC's Climate Disclosures proposal, *see* our April 2022 alert memos available here. Press Release, *SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors*, Sec. & Exch. Comm'n (March 21, 2022), available here; *see also* Proposed Rule: The Enhancement and Standardization of Climate-Related Disclosures for Investors, Sec. & Exch. Comm'n, Securities Act Release No. 33-11042, Exchange Act Release No. 34-94478 (March 21, 2022), available here (Proposed ESG Rules).

reactions and challenges to the proposal, the proposed rules call for certain disclosures regarding carbon.

One element of the proposed rule calls for mandatory disclosures by any registrant that "maintains an internal carbon price" regarding the price per metric ton of carbon dioxide, the total price and how it is estimated to change over time, the rationale for the internal carbon price, and how it uses the internal carbon price to evaluate and manage climate-related risks.[10]

Another aspect of the proposed rule requires any public filer who utilizes carbon offsets[11] or renewable energy credits or certificates (RECs)[12] as part of its net emissions reduction strategy to disclose the role of such carbon offsets or RECs in the registrant's climate-related business strategy.[13] These disclosures include the amount of carbon reduction represented by the offsets or the amount of generated renewable energy represented by the RECs, the source of the offsets or RECs, a description and location of the underlying projects, any registries or other authentication of the offsets or RECs and the cost of the offsets or RECs.[14] The proposed rule also encourages registrants to discuss the role of carbon offsets and RECs in meeting climate-related targets or goals.[15]

Comments submitted to the SEC in response to the carbon disclosure proposals have expressed some concern. For example, NASDAQ expressed concern on behalf of its listed companies that many disclosure requirements, including those related to internal carbon pricing and use of carbon offsets and RECs, only apply when the company has first voluntarily adopted an internal target or program. This, in turn, may have a chilling effect on the adoption of such targets and programs, as companies may seek to avoid the associated disclosure burdens.[16] Other commenters expressed concern that the information that the SEC seeks regarding internal carbon pricing and use of carbon offsets and RECs is, in some cases, commercially sensitive, proprietary and immaterial.[17] The SEC's upcoming final rulemaking is obviously an important area for boards of directors and executives to watch.

Inflation Reduction Act

August 2022 saw the passage of the Inflation Reduction Act (IRA), which represents the outcome of the significantly more ambitious "Build Back Better" bill. This nonetheless far-reaching law includes provisions to "finance green power, lower costs through tax credits, reduce emissions, and advance environmental justice."[18] In pertinent part, the IRA is intended to reduce U.S. carbon emissions by roughly 40% by 2030[19] and to reach a net-zero economy by 2050.[20] In support of these goals, the IRA makes "the single largest investment in climate and energy in American history,"[21] in the amount of $369 billion.[22]

The IRA also opens new pathways to transfer private capital into renewable projects. For example, the IRA includes updates to a tax credit located in Section 45Q

[10] For additional information on comments to the SEC's Climate Disclosures Proposal, *see* our May alert memo available here; *see also* Proposed ESG Rules, *supra* n. 9 at § 229.1502(e).

[11] The proposed rules use carbon offsets to refer to "an emissions reduction or removal of greenhouse gases (GHG) in a manner calculated and traced for the purpose of offsetting an entity's GHG emissions." Proposed ESG Rules, *supra* n. 9 at § 229.1500(a).

[12] The proposed rules define an REC as "a credit or certificate representing each megawatt-hour (1 MWh or 1,000 kilowatt-hours) of renewable electricity generated and delivered to a power grid." *Id.* at § 229.1500(n).

[13] *See id.* at 77 & §§ 229.1502(b)(6), (d).

[14] *Id.* at § 229.1502(d).

[15] *Id.* at § 229.1502(b)(6).

[16] *See Letter from Nasdaq, Inc. to Sec'y Vanessa A. Countryman*, Sec. & Exch. Comm'n (June 14, 2022) at 13, available here; *see also Letter from Kenneth E. Bentsen, Jr., President and CEO, Securities Industry and Financial Markets Association (SIFMA) to Sec'y Vanessa A. Countryman*, Sec. & Exch. Comm'n (June 17, 2022) at 28, available here.

[17] *See, e.g., Letter from Chevron Corporation to Sec'y Vanessa A. Countryman*, Sec. & Exch. Comm'n (June 17, 2022) at 12-13, available here; *Letter from Amazon.com, Inc. to Sec'y Vanessa A. Countryman*, Sec. & Exch. Comm'n (June 17, 2022) at 7-8, available here.

[18] *The Inflation Reduction Act*, U.S. Env't Prot. Agency (last visited December 7, 2022), available here.

[19] *Summary: The Inflation Reduction Act of 2022*, Senate Democrats (last visited December 7, 2022), available here.

[20] *Inflation Reduction Act of 2022*, U.S. Dep't of Energy (last visited December 7, 2022), available here.

[21] *Id.; see also Statement by Administrator Regan on the Passage of the Inflation Reduction Act of 2022*, U.S. Env't Prot. Agency (August 12, 2022), available here.

[22] *See Remarks by President Biden At Signing of H.R. 5376, The Inflation Reduction Act of 2022*, The White House (August 16, 2022), available here.

of the Internal Revenue Code.[23] This credit incentivizes use of carbon capture, utilization and storage (CCUS) technology. The updates increase the credit values for qualifying technologies, thus increasing the incentive to use these technologies. Further, the updates allow 45Q credit recipients to transfer all or any portion of the credit value to any third-party tax-paying entity in exchange for a cash payment during the credit window.[24] Beyond monetization of 45Q credits, these updates also have the potential to advance the voluntary carbon markets. Projects utilizing CCUS technology may have the opportunity to sell carbon credits into the market representing their carbon abatement.[25] Thus, if more businesses adopt CCUS technology due to the favorable tax treatment under 45Q, this may also lead to an increased supply of carbon credits, and therefore increase trading, in the voluntary carbon markets.

Boards of directors and executives, as well as other participants in these markets should keep a close eye on legal and regulatory developments as they consider their use of carbon credits and offsets as part of overall emissions reductions targets and strategy.

Conclusion

As the voluntary markets are expected to serve a growing role in fulfilling carbon emissions commitments, it is likely that regulation in this space will also increase. Boards of directors and executives, as well as other participants in these markets should keep a close eye on legal and regulatory developments as they consider their use of carbon credits and offsets as part of overall emissions reductions targets and strategy.

[23] *See* 26 U.S.C.§ 45Q (credit for carbon oxide sequestration).

[24] *See* Clean Air Task Force, *Carbon Capture Provisions in the Inflation Reduction Act of 2022* (2022), available here.

[25] *See* Krysta Biniek et al., *Scaling the CCUS industry to achieve net-zero emissions*, McKinsey & Co. (October 28, 2022), available here; *see also* Brandon Mulder, *45Q, Financial Uncertainties Hinder Capital Flow for CCS Deployment: Panel*, S&P Glob. Commodity Insights (June 16, 2022), available here.

Cybersecurity: Continued Cyberattacks and New Regulations Result in Increased Risk

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In a recent survey of almost 2,800 global organizations, one in five respondents reported experiencing a ransomware attack in 2021—with almost half of those respondents suffering significant operational impacts as a result.[1] This past year proved to be no better, as a steady stream of governments, businesses and individuals alike became victims of high-profile cyber-attacks in 2022. Still, despite the frequency, sophistication and severity of these attacks, available data suggests that only about half of U.S. companies even have a cybersecurity response plan in place—and many are not financially prepared should a material cyber-attack occur.[2] As new rules, guidance and initiatives on cyber-related issues continue to emerge, boards should pay particular attention to the demands of cybersecurity oversight and the significant risks posed by cyberattacks, especially as regulators and private litigants continue to bring large numbers of cybersecurity-related actions in response to data breaches.

1 Thales, "2022 Thales Data Threat Report" (February 2022), available here.

2 Forbes, "Alarming Cyber Statistics For Mid-Year 2022 That You Need To Know" (June 3, 2022), available here.

As new rules, guidance and initiatives on cyber-related issues continue to emerge, boards should pay particular attention to the demands of cybersecurity oversight and the significant risks posed by cyberattacks, especially as regulators and private litigants continue to bring large numbers of cybersecurity-related actions in response to data breaches.

In this summary, we provide an overview of the legal cybersecurity landscape in 2022 for boards and their directors, including by highlighting notable breaches, regulatory developments, and decisions, as well as best practices to keep in mind for 2023.

Data Breaches and Ransomware Attacks

As with 2021, 2022 was a year filled with significant data breaches and widely disruptive ransomware attacks taking headlines:

— In February, aviation company Swissport International suffered a ransomware attack affecting the company's information technology infrastructure and services.

— In March, Nvidia, one of the world's largest semiconductor companies, confirmed that the company had suffered a cyberattack at the hands of the hacking group Lapsus$, which resulted in the leak of personally identifying information (PII) of more than 71,000 employees.

— In April, mobile payment service Cash App disclosed to the SEC through its parent company Block that the company had suffered a data breach affecting 8.2 million customers in December 2021.

— In July, Marriot confirmed that a hacking group targeted an unsuspecting employee and successfully gained access to Marriot computer systems in June. The group obtained various categories of personal information for over 5 million people.

— In August, convenience company 7-Eleven suffered a cyber-attack resulting in the shutdown of 175 stores due to a compromise in its systems that prevented the use of cash registers and receipt of payments.

— In October, car manufacturer Toyota posted a message on the company's website starting that almost 300,000 customers who had used its telematics service had their email addresses and customer control numbers compromised.

Numerous other breaches included a national emergency causing ransomware attack in Costa Rica and breaches at global not-for-profit organizations like the Red Cross, U.S. government agencies including the U.S. Department of Education, and several universities, colleges and public school systems.

Of course, this is just a small selection of the cybersecurity attacks that impacted companies and organizations around the globe. Each of these incidents, impacting firms large or small, frequently had a devastating effect on the operations of those entities, forcing difficult decisions such as how best to respond to the attack, whether and how to disclose the attack publicly, whether to pay a ransom to obtain access to systems and data (and whether to trust that a payment would result in that outcome at all), and how to manage the fallout from the attack for customers and stakeholders.

Regulatory Focus on Cybersecurity

Regulators issued new rules, guidance and initiatives on cybersecurity-related topics as the sophistication and number of data breaches continued to increase:

— President Biden signed into law the Cyber Incident Reporting for Critical Infrastructure Act of 2022 (CIRCIA), which, among other things, requires the Cybersecurity and Infrastructure Security Agency (CISA) to develop and implement regulations requiring covered entities to report covered cyber incidents and ransomware payments to CISA.[3] These reports allow CISA to rapidly deploy resources and render assistance to victims suffering attacks, analyze incoming reporting across sectors to spot trends and quickly share that information with network defenders to warn other potential victims.[4]

— The U.S. Securities and Exchange Commission (SEC) announced new proposed disclosure rules for cybersecurity incidents and cybersecurity risk management, strategy and governance. These new rules, which would apply to domestic and foreign companies subject to the reporting requirements of the Securities Exchange Act of 1934, impose various new requirements, including the disclosure of: (i) material cybersecurity incidents within four days after a registrant determines that it experienced such an incident; (ii) a company's cybersecurity policies and procedures and governance; and (iii) cybersecurity expertise of board members.[5]

— The SEC's Division of Examinations—formerly the Office of Compliance Inspections and Examinations—released its 2022 Examination Priorities, one of which was information security. According to the report, the Division has set out to review registrants' information security practices in order to protect critical investment information and prevent interruptions that could jeopardize businesses.[6]

— In September, the U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) published Cyber-Related Sanctions Regulations.[7] While the Regulations do not introduce new or change prior guidance, they amalgamate existing executive orders, laws and other regulations and reiterate the U.S. government's disapproval of making payments to bad actors in connection with cyberattacks, in particular relating to activity originating outside the United States.

— In November, the Treasury Department's Financial Crimes Enforcement Network (FinCEN) issued a financial trend analysis regarding ransomware-connected Bank Secrecy Act filings occurring during the second half of 2021. [8] FinCEN found that the number and dollar amounts at issue of ransomware-related, suspicious activity reports had tripled between 2020 and 2021, shifting from approximately $400 million to $1.2 billion. Notably, this increase comes on the heels of FinCEN's and OFAC's Fall 2021 advisories regarding the reporting of ransomware-related incidents.

3 CIRCIA, "Cyber Incident Reporting for Critical Infrastructure Act of 2022 (CIRCIA)," available here.

4 For additional details, *see* our March blog post available here.

5 For additional details, *see* our April alert memo available here, Practical Steps for Increased Board Effectiveness and Turning a Corner on Corporate Governance: The SEC's Disclosure Agenda.

6 *See* SEC Division of Examinations, "2022 Examination Priorities," available here. The Division will also be reviewing registrants' business continuity and disaster recovery plans, which in some cases, will account for certain climate-related risks. This focus in information security goes hand in hand with the proposed cybersecurity rules released in February 2022, which included comprehensive reforms for registered advisers regarding cybersecurity risk management policies and procedures, mandatory reporting of certain cybersecurity incidents to the SEC (including a new Form ADV-C), and mandatory disclosures to investors and other market participants. For additional details, *see* our April blog post available here. For additional details on the proposed SEC rules, in particular, *see also* our February blog post available here. *See also* New York State Department of Financial Services, "DFS Superintendent Adrienne A. Harris Announces Updated Cybersecurity Regulation" (November 9, 2022), available here.

7 U.S. Department of the Treasury OFAC "Amendment to the Cyber-Related Sanctions Regulations and Associated Administrative List Updates" (September 2, 2022), available here.

8 Financial Crimes Enforcement Network, "FinCEN Analysis Reveals Ransomware Reporting in BSA Filings Increased Significantly During the Second Half of 2021" (November 1, 2022), available here.

— The New York Department of Financial Services (DFS) announced proposed updates to its cybersecurity regulations first promulgated in 2017. [9] The recent amendments strengthen the DFS's "risk-based approach to ensure cybersecurity risk is integrated into business planning, decision-making, and ongoing-risk management."[10]

As regulators continued to implement these new rules, guidance and initiatives, there were a number of cybersecurity enforcement actions against companies that allegedly maintained inadequate cybersecurity protections or that failed to comply with related disclosure obligations:

— In August, crypto-currency trading platform Robinhood Crypto LLC (RHC) entered into a Consent Order with the DFS based on "serious deficiencies" related to, among other issues, cybersecurity and virtual currency identified in DFS's examination of RHC from January to September 2019. DFS found that during a period of rapid growth for RHC's business in 2019, RHC "failed to invest the proper resources and attention to develop and maintain a culture of compliance—a failure that resulted in significant violations of [DFS's] anti-money laundering and cybersecurity regulations."[11] The Consent Order required RHC to pay a $30 million civil penalty and hire an independent consultant for eighteen months to review and report on RHC's efforts to improve its compliance program.[12]

— In October, a federal jury convicted Uber's former Chief Security Officer (CSO) of criminal obstruction of Federal Trade Commission (FTC) proceedings and concealment of a felony for attempting to hide Uber's 2016 data breach.[13] In this case, the evidence presented by the Department of Justice at trial showed that the CSO participated in negotiations with the FTC in connection with an FTC investigation of Uber's data security practices without disclosing the attack, and took affirmative steps to hide the information.

— DFS entered into a Consent Order with licensed health care company EyeMed Vision Care for alleged cybersecurity violations that "contributed to the exposure of hundreds of thousands of consumers' sensitive, non-public, personal health data, including data concerning minors."[14] DFS found that the company had failed to (i) limit user privileges by allowing nine employees to share email mailbox credentials, and (ii) implement data management processes, both of which resulted in significant consumer data being accessible through the impacted mailboxes. DFS also found that the company had failed to conduct an adequate risk assessment. The Consent Order imposed a $4.5 million fine on EyeMed and required the company to undertake significant remedial efforts to improve its cybersecurity, including by conducting a comprehensive risk assessment system and developing a plan to address issues identified in the assessment.

— The New York Attorney General (NYAG) fined fashion retail brand Shein's parent company, Zoetop, for its handling of a 2018 data breach involving the exposure of data for approximately 40 million customers that had accounts with the clothing brand.[15] According

[9] 23 NY Comp Codes Rules and Regs § 500.0. The original regulations established a regulatory model for ensuring that entities addressing the evolving nature of cybersecurity threats adequately protected consumers and businesses with the most effective controls and best practices available. Among other items, the amendments contemplate a tier-system that imposes heightened requirements based on a regulated entity's size, enhanced governance requirements for executive management, controls to prevent unauthorized access to technology systems, and more frequent risk and vulnerability assessments. These changes also reflect DFS's commitment to "promote the protection of customer information as well as the information technology systems of regulated entities."

[10] New York Department of Financial Services, "DFS Superintended Adrienne A. Harris Announces Updated Cybersecurity Regulation" (November 9, 2022), available here.

[11] New York Department of Financial Services, "DFS Superintendent Harris Announces $30 Million Penalty on Robinhood Crypto for Significant Anti-Money Laundering, Cybersecurity & Consumer Protection Violations," available here.

[12] For additional details, *see* our August blog post available here.

[13] United States Attorney's Office, Northern District of California "Former Chief Security Officer Of Uber Convicted Of Federal Charges For Covering Up Data Breach Involving Millions Of Uber User Records" (October 5, 2022), available here.

[14] New York State Department of Financial Services, "DFS Superintendent Harris Announces $4.5 Million Cybersecurity Settlement with EyeMed Vision Care LLC" (October 18, 2022), available here.

[15] NY Attorney General Letitia James, "Attorney General James Secures $1.9 Million from E-Commerce SHEIN and ROMWE Owner Zoetop for Failing to Protect Consumers' Data" (October 12, 2022), available here.

to the NYAG, Zoetop misrepresented the size and nature of the breach, originally claiming that the leak affected only 6 million accounts and did not involve credit card information (when it in fact did).

— SolarWinds indicated in a SEC filing that the company had received a Wells notice informing the company of the agency's intention to bring an enforcement action with respect to its cybersecurity disclosures and public statements, as well as its internal controls and disclosure procedures.[16] This follows the SEC's announcement at the end of 2021 regarding a sweep of public companies and corresponding disclosures related to the SolarWinds software cyberattack that became public in 2020.

Litigation Developments

There were also significant developments in cyber-related litigation in 2022:

— In January, a federal judge in New York dismissed a putative class action filed against men's clothing company Bonobos, Inc., following an August 2021 data breach. The court determined that a Bonobos customer whose personal information was stolen in the breach failed to demonstrate a sufficiently substantial risk of harm to establish standing to sue. The decision reflects the increased uncertainty regarding the viability of suits for damages based solely on future risk of identity theft or fraud, in light of the Supreme Court's recent decision in *TransUnion LLC v. Ramirez*.[17]

— In April, one day after going to trial, Aerojet Rocketdyne Holdings, Inc. agreed to settle a matter in which a *qui tam* relator attempted to hold his former employer accountable using the False Claims Act for its alleged cybersecurity fraud. The relator alleged that Aerojet fraudulently concealed its failure to comply with government regulations requiring defense contractors to implement cybersecurity measures and report incidents and breaches. This litigation signals the dangers of non-compliance with cybersecurity regulations for government contractors.[18]

— In October, an Illinois jury issued the first-ever verdict against a company for violating the Illinois Biometric Information Privacy Act (BIPA), awarding $228 million to a class of plaintiffs who were fingerprinted by one of the defendants' third-party vendors. The verdict highlights juries' willingness to hold companies responsible for BIPA violations as well as a federal court's unwillingness to allow the involvement of third parties to defeat liability.[19] Other states, including Texas and Washington, have their own biometric data privacy laws. Companies that operate on a national scale should consider whether their operations in each state comply with all applicable biometric data privacy laws.

In light of emerging regulatory and litigation trends regarding cybersecurity, as well as the SEC's proposed cybersecurity disclosure rules, boards should continue to review and ensure the adequacy of their oversight measures.

Board Oversight Best Practices for 2023

In light of emerging regulatory and litigation trends regarding cybersecurity, as well as the SEC's proposed cybersecurity disclosure rules, boards should continue to review and ensure the adequacy of their oversight measures. In particular:

[16] *See* SolarWinds Corporation Form 8-K (October 28, 2022), available here.

[17] For additional details, *see* our January blog post available here.

[18] U.S. Department of Justice, "Aerojet Rocketdyne Agrees to Pay $9 Million to Resolve False Claims Act Allegations of Cybersecurity Violations in Federal Government Contracts" (July 8, 2022), available here.

[19] Celeste Bott, "BNSF Hit With $228M Judgment In First BIPA Trial" (October 12, 2022), available here.

— Ensure that oversight of cybersecurity risks is delegated to a committee of the board (or establish specific cybersecurity review guidelines if responsibility is retained at the full board) including assessment of risks as part of strategy, risk management and financial oversight and disclosure.

— Establish regular briefings by management to the board of cybersecurity risks including benchmarking company policies and procedures against industry peers and best practices.

— Ensure that the company has a cyber-incident response and that the board is familiar with it, including the proposed reporting matrices to communicate incidents. Relatedly, periodically engage in a cybersecurity response tabletop exercise to familiarize directors with their oversight role in the event of cyber-related incidents.

— Regularly review the company's cybersecurity budget and assess cyber-related insurance coverage.

— Document the board's engagement in cybersecurity oversight, including its engagement in such cybersecurity discussions and participation in tabletop exercises.

Among other things, boards should establish clear ownership of cyber risk oversight, have briefings on cybersecurity risks to the full board and document steps the board has taken in connection with its oversight.

Key Takeaways

— The continued frequency of data breaches and ransomware attacks, coupled with increased regulatory scrutiny and litigation risk, makes cybersecurity an essential issue for boards.

— Ransomware attacks in particular continue to result in substantial costs, legal risks and reputational concerns.

— In light of the SEC's proposed cybersecurity rules, we expect the SEC to continue to actively investigate cybersecurity-related disclosures by public companies. The DFS and State Attorneys General continue to be active as well in investigating breaches.

— Private litigation arising out of data breaches continues to be a substantial risk. The recent $228 million verdict in the BIPA litigation—while not itself related to a cybersecurity breach—highlights the possibility of substantial verdicts against companies for alleged cyber and privacy failures. Biometric privacy laws are a particular risk, but litigation relating to data breaches can also result in sizable settlements.

— These trends underscore the need for boards to take an active role in overseeing management's preparation for cyberattacks and responses to incidents. Among other things, boards should establish clear ownership of cyber risk oversight, have briefings on cybersecurity risks to the full board and document steps the board has taken in connection with its oversight.

Privacy and Data Protection Compliance Will Remain a Top Priority in 2023

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As the value of data continues to increase exponentially, so too do the associated risks, including risk of cyberattacks, data breaches or data-related litigation, as well as rising regulation throughout the world designed to restrict the exploitation of these assets. This tension between an organization's desire to maximize the benefits derived from data collection versus mounting exploitation risks will only continue to grow in 2023. For example, according to the International Association of Privacy Professionals, in the absence of a federal standard in the U.S., state-level momentum for comprehensive privacy bills was at an all-time high in 2022, with 29 states and the District of Columbia either introducing data privacy bills or carrying them over from last year's sessions, and two states successfully passing comprehensive privacy legislation as discussed below. Similarly, in Europe, new proposals for regulations designed to address data usage have started to proliferate as policymakers moved from deliberation to action.

We expect that these trends will hold, leading to increasingly nuanced and disparate requirements with which companies will need to comply, especially those active in interstate and global commerce. In 2023, U.S.-based businesses will confront hurdles in designing a privacy compliance program that complies with five new state laws regulating the collection, processing and disclosure of personally identifiable information (PII). Further, recent regulatory trends have shifted privacy and data protection compliance away from mandating technical compliance measures to require greater board accountability with mounting attempts to regulate corporate behavior through governance. Thus, it is critical that management be aware of and understand the organization's data processing activities and the risks that follow when maximizing the value of such data to satisfy commercial needs and initiatives.

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U.S. State Legislation and Enforcement

California Rulemaking Activities and Attorney General Enforcement

After two years of waiting, on January 1, 2023 the California Privacy Rights Act (the CPRA),[1] which amends the California Consumer Privacy Act (CCPA), finally took effect, significantly broadening compliance obligations for covered entities and strengthening protections for consumers to control usage of their PII. Simultaneously, (i) the thirty-day cure period provided under the CCPA will sunset, permitting the California Attorney General (CA AG) to immediately file civil complaints for alleged violations, without any prior notice to an impacted entity and (ii) employee and commercial contact or "B2B" PII will no longer be exempt from the CCPA/CPRA's requirements, meaning that employee or B2B PII collected or processed after January 1, 2022 will require similar treatment as consumer PII.

In July, the California Privacy Protection Agency (the CPPA), the state agency tasked with interpreting and enforcing the CPRA alongside the CA AG, commenced a formal rulemaking process to introduce a number of proposed and CPRA-mandated revisions to the current CCPA regulations (the Draft Regulations).[2] At a high level, the Draft Regulations (i) expand upon notification requirements, including where privacy notices must be provided and what content such notices must disclose, (ii) detail how to effectively request and receive valid consumer consent, (iii) offer guidance with respect to opt-out, alternative opt-out and other data processing limitation links as well as other consumer rights request mechanisms, methods and processes and timelines for compliance therewith and (iv) summarize vendor management and oversight obligations, including with respect the required provisions in agreements with "service providers," "contractors" and "third parties." It is expected that the regulations will take effect sometime in April; until then, the CCPA regulations continue to be in effect.

With respect to *enforcement priorities*, in 2022, the CA AG continued his enforcement sweep with over a dozen entities receiving notices of CCPA non-compliance, many of which concerned failures by regulated entities to (i) post CCPA-compliant privacy policies and fully comply with statements made therein, (ii) provide a "Do Not Sell My Personal Information" link where "selling" consumer PII, (iii) honor consumer opt-out requests, particularly those sent via universal opt-out mechanisms/user-enabled global privacy controls, or other consumer privacy rights requests such as the rights to know, access and delete and (iv) notify and receive opt-in consent from consumers with respect to consumer loyalty programs or other financial incentives. We expect this trend to continue and increase in 2023.

[1] The full text of the CPRA can be found here.

[2] A current draft of the Draft Regulations can be found here.

In 2022, Utah and Connecticut became the fourth and fifth state, respectively, after California, Virginia and Colorado, to impose comprehensive privacy and data protection obligations on covered business and provide these states' residents with control over the collection and processing of their PII.

New Comprehensive Privacy Laws in Utah and Connecticut

In 2022, Utah and Connecticut became the fourth and fifth state, respectively, after California, Virginia and Colorado, to impose comprehensive privacy and data protection obligations on covered business and provide these states' residents with control over the collection and processing of their PII. Utah's Consumer Privacy Act (the UCPA; previously discussed here)[3], effective December 31, 2023, aligns most closely with Virginia's law and is arguably the least commercially restrictive law to date, whereas Connecticut's Data Privacy Act (the CDPA; previously discussed here)[4], effective July 1, 2023, aligns more closely with California and Colorado's laws and is slightly more protective of consumer rights.

Fortunately, the UCPA and CDPA largely track the obligations and restrictions set forth under similar omnibus privacy laws passed last year—namely the Virginia Consumer Data Protection Act, effective January 1, 2023, and the Colorado Privacy Act, effective July 1, 2023, (discussed here and here, respectively)—meaning organizations already covered by such laws may be able to easily adapt or modify certain existing compliance measures to satisfy many of the new laws' requirements.

[3] The full text of the UCPA is available here.

[4] The full text of the CDPA is available here.

Other U.S. Privacy Developments

— **Congress Makes Progress on Federal Privacy Legislation.** Last summer, legislators made progress on a bipartisan, bicameral proposal for comprehensive federal data protection legislation with the introduction of the American Data Privacy and Protection Act (the ADPPA).[5] Despite revisions to the initial legislation, the two most contentious aspects of the ADPPA— namely, its broad preemption of state data privacy laws and the inclusion of a private right of action—remain, which continue to impede progress as lawmakers on each side of the aisle negotiate to strike a palatable balance. We expect momentum to pass the ADPPA to resurface during this year's legislative session, particularly as concerns surrounding the lack of a federal standard and growing patchwork of state legislation continue to amplify; but that it will also receive pushback as states that already have their own law continue to argue that their state level protection should prevail.

— **Continued Focus on Regulation on Children's Data.** As predicted, the processing of children's data continued to be a major focus in 2022 with proposals and ultimate enactment of legislation aimed at protecting children from misuse and exploitation of their PII and recent enforcement actions signaling that regulators intend to commit to their objective of defending children's privacy rights.[6]

In California, lawmakers continued to advance legislation to increase protections surrounding children's PII with enactment of the California Age Appropriate Design Code (Code). The Code, which becomes effective July 1, 2024, applies to businesses covered by the CPRA that develop and provide online services, products or features that are

[5] The full text of the revised version of the ADPPA can be found here.

[6] For example, in December, the United States Federal Trade Commission's (FTC) entered into two record-breaking settlements totaling over $520 million with Epic Games, Inc., the video game publisher behind the popular online multiplayer game Fortnite, over alleged violations of the Children's Online Privacy Protection Act and use of "dark patterns" to deceive players into making unwanted, in-game purchases. For additional information, *see* our December blog post available here.

"likely to be accessed by children."[7] Specifically, the Code imposes new obligations on covered entities, including requirements to conduct data protection impact assessments for online products, services or features likely to be accessed by children, including those offered to the public *prior* to the Code's effective date, and new and enhanced notice requirements, including obligations to provide "obvious signals" where a child's online activities or location are being tracked or monitored. With increased focus on the protection of children's PII both stateside and around the world,[8] additional states have introduced similar proposals based on the Code,[9] and we expect this trend will continue with additional states likely to introduce similar proposals to protect children who engage in online activities.

— **NY Department of Financial Services Proposes Amendments to its Cybersecurity Regulation**. For the first time since its enactment in 2017, the New York Department of Financial Services (NYDFS) is overhauling its Cybersecurity Regulation, the first of its kind to codify technical and organizational cybersecurity best practices into binding regulation (the NYDFS Regulation). The proposed amendments,[10] for which the public comment period concludes January 9, 2023, contain significant revisions designed to mandate preventative measures to address common attack vectors and enhance cybersecurity governance for public companies and other covered entities, bringing more formality and uniformity to the assessment of and response to a covered entity's bespoke cybersecurity risks. Most notably, the proposed amendments (i) contain robust board accountability and governance requirements, such as increased oversight by a covered entity's senior governing body, (ii) create a new, distinct category of regulated firms (*i.e.*, entities that are larger, more complex and assumed to have more resources available to address cybersecurity risks) and (iii) provide an alternative avenue for covered entities to provide acknowledgements of noncompliance in place of the current annual certification requirement (that does not have an option of admitting any non-compliance). Once the amendments are finalized and adopted, covered entities will have 180 days to become compliant with most provisions in the revised NYDFS Regulation, subject to certain exceptions as detailed therein.

EU / UK Privacy Developments

— **New EU-U.S. Data Privacy Framework Proposed.** After over two years of detailed negotiations, in March, a new EU-U.S. Data Privacy Framework (the Framework) was agreed in principle kickstarting a process to establish a new mechanism to legitimize cross-border transfers of personal data from the EU to the U.S. To implement its commitments under the Framework, in October, President Biden signed an Executive Order in October on Enhancing Safeguards for United States Signals Intelligence Activities (the Executive Order),[11] prompting the European Commission (EC) to formally launch the process to adopt an adequacy decision based on the Executive Order in December.[12] The formal adoption process is expected to take several months, with the final text likely to be published around April 2023; however, certain critics and privacy advocacy groups have already publicly challenged the validity of this new adequacy decision, believing it may once again be invalidated before the Court of Justice European Union.[13]

7 Carve-outs exist for online services, products and features including broadband internet access services, telecommunications services and delivery or use of a physical product, such as connected devices.

8 The UK recently began enforcement of its own Age-Appropriate Design Code in September of 2021.

9 *See, e.g.*, New York's "Child Data Privacy and Protection Act" and New Jersey's proposed bill to create the New Jersey "Children's Data Protection Commission."

10 A copy of the proposed amendments can be found here.

11 A copy of Executive Order can be found here. A copy of the fact sheet published by the White House can be found here.

12 A copy of the draft adequacy decision can be found here.

13 Our previous coverage of the announcement of the Framework, the Executive Order and the draft adequacy decision can be found in our blog posts available here, here and here, respectively.

— **Cyber Resilience Act Proposal.** In September, the EC published its proposal for a new regulation setting forth cybersecurity-related requirements for products with "digital elements," known as the proposed Cyber Resilience Act,[14] which is expected to be adopted into law by 2025. The proposal mandates that manufacturers (i) ensure that products placed on the EU market are secure, (ii) will remain responsible for cyber security throughout a product's life cycle, (iii) notify users of any actively exploited vulnerabilities or incidents that have an impact on the cybersecurity of their products and (iv) monitor, disclose and address vulnerabilities in respect of their product suite (including any components they source from third parties). Further, manufacturers, and in some instances, distributors or importers of products, must provide security updates and support for a reasonable period of time as well as end-of-life information to relevant users. Given that products that fall within the scope of the proposal might have long manufacturing runs, or might be embedded in other hardware and software as components, manufacturers covered by the Cyber Resilience Act may be exposed to a long tail of supply chain issues.

Given that products that fall within the [EC Cyber Resilience Act] proposal might have long manufacturing runs, or might be embedded in other hardware and software as components, manufacturers covered by the Cyber Resilience Act may be exposed to a long tail of supply chain issues.

— **Regulation on the European Health Data Space.** In May, the EC published its proposal for a regulation on the "European Health Data Space." The proposed regulation strives to create a "European Health Union" by strengthening individuals' access to and portability of their electronic health data and allowing innovators and researchers to process this data through reliable and secure mechanisms.[15] In particular, from a privacy perspective, the proposed regulation aims to define individuals' electronic health data rights (including, for instance, restricting healthcare professionals' access to all or part of their electronic health data), but simultaneously making it less burdensome for entities to use electronic health data for research, innovation and policymaking purposes.[16] While this proposed regulation is still under discussion before the European Council and is not expected to be adopted until the end of 2024, it may bring about additional changes to the regulatory landscape surrounding the processing of health data.

— **Transfers of Personal Data from the UK After Brexit.** In March, the UK's Information Commissioner's Office published its International Data Transfer Agreement (UK IDTA) and UK Addendum as valid transfer mechanisms under the UK's General Data Protection Regulation (GDPR),[17] replacing the old standard contractual clauses (old SCCs) issued by the EC. Organizations that are subject to the UK GDPR will have to adapt their existing contractual arrangements to incorporate the UK IDTA and/or the UK Addendum. Contracts signed on or before September 21, 2022 can continue to use the old SCCs until March 21, 2024, after which the old SCCs must be replaced by either the IDTA or the Addendum in conjunction with the new standard contractual clauses that the EC issued in 2021 (new SCCs) to replace the old SCCs. All contracts signed after September 21, 2022 must use either the IDTA or the UK Addendum in conjunction with the new SCCs.

[14] The full text of the proposal can be found here.

[15] For more information, please *see* our alert memorandum on the European Health Data Space, available here.

[16] Note that, in response to the EC's proposal, the European Data Protection Board and the European Data Protection Supervisory issued a Joint Opinion in July, expressing a range of concerns with the proposed regulation, including some aspects that may have a weakening effect on data subjects' rights and protections under the GDPR.

[17] A copy of the IDTA and UK Addendum can be found here.

— **UK Government's Consultation to Reform the UK GDPR**. The future of the data protection regulatory landscape in the UK remains unclear. In July, the UK government put forth a Data Protection and Digital Information Bill intended to revise the current UK GDPR framework without radically changing the core principles and obligations of organizations. However, in October, the UK's Department for Digital, Culture, Media and Sport announced that the UK is now intending to introduce more significant changes and to replace the UK GDPR "with [a] business and consumer-friendly, British data protection system." This may result in the UK having a data protection regime that imposes relatively less onerous data privacy obligations for businesses as compared to the EU GDPR, which may affect the adequacy decision the EC adopted in respect of the UK in 2021 allowing for the free-flow of data between the UK and the EU.[18] In addition, UK businesses operating in the EU may soon need to comply with two different sets of privacy laws.

Key Takeaways

— Organizations must stay abreast of new and modified compliance obligations as regulators continue to introduce and amend privacy and data protection laws to account for increasing risks.

— To the extent actions have not been taken to date, organizations must prioritize and take steps to determine which current laws and regulations apply to their business and implement a compliance strategy to satisfy data privacy- and protection-related obligations.

— Businesses that process sensitive data (*e.g.*, children's data, biometric information or health-related data) or that otherwise engage in high-risk processing activities heavily scrutinized by regulators (*e.g.*, cross-border data transfers, use of data for cross-context behavioral and targeted advertising), must be keenly aware of the bespoke risks that arise in connection with these collection and processing activities and, consequently, the related compliance obligations, to ensure protection of such data assets and insulate against liability that may result from high-risk processing.

[18] A copy of the EU's adequacy decision in respect of the UK can be found here.

CAMT, Excise Tax and Green Credits: U.S. Tax Lingo to Spice up Your Next Cocktail Conversation

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In the United States, the Inflation Reduction Act of 2022 (IRA) was passed in August. The IRA will be of relevance to many U.S. taxpayers, with three particular areas of focus for large corporations: the new corporate alternative minimum tax (CAMT), a new 1% excise tax imposed on certain net stock redemptions and repurchases, and tax credit provisions relating to renewable energy.

CAMT

The CAMT is a 15% alternative minimum tax imposed on certain large corporations and corporate groups (whether public or private), measured on a base of "adjusted financial statement income" (AFSI) – which is basically the income reported on the corporation's financial statements, with adjustments to certain specified items. Most of the adjustments are to follow the normal tax treatment of a specific item instead of the normal financial accounting treatment (*e.g.*, tax depreciation instead of book depreciation, no deduction for certain income taxes, and the tax-free treatment of certain reorganizations). The CAMT is in effect as of January 1, 2023.

The CAMT is expected to have a particular impact on corporations that have significant deductions under the tax rules that are not matched by accounting deductions (*e.g.*, the tax deductions arising from employee stock options, operating loss carryforwards).

The CAMT is expected to have a particular impact on corporations that have significant deductions under the tax rules that are not matched by accounting deductions (*e.g.*, the tax deductions arising from employee stock options, operating loss carryforwards). Which corporations are most hurt by the CAMT remains to be seen and may depend in large part upon how the new statute is interpreted and applied in forthcoming Treasury regulatory guidance.

Once a corporation meets the earnings thresholds to subject it to the CAMT it remains subject to the CAMT, although the IRS is authorized to provide rules under which corporations may be given a fresh-start (*e.g.*, if earnings have dropped below the threshold or there is a change of control).

Key Considerations for Companies Regarding CAMT

— The details of how CAMT will apply are, at this point, very uncertain. In response to pressure both from within the government and outside stakeholders, Treasury and the IRS issued the first interim guidance on the CAMT (Notice 2023-7) in the last week of December 2022. This Notice addressed only a handful of the issues that taxpayers have said need urgent guidance. Guidance is necessary because the statutory language, standing alone, does not tell corporations enough to determine what their likely CAMT liability, if any, will be in 2023, and the CAMT consequences of undertaking certain transactions.

— For corporate groups that are near the $1 billion average income threshold (not clearly above or below it), whether they fall into the CAMT or not will be an important question. Because of the cliff effect of the threshold (a dollar above or below the threshold can make a material difference), and the "once in, always in" rule, the details of how the government implements the determination of AFSI may take on particular relevance.

— CAMT will also become a new focal point in M&A transactions, including determining the AFSI and CAMT impact of the transaction itself, understanding the book/tax differences created by the transaction, modelling future after-tax returns, and additional due diligence.

The government has promised additional CAMT guidance early in 2023 and for interested stakeholders it cannot come too soon. The use of accounting statement income as a tax base is new to U.S. tax law (the last and only time accounting income was used as part of the U.S. tax base was in 1987-1989 under a temporary law referred to as the "BURP," which stood for "business untaxed reported profits"). We expect it will take many years for the CAMT rules to be worked out and we look forward to assisting our clients as the rules are developed.

1% Excise Tax

The IRA also introduced a 1% excise tax on net stock redemptions and repurchases, starting in 2023. The tax is levied on the value of the stock redeemed or repurchased in the tax year, netted against the value of stock issued for cash, property or to employees for services in that year, and is subject to certain exceptions (*e.g.*, it does not apply to tax-free reorganizations to the extent gain or loss is not recognized). The tax applies only to stock issued by publicly traded corporations (and in the case of public corporations, it applies regardless of whether the stock redeemed is publicly traded). In general it applies to U.S. publicly traded companies, excepting REITs, BDCs and other mutual funds, but it can also apply to "inverted" public non-U.S.

corporations, and to domestic "specified affiliates" (*i.e.*, more than 50% owned subsidiaries) that acquire (or are deemed to acquire) stock of their non-U.S. publicly traded parent corporations.

The application of this 1% excise tax is still subject to uncertainty, although in late December 2022 the IRS and Treasury issued a notice of proposed regulations (the December Notice) that has, as an interim matter, provided guidance on which taxpayers can rely until proposed regulations are issued.

The 1% excise tax currently applies to all redemptions or repurchases of *equity*, including debt-like redeemable preferred stock (with no grandfathering), and excluding options, convertible debt and other non-equity instruments with equity-related returns.

Key Considerations for Companies Regarding the Excise Tax

— The 1% excise tax currently applies to all redemptions or repurchases of *equity*, including debt-like redeemable preferred stock (with no grandfathering), and excluding options, convertible debt and other non-equity instruments with equity-related returns. The IRS and Treasury have asked for comments about the application of these rules to redeemable preferred stock and other special classes of stock or debt, including convertible debt.

— While in certain circumstances the application of the 1% excise tax will be relatively simple and understandable (*e.g.*, a domestic public corporation simply redeeming outstanding stock), in others the results may appear to be arbitrary. For example, in M&A transactions the 1% excise tax may or may not apply depending on the source of cash for the acquisition or what entity is primarily liable for the financing. This will become another tax consideration to take into account in structuring M&A transactions and related financing.

— In the context of *non*-U.S. publicly traded corporations, the December Notice has proposed a "funding" rule that may have a broad and unexpected application. It imposes the 1% excise tax on a domestic subsidiary that "funds" a non-U.S. public company (by any means including through dividends, debt or capital contributions) with the "principal purpose" of avoiding the 1% excise tax. Any funding other than by distribution which occurs within two years of the redemption or repurchase is *deemed* to have such a principal purpose. The 1% excise tax imposed in respect of a public non-U.S. company is not netted against stock issuances by that non-U.S. corporation. The application of this "funding" rule is currently unclear, although it has the potential to impose the 1% excise tax on intercompany cash flows that otherwise would be tax-neutral.

The IRA significantly expands the scope of available tax incentives and allows for new techniques to monetize tax credits, with the aim of decreasing carbon emissions and boosting U.S. jobs.

"Green" Tax Credits

The IRA provides far-reaching tax incentives for investments in renewable energy projects and activities related to reducing greenhouse gases. The IRA significantly expands the scope of available tax incentives and allows for new techniques to monetize tax credits, with the aim of decreasing carbon emissions and boosting U.S. jobs. These tax credits will be of significant interest to taxpayers engaged in renewable energy projects and businesses, and potentially to potential purchasers of the tax credits.

The IRA restores and expands existing tax credits for wind, solar, biomass, geothermal, hydropower, and hydrokinetic energy projects, and adds new tax credits for, among other things: domestic manufacturing of components of renewable energy property (such as electric vehicle batteries, solar panels, or wind turbines), clean hydrogen, nuclear power, stand-alone energy storage, biogas, microgrid controllers, dynamic glass, and any technology used to generate electricity without greenhouse gas emissions. In order to obtain the full benefits of the available credits, projects must meet minimum wage and apprenticeship requirements, minimum thresholds of domestically produced content, and location requirements.

The IRA also allows two important new monetization techniques.

— Taxpayers who own eligible property may sell the tax credits they generate to any unrelated party, provided the credits are sold only once and are exchanged for cash.

— Alternatively, taxpayers who are eligible for clean hydrogen, carbon capture, or domestic manufacturing credits may elect to receive cash refunds for these credits from the government. (Tax-exempt and governmental entities generally are eligible to receive cash refunds for most other available tax credits.)

In addition to the credits described above, the IRA also expands deductions for energy efficient buildings and includes a number of credits for individuals and homeowners, such as credits for buying electric vehicles and making energy efficient home improvements.

Changes to Tax Creditability of Foreign Taxes

In December, 2021 the IRS and Treasury released regulations changing the criteria for determining what foreign taxes may be credited against a taxpayer's U.S. tax liability. Although the regulations represent a response to the imposition of so-called "digital taxes" on U.S. tech companies outside of the United States, their potential reach is much wider. The regulations effectively require that, in order to be creditable against U.S. tax liability, a foreign tax must be an "income tax," which effectively is now defined as a tax imposed under rules that are consistent with U.S. income tax principles. Thus, a determination of whether a foreign income tax (including a withholding tax) is creditable appears to require both: (i) a detailed understanding of the relevant foreign tax regime and (ii) the ability to make a determination whether that regime is sufficiently consistent with U.S. tax principles to warrant creditability.

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U.S. taxpayers in certain circumstances are entitled to rely upon specific provisions in tax treaties ensuring that a foreign tax will qualify as an "income tax," although this safe harbor may not always be applicable (*e.g.*, it does not appear to apply to non-U.S. corporate subsidiaries of multinationals, because such subsidiaries are not themselves U.S. taxpayers). Because the regulations are already effective (they apply for taxable years beginning after December 28, 2021 and so are not prospective), they have created uncertainty among taxpayers as to which foreign taxes were creditable for the 2022 tax year and beyond. The IRS has refused to release an "angel list" of creditable foreign taxes, but in response to political pressure on this point, proposed regulations were released in November of 2022 (and on which taxpayer are entitled to rely currently) that allow for certain specified deviations from U.S. tax principles in an apparent effort to expand the universe of taxes that are creditable. The ultimate impact of the regulations on creditability of foreign taxes remains unclear. Taxes that cannot be credited under the new regulations may still be treated as deductible expenses.

The result of these new regulations are that non-U.S. taxes that previously were considered creditable may not be, with the result that taxpayers with non-U.S. operations may be subject to an unexpectedly high rate of marginal income on their non-U.S. income. The adverse effect will vary corporation by corporation, depending on the sources of a corporation's income and its international structuring.

Recent EU Tax Developments

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With the various global crises, budget spending to address inflation and post-COVID-19 pandemic effects continuing to weigh on fiscal budgets globally, governments will at some point soon need to recoup lost revenue.

As regards the EU, there are a large number of current and upcoming legal developments that will significantly change the tax landscape and need to be monitored.

During 2023, expect further focus related to discussions on Pillar 1 (the digital nexus or, alternatively, digital services taxes), DEBRA (Debt-equity bias reduction allowance), Unshell (ATAD 3), SAFE (Securing the activity framework of enablers) and BEFIT (Business in Europe: Framework for Income Taxation).

Most notably, in mid-December 2022, the EU Member States agreed on the EU Directive implementing Pillar 2 on the 15% effective minimum corporate tax rate that will need to be transposed into national laws by December 31, 2023[1]. During 2023, expect further focus related to discussions on Pillar 1 (the digital nexus or,

[1] The forthcoming rules for joint audits in the various EU Member States implementing the 7th amendment to the EU Directive on administrative cooperation (known as DAC7) will change the landscape for large audits and DAC8 will include new reporting rules for crypto assets, automatic exchange of information regarding tax rulings for wealthy individuals and penalties for non-reporting.

alternatively, digital services taxes), DEBRA (Debt-equity bias reduction allowance), Unshell (ATAD 3), SAFE (Securing the activity framework of enablers) and BEFIT (Business in Europe: Framework for Income Taxation).

Pillar 2 aims to reduce the scope for tax base erosion and profit shifting by ensuring that large multinationals with an annual turnover of at least €750 million pay an effective minimum global corporate tax rate of 15%.

Implementation of Pillar Two in the EU

The Directive implementing Pillar 2 of the OECD/G20 Anti-Tax Avoidance and Profit Shifting (BEPS) Inclusive Framework was unanimously adopted by EU Member States on December 14, 2022.[2] Pillar 2 aims to reduce the scope for tax base erosion and profit shifting by ensuring that large multinationals with an annual turnover of at least €750 million pay an effective minimum global corporate tax rate of 15%.

The now adopted EU Directive introduces the EU version of Pillar 2. Essentially, the Directive requires EU Member States to impose a surcharge if an in-scope company's effective tax rate on its covered income is less than 15%. In principle, the surcharge is levied through the Income Inclusion Rule (IIR). The IIR is supplemented by the minimum tax under the Undertaxed Profit Rule (UTPR) if the country in which the parent company is resident does not apply the IIR. In such case, the countries in which the subsidiaries operate can levy the UTPR on their payments abroad. The political motivation is to reduce the risk of tax base erosion and profit shifting and limit the race to the bottom in corporate tax rates.

We have separate detailed materials available on the two Pillars and are happy to share that with you upon your request.

DEBRA aims to address the unequal tax treatment of debt and equity that result in certain tax advantages of debt over equity financing in most EU countries with the aim of reducing incentives to raise debt capital.

DEBRA

As part of the EU strategy on corporate taxation, the EU Commission presented the DEBRA draft directive. DEBRA aims to address the unequal tax treatment of debt and equity that result in certain tax advantages of debt over equity financing in most EU countries with the aim of reducing incentives to raise debt capital. DEBRA provides for two measures: a notional tax deductible allowance for increases in equity and a further limitation of the tax deductibility of interest expenses. DEBRA would apply to taxpayers that are subject to corporate income tax in a Member State with the exception of financial companies.

Under the interest expense deduction limitation of DEBRA, only 85% of net interest expenses (interest expenses exceeding interest income) would be tax deductible. This rule will work alongside the Anti-Tax Avoidance Directive (ATAD) interest limitation rule pursuant to which the deductibility of interest is limited to €3 million or, if higher, to a maximum 30% of the taxpayer's EBITDA. Taxpayers will have to calculate both the deduction amount set by DEBRA and ATAD. Companies will only be able to deduct the lowest amount in a tax year, but would generally be able to carry the difference forward or back.

The tax deductible allowance for equity increases works as follows: the difference between (i) the net equity at the end of the current tax year and (ii) the net equity

[2] In October 2021, almost 140 countries working together in the OECD's inclusive framework reached political agreement on the Pillar 1 and 2 proposals.

at the end of the previous tax year is multiplied by a notional interest rate. The result is the tax deductible allowance for the amount of an equity increase in a given year. The notional interest rate corresponds to the 10-year risk-free interest rate for the respective currency to which a risk premium of 1% is added (1.5% for small and medium-sized enterprises). The allowance is in principle deductible in ten consecutive tax years, provided that the annual deduction is capped at 30% of the taxpayer's EBITDA (unused excess can generally be carried forward for 5 years). In addition, DEBRA provides for various special features and rules to prevent abuse.

The EU Member States will be required to implement DEBRA (if adopted) by the end of 2023. The first-time application of DEBRA is planned from January 1, 2024. Member States that already provide for a tax allowance for equity may defer DEBRA application up to ten years.

Unshell

The Unshell draft directive aims at preventing abuse by the use of shell companies in the EU that serve no genuine economic purpose. In summary, Unshell provides for a two-tier substance test, based on total revenues, asset location and outsourcing of management at the first tier, and reporting and verification requirements at the second tier. An entity is not qualified as a shell if it has its own business premises, actively uses its own bank account in the EU and either has at least one managing director in the entity's member state who has and uses sufficient decision-making powers and is not additionally employed by a company outside the group, or has employees, the majority of whom are resident in the company's member state and are appropriately qualified for their work. If such criteria are not met, the existence of a shell company is rebuttably presumed. The qualification as a shell results in the denial of certain tax benefits (*e.g.*, denial of no application of a double tax treaty), the taxation of the income of the shell company at the level of the shareholder as well as the denial of a residence certificate in the state of residence of the shell, which is regularly required to claim withholding tax relief provided for in DTAs or EU Directives. The proposal of the new directive is to be transposed into national law by June 30, 2023 and is expected to be applicable for the first time as of January 1, 2024.

The key objective of SAFE is to prevent enablers from setting up complex structures in non-EU countries the purpose of which is to erode the tax base of Member States.

SAFE

The EU Commission concluded a consultation on its initiative known as SAFE, short for "securing the activity framework of enablers." In short, the SAFE initiative aims to tackle the role that enablers can play in facilitating arrangements that lead to tax evasion or aggressive tax planning in EU Member States. The key objective of SAFE is to prevent enablers from setting up complex structures in non-EU countries the purpose of which is to erode the tax base of Member States.

SAFE will interact and build upon existing initiatives, notably the mandatory reporting regime of cross-border arrangements known as DAC6, the ATAD, the Anti-Money Laundering (AML) Directive and the Whistle-blowers Directive. In the Commission's view, it is noteworthy that those measures primarily aim at the taxpayer, but do not target those who enable aggressive structures (arguably with the exception of DAC6 reporting). The Commission contemplates several policy options.

In addition, it has been contemplated that EU taxpayers would in future have to declare in their tax returns any shareholding in an unlisted company based outside the EU that amounts to 25% or more of the shares, voting rights or other controlling rights.

The stakeholder consultation for the SAFE resulted in almost universally negative feedback.

The EU Commission announced that a proposal for a SAFE Directive would be forthcoming in the first quarter of 2023.

BEFIT would be a single corporate tax rulebook for the EU ,

BEFIT

The EU Commission stated, as in the past, that the lack of a common corporate tax system in the Single Market acts as a drag on competitiveness, resulting in distortions of investment and financing decisions (where these are driven by tax optimization strategies rather than other considerations), and higher compliance costs for businesses active in more than one EU Member State. This creates a competitive disadvantage compared to third country markets. The Commission will propose a new framework named BEFIT, short for "business in Europe: framework for Income Taxation." BEFIT would be a single corporate tax rulebook for the EU, based on the key features of a common tax base and the allocation of profits between Member States based on a formula (formulary apportionment).

BEFIT would be based on the OECD's two-pillar solution regarding the partial redistribution of profits (Pillar 1) and the calculation of the tax base (Pillar 2). The EU Commission has announced that a legislative proposal for BEFIT will be forthcoming in the third quarter of 2023. In the past, the EU initiatives for a common consolidated corporate tax base (CCCTB) never made it into law, but it remains to be seen whether the OECD inclusive framework Pillars 1 and 2 facilitate BEFIT.

2023 Update: U.S. Antitrust Sets Sail into Uncharted Seas

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2023 Update: U.S. Antitrust Sets Sail into Uncharted Seas

Last year we noted that U.S. antitrust enforcement was in a period of nearly unprecedented public attention and policy debate, and also that the Biden Administration seemed likely to launch significant new policy initiatives as the year progressed. And so it was — 2022 saw substantial shifts in announced U.S. antitrust policy, political and legislative hubbub over antitrust law and bold public statements from the Administration's antitrust enforcers. What 2022 did not see, however, was a matching surge in actual enforcement. Instead, by most measures, U.S. enforcement levels remained comparable to the two prior administrations, and U.S. enforcers suffered unprecedented setbacks in court. Similarly, while sweeping legislation was proposed, the only bills to actually become law were technical changes adjusting merger filing fees and venue over antitrust claims by state Attorneys General.

The FTC and DOJ have changed the focus of merger enforcement, emphasizing vertical theories of harm (as seen through challenges of the *Lockheed/Aerojet, UnitedHealth/Change*, and *Microsoft/Activision* acquisitions), sharply scrutinizing private equity firms and transactions in which they are involved, and launching significant initiatives in policing interlocking directorates, attacking non-competes (including through proposals for new rules prohibiting them), as well as policing no-poach provisions, Robinson-Patman pricing enforcement and more.

All that said, the FTC and DOJ have changed the focus of merger enforcement, emphasizing vertical theories of harm (as seen through challenges of the *Lockheed/Aerojet*, *UnitedHealth/Change*, and *Microsoft/Activision* acquisitions), sharply scrutinizing private equity firms and transactions in which they are involved, and launching significant initiatives in policing interlocking directorates, attacking non-competes (including through proposals for new rules prohibiting them),[1] as well as policing no-poach provisions, Robinson-Patman pricing enforcement and more. And in 2023 we expect major policy developments, notably the issuance of new Merger Guidelines to replace both the widely accepted 2010 Horizontal Merger Guidelines and the controversial 2020 Vertical Merger Guidelines. All told, fasten your seatbelts — 2023 promises to be quite a ride.

In 2023 we expect major policy developments, notably the issuance of new Merger Guidelines to replace both the widely accepted 2010 Horizontal Merger Guidelines and the controversial 2020 Vertical Merger Guidelines.

2022 Was a Strange Year in Merger Enforcement

2022 was a year of anomalies for U.S. merger enforcement. On the one hand, leadership at the agencies continued to promise enforcement at unprecedented levels. But on the other hand, the statistics do not fully live up to that promise. While the FTC brought more merger challenges in 2022 than in 2021, it still fell short of levels seen in 2020, though DOJ brought more merger challenges than it did in a comparable period in the prior administration.[2] The government did bring two vertical merger challenges — doubling the total number of such litigated challenges over at least the prior two decades — but as of this writing, lost one of the two in court (*United/Change*), with the other in early stages of litigation.

That litigation loss leads to another point — the government's startlingly bad court record in merger challenges. Out of six merger challenges resolved in court in 2022, the DOJ and FTC collectively lost 5 (DOJ went 1-3 and the FTC 0-2), which is likely the worst government merger litigation record in modern U.S. antitrust history.[3] And this is not a function of bringing more cases and so losing more; 2019-2020, for example, saw similar numbers of merger litigations, with far better results for the government.

[1] For more detail on the proposal, *see* our January 2023 alert memo available here.

[2] PaRR, "FTC merger challenges lead to abandonment in 80% of cases." DOJ's overall enforcement statistics are being suppressed because it is not obtaining consent decrees in any mergers (*see* below).

[3] We should note that some of these losses are being appealed, and at least with the FTC's appeals—which are to the Commission itself—there is a reasonable likelihood of the government prevailing, at least temporarily.

In the meantime, on the policy front the government continued its refusal to grant early termination of the HSR waiting period for merger filings that raise no competition issues. That policy, initially explained as a response to historically high merger filings in 2020 and 2021, has not changed despite a decline in the number of mergers. Additionally, merger investigations continue to probe areas that historically did not receive much attention, such as executive compensation and the levels of unionization among the merging firms' employees. And, perhaps most significant of all, the FTC and DOJ have been working on revised Merger Guidelines, which we expect to see in 2023.

2022 brought internal tumult at the FTC, mixed results in enforcement, but significant moves on policy and regulation.

A Tumultuous Year at the FTC

2022 brought internal tumult at the FTC, mixed results in enforcement, but significant moves on policy and regulation.

Internally, the FTC suffered a collapse in staff morale. The FTC overall fell from nearly always being ranked as one of the very best comparably-sized agencies to work at to being one of the worst. The Bureau of Competition—the FTC's antitrust enforcement arm—fell from 3rd place (out of 411 comparable units) in 2020, to 401st (out of 432) in 2021 (the rankings were released in 2022, hence their inclusion in this report). Interestingly, the Antitrust Division of DOJ did not suffer a similar decline, instead improving slightly from its cellar-dwelling rankings in the Trump Administration. Potentially signaling an attempt to address staff morale issues, the FTC's Chief of Staff was replaced.

The FTC also experienced other major personnel changes in 2022. Most critically, Alvaro Bedoya, a Georgetown law professor and privacy expert, was sworn in as an FTC Commissioner, providing the Democrats the decisive 3-vote margin they had been lacking since former Commissioner Chopra's departure (and the expiration of the zombie votes he had left behind). While considered likely to focus on consumer protection enforcement, Commissioner Bedoya has advocated for increased Robinson-Patman Act enforcement. FTC Commissioner Noah Phillips resigned from his position, leaving a Republican vacancy, though his departure did not alter the FTC's balance of power in voting. In another important development, Professor Aviv Nevo, a widely respected antitrust economist, was selected to fill the long-vacant position of the Director of the FTC's Bureau of Economics, bringing top-level leadership to that important component of the FTC.

As noted above, the FTC brought several litigated merger challenges in 2022, though it lost the two that made it to a court decision (other mergers were abandoned in the face of the FTC's challenges, while some FTC merger litigation remains pending). Perhaps just as importantly, though, the FTC used consent decrees in merger cases to advance a number of policy positions, including its resurrected "prior approval" requirement for subsequent transactions in markets subject to the decrees. On the conduct side, the FTC conducted a study of supply chain issues, but once again filed no new significant conduct cases, instead continuing to litigate cases brought by prior administrations.[4] It should be noted, though, that major conduct cases take considerable time to put together—so stay tuned.

On the policy front, however, the 2022 FTC was quite active. Notably, in addition to ongoing work on new Merger Guidelines and the groundbreaking rulemaking on noncompetes we mentioned above, in November the FTC announced a new Section 5 Policy Statement

[4] The FTC's cases and proceedings index shows no conduct case filings in 2022 other than the settlement of the long-pending Louisiana Real Estate Appraisers matter.

Regarding the Scope of Unfair Methods of Competition, in which the FTC asserted that its statutory authority sweeps far beyond the Sherman and Clayton Acts. 2023 may bring more information on how the FTC uses its new views of its authority in enforcement and regulation—and also on how courts respond.

In 2022, the DOJ brought its highest number of merger challenges in a single year in at least recent history, though as noted above it lost nearly all of those cases. DOJ also continued aggressive criminal enforcement in the no-poach area, though again with mixed results.

The DOJ Springs Into Action

DOJ civil enforcement had trailed the FTC's activity levels for some time, dating back to the Trump Administration. AAG Jonathan Kanter's appointment in late 2021 appears to have changed that. In 2022, the DOJ brought its highest number of merger challenges in a single year in at least recent history, though as noted above it lost nearly all of those cases. DOJ also continued aggressive criminal enforcement in the no-poach area, though again with mixed results, including significant losses at trial, offset to some extent by favorable pretrial rulings.

In a somewhat related development, DOJ announced an enforcement initiative involving Section 8 of the Clayton Act, which prohibits corporations from having interlocking directorates (under certain technical conditions). DOJ kick-started this effort with a series of consent decrees, and appears to be continuing to launch investigations in this area. DOJ also announced in speeches that it was looking at bringing criminal charges in monopolization cases under Section 2 of the Sherman Act — an area of enforcement that had been dormant for decades due to the widely-held view that Section 2 is far too nebulous for criminal prosecution. DOJ, however, lived up to its word, bringing two criminal monopolization cases — one, a guilty plea where the individual had attempted to collude with a competitor to divide markets and exclude rivals, and the second, an 11-count indictment against a number of participants in what appears to be a sweeping criminal scheme (going well beyond antitrust) in connection with the "transmigrante forwarding" industry (relating to shipping goods between the United States, Mexico and Central America).

It appears that DOJ has been accepting self-help remedies, where merging firms privately "fix" issues in a merger and then file a "clean," no-issues merger that can be cleared without a consent.

One final significant development at DOJ is something that did not happen—the absence of any merger consent decrees. Merger challenges are often resolved with consent decrees that attempt to fix the government's concerns while allowing some part of the merger to proceed. The consent decree — which, for DOJ, must be approved in a public federal court proceeding under the Tunney Act — allows ongoing government supervision of the remedy. AAG Kanter has expressed skepticism about the efficacy of merger remedies, and under his leadership, DOJ has not agreed to any — at least not publicly. However, it appears that DOJ has been accepting self-help remedies, where merging firms privately "fix" issues in a merger and then file a "clean," no-issues merger that can be cleared without a consent (the FTC has continued its normal consent decree process).While this process may be efficient, it's unclear how it will evolve.

2022 saw perhaps the most legislative activity related to antitrust since the 1930s. But at the end of the year, virtually all of the efforts to pass significant antitrust legislation had failed.

Legislation

Finally, as we highlighted at the beginning of this section, 2022 saw perhaps the most legislative activity related to antitrust since the 1930s. But at the end of the year, virtually all of the efforts to pass significant antitrust legislation had failed. Anti-"Big Tech" bills died in Congress, as did various proposals for sweeping antitrust overhauls from sources as varied as Senators Klobuchar and Hawley. And in the new divided Congress, we see much less likelihood that major antitrust bills will move forward, at least at the federal level (the states bear watching, though). We do expect Congress to continue probing technology companies, albeit for very different reasons on different ends of the political spectrum, and the Republican-controlled House may launch probes into whether various efforts relating to ESG raise antitrust issues.

That's not to say that the bills that did pass have no impact. Of most practical significance, Congress passed legislation revamping merger filing fees—basically, drastically raising fees on large transactions, while reducing fees on smaller deals. The FTC hasn't yet issued new guidance, so the new fees are not yet in effect, but we expect that to change shortly.[5]

[5] Once in effect, the new fee structure will be: $30,000 for deals valued at under $161.5 million; $100,000 for deals valued at $161.5 million or more but not more than $500 million; $250,000 for deals valued at $500 million or more but not more than $1 billion; $400,000 for deals valued at $1 billion or more but not more than $2 billion; $800,000 for deals valued at $2 billion or more but not more than $5 billion; and $2.25 million for deals valued at $5 billion or more.

Europe and ROW

In Europe, 2022 saw continued scrutiny of digital platforms, close scrutiny of European Commission (EC) decisions by the EU Courts, heightened interventionism by the UK agency (the CMA), and a mandate to use antitrust to tackle climate change. All will remain topics to watch in 2023.

Digital Regulation Takes Center Stage in Europe...

In 2022, the EU's new suite of digital regulation came into force: the Digital Markets Act (DMA) on November 1, 2022 and the Digital Services Act (DSA) two weeks later. Together, the regulations aim to "*create a safer digital space where the fundamental rights of users are protected and to establish a level playing field for businesses*."[6]

Although the regulation has the potential to reshape how businesses and consumers interact with digital platforms, we will not have a chance to see how this takes shape until the early part of 2024, when the behavioral rules start to apply.

The DMA introduces a set of 'dos and don'ts' governing the behavior of so-called gatekeeper digital platforms, and are largely inspired by past and present antitrust cases in digital markets. Unlike traditional antitrust, though, they do not take account of competitive effects or harm and they do not explicitly allow for efficiency justifications. Potential gatekeepers will be gearing up to submit which services are in scope by mid-2023. Although the regulation has the potential to reshape how businesses and consumers interact with digital platforms, we will not have a chance to see how this

[6] *See* European Commission, "The Digital Services Act Package" (last modified November 24, 2022), available here.

takes shape until the early part of 2024, when the behavioral rules start to apply.

The DSA focuses on the distribution of user-generated content online. It introduces a multi-layered set of obligations designed to protect users, improve transparency and foster innovation. Rules include a prohibition of dark patterns and an obligation on platforms to publish an annual transparency report on content moderation (showing, *e.g.*, the number of user complaints received). Enforcement will be the responsibility of designated authorities in each Member State, and rules will apply in early 2024.

...And the Trend Catches on in the Rest of the World

Policymakers around the world are also exploring proposals for digital regulation, similar to the DMA.

We discussed Germany's new digital regime in our 2021 report. Under those rules, the Federal Cartel Office (FCO) can issue an ex ante prohibition order against certain conduct by companies with "paramount cross-market significance" (PCMS), based on an open-ended list of practices (*e.g.*, impeding interoperability, gaining unfair advantages, leveraging, or self-preferencing). In 2022, the FCO designated Amazon and Facebook (Meta) as having PCMS: 2023 may see further designations and perhaps the first conduct prohibition decisions.

Other jurisdictions are still at a preparatory stage. In Japan, the Japan Digital Market Competition Headquarters is consulting on the need for new regulations for mobile ecosystems, voice assistants, and wearable devices. The Australian Competition and Consumer Commission (ACCC) is now halfway through its five-year Digital Platform Services Inquiry. The former ACCC chair called for "*ex ante rules to describe what [digital platforms] should and shouldn't do,*" anxious that "*if Australia doesn't get on board, the bus will leave without us.*"[7] Nearing the end of the year, the Turkish Competition Authority published its Draft Regulation to ensure that Turkish competition law reflects "*the fast-paced changes in internet technologies in recent years [that] have reshaped the digital market and consumer habits.*"

In the UK, new digital legislation remains on the agenda, despite delays to the expected timing of the draft bill. The new regime will establish a code of conduct for firms with 'strategic market status.' The CMA has established a Digital Markets Unit to enforce the regime and "*promote competition in digital markets for the benefit of consumers.*"[8] The timing of the draft bill remains uncertain but CMA officials have expressed that they wish the regime to be in place by October 2023.[9]

In 2022, the European courts showed that they are increasing their scrutiny of European Commission (EC) decisions, especially in relation to abusive unilateral conduct.

Antitrust Enforcement Continues, but is Subject to Close Review by the EU Courts

In 2022, the European courts showed that they are increasing their scrutiny of European Commission (EC) decisions, especially in relation to abusive unilateral conduct. Three decisions by the General Court highlight this trend: its partial annulment of the EC decision imposing a fine of approximately €1 billion on Intel, in which it found the EC's analysis of the rebates granted by Intel was insufficient to establish anticompetitive effects; its annulment of the EC's *Qualcomm* decision in its entirety (including a ~€1 billion fine), in which the General Court observed that the EC failed to prove

7 *See* Monash University, Roundtable Discussion (September 28, 2022), 1:05-1:07, available here.

8 UK Secretary of State for Digital, Culture, Media and Sport and the Secretary of State for Business, Energy and Industrial Strategy "A new pro-competition regime for digital markets - government response to consultation" (May 6, 2022), available here.

9 For more information on how digital regulation is taking shape around the world, *see* our Digital Markets Regulation Handbook available here.

that the alleged anticompetitive effects were caused by Qualcomm's exclusionary payments; and its findings, in the course of largely upholding the EC's *Google Android* decision, that the EC had erred in concluding that the portfolio-based revenue share agreements were in themselves abusive and that the Commission's investigation suffered from procedural errors. The *Google Android* judgment underscores the Commission's obligation to examine alleged exclusionary effects rigorously.[10]

Merger Control Becomes More Complex…

There are three trends to watch out for in merger control in 2023.

First, the EC will seek to use Art. 22 of the EU Merger Regulation and the *Illumina/Grail* precedent to review mergers that would previously not have been investigated. Art. 22 of the EU Merger Regulation allows Member States to ask the EC to examine certain transactions, even post-closing, that do not meet EU/national thresholds. The provision has been around for decades, but the EC gave it new life with a 2021 guidance paper to try to capture potentially problematic deals that fall below traditional revenue-based jurisdictional thresholds.

For example, the *Illumina/Grail* transaction did not meet any EU/national notification thresholds because GRAIL had no products or sales in the EU. After receiving a complaint about the deal, the EC wrote to Member States asking them to consider a referral request. The French authority was the first to do so, and five others followed. The EC accepted the referral request. Illumina appealed to the General Court, which upheld the EC's decision on jurisdiction.

The GC judgment has been appealed and the ECJ will now confirm or reverse the EC's approach. The new interpretation of Article 22 creates uncertainty as to whether a transaction may be subject to merger control in the EU, and adds a layer of merger control below the EU and national thresholds. Previously, businesses could rely on bright line thresholds to determine whether a given transaction would be subject to review. Under the new approach, national authorities can, at their own volition or the request of the EC, refer transactions to the EC even after they have closed, triggering a merger investigation.

Second, the DMA will require gatekeepers to inform the EC of intended transactions involving "*another provider of core platform services or of any other services provided in the digital sector*" regardless of whether they meet EU or Member States' merger control thresholds. Providing that information to the EC could kickstart a referral process just like the one in *Illumina/Grail*.

Third, the Foreign Subsidies Regulation (FSR) enters into force as of July 12, 2023, adding another layer of regulatory review. Companies that have received non-negligible non-EU State financial contributions will be required to make mandatory and suspensory notifications to the EC from October 12, 2023 onwards when making large acquisitions of control in the EU or participating in large tenders in the EU. Under the FSR, to mirror its State Aid control for EU aid, the EC will assess whether any such non-EU State support amounts to a distortive foreign subsidy and if so, whether redressive measures should be imposed. The scope of the FSR is deliberately broad so further guidance from the EC on its interpretation and application, which is expected in early 2023, will be welcome.

…And the CMA Cements Itself as a Leading Agency

In 2021 we observed that the CMA was taking an increasingly interventionist approach to mergers. This trend continued in 2022. The CMA was the first regulator to open an in-depth investigation into Microsoft's $69 billion attempt to buy Activision, with the EC later following suit, and the U.S. Federal Trade Commission deciding to sue to block the deal shortly afterwards. Two years since the end of the Brexit transition period, the CMA is cementing its place as a

[10] For further details, please *see* our October alert memo available here.

powerful and proactive regulator on the global stage. To take two examples:

Facebook (Meta) / GIPHY marked the first time the CMA reversed a completed deal involving a GAFAM firm. The CMA's decision (appealed to the CAT and largely upheld in June 2022) was grounded in a relatively novel theory of dynamic competition. The CMA essentially found that the threat of GIPHY potentially competing with Facebook in the future in display advertising acted as competitive constraint on Facebook today and this amounted to a substantial lessening of competition.

The investigation is also significant because the CMA imposed its largest ever fine for breach of a hold-separate order. The CMA fined Facebook (Meta) £50.5 million for "*consciously refusing to report all the required information*" under the CMA's compliance reporting regime and for twice changing its Chief Compliance Officer without seeking the CMA's permission.[11] The fine underlines the CMA's determination to apply and enforce interim measures strictly.

Cargotec / Konecranes provided an illustration of the post-Brexit divergence between the UK and EU. The EC and CMA examined the same markets and theories of harm: horizontal effects in cargo handling equipment in Europe-wide markets, as well as potential vertical concerns in the market for crane spreaders. Both opened a Phase 2 investigation. And both regulators said they had been in regular contact throughout the investigations. Ultimately, the EC accepted the parties' proposed divestiture package as a remedy, but just four days later, the CMA announced that it would block the merger. It found that the same divestiture package accepted by the EC "*lacked important capabilities.*"[12] The deal fell apart shortly afterwards.

[11] CMA Press Release "CMA fines Facebook over enforcement order breach" (October 20, 2021), available here.

[12] CMA Press Release "CMA blocks planned Cargotec / Konecranes merger" (March 29, 2022), available here.

With climate change becoming a global priority, the last few years have seen a number of competition authorities considering guidelines on how competition policy and sustainability economics can be integrated.

A Focus on Sustainability Economics

Europe has led the charge on making sustainability part of the antitrust agenda. Some think the two are not natural companions, although others think that competition policy can backfire if market failures that led to the climate crisis are ignored. While it can be efficient for companies to collaborate on sustainability goals, some take the view these arrangements could be caught by rules against competitor cooperation and standardization agreements. With climate change becoming a global priority, the last few years have seen a number of competition authorities considering guidelines on how competition policy and sustainability economics can be integrated.

These efforts continued into 2022. In the EU, the EC published its new Draft Horizontal Guidelines and Horizontal Agreements Block Exemption Regulations. Under the draft revised Guidance, sustainability agreements may fall outside the scope of application of competition rules if the agreements do not affect price, quality, quantity, choice or innovation. Even beyond that, the draft revised guidelines provide a safe harbor for sustainability standards, and suggestions on conditions for exemption of sustainability agreements. For instance, the Guidance states that a restriction of competition can only be justified if consumers in the relevant market receive a fair share of the benefits - though there is debate on how this 'fair share' will be measured.[13]

[13] *See* Oxford Business Law Blog, "New EU Guidelines for Horizontal Agreements: A Changing Climate for Sustainability Cooperation?" (March 23, 2022), available here.

Over in the UK, the CMA's Annual Plan for 2022-2023 listed the transition to low carbon growth as one of the CMA's focuses, "*including through the development of healthy competitive markets in sustainable products and services.*"[14] In March 2022, the CMA launched a sustainability task force to lead the CMA's sustainability work. Its role is to "*develop formal guidance, lead discussions with government, industry and partner organisations and continually review the case for legislative change.*"[15] Guidance is expected February 2023, and it is expected to be quite permissive especially with respect to agreements to mitigate the climate crisis.

National authorities like the German FCO and the Netherlands' Authority for Consumers and Markets (ACM) took the lead in developing precedent. The ACM applied its draft sustainability guidance to informally approve a number of arrangements in 2022. The ACM, for instance, approved a collaboration between Shell and TotalEnergies to store CO2 in empty natural-gas fields, an agreement between Coca Cola, Vrumona, and two supermarket chains to discontinue the use of plastic handles on soft drink and water multipacks, and an agreement between garden centers to avoid buying from flower growers who used illegal pesticides.

The new guidance should help companies navigate competition law while exploring new initiatives to pursue their CSR goals. The limits of these principles will become clear as we see more examples of cooperation in the private sector. November's UN Climate Change Conference (COP27), and the debate on the antitrust analysis of the Race to Zero policy to stop finance and insurance of new unabated fossil fuel projects, made clear that sustainability remains a key topic for debate.[16] We should not be surprised if this continues to be top of mind for antitrust enforcers going into 2023.

[14] CMA Press Release "CMA publishes Annual Plan 2022 to 2023" (March 24, 2022), available here.

[15] CMA Press Release, "CMA publishes environmental sustainability advice to government" (March 14, 2022), available here.

[16] Cleary Gottlieb partner Maurits Dolmans gave a presentation on the need for the law and enforcement policies to adjust to the climate crisis (*see* here for a blog post regarding his overall impressions of the Conference, and here for a personal take on the Race to Zero policy).

Russia and Beyond: Sanctions Developments and Lessons for Boards from 2022

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This past year's Russia-Ukraine conflict sparked a significant transformation of the global economic sanctions landscape, with developments and lessons extending well beyond Russia. In 2023, boards of directors should continue to monitor Russia-related sanctions across multiple jurisdictions, be aware of the implications of sanctions developments for the energy sector and consider planning for sanctions and export control contingencies, particularly relating to China.

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Russia-Ukraine Sanctions

In the wake of the Russian invasion of Ukraine, the United States and its partners and allies imposed a range of sanctions that were unprecedented in scale, scope and speed of deployment. In particular, the United States, European Union and United Kingdom imposed various prohibitions and restrictions relating to major Russian financial institutions, oligarchs and government officials (as well as entities owned or controlled by such parties); any new investment in Russia; the provision of certain professional services (including accounting and management consulting services) to Russia; export/import bans (including prohibitions and restrictions related to Russian-origin crude oil and petroleum products); transactions with the Russian Central Bank, Ministry of Finance and National Wealth Fund; and dealings with certain occupied territories of Ukraine.[1] In response, the Russian government implemented a number of novel countermeasures that include various forms of capital controls, disclosure exemptions, trade and intellectual property restrictions and other government approval requirements and restrictions on foreign parties.

Boards should be aware that the consequences of these sanctions extend beyond their immediate economic effects and compliance obligations for companies. Indeed, new and newly revised sanctions measures—such as the new investment ban and sector-specific services bans, as well as Russian countermeasures—that have been deployed since February 2022 may constitute a new "blueprint" for sanctions to be applied in future contexts beyond the conflict in Ukraine. In addition, the UK and EU sanctions regimes have not only expanded, but have also undertaken significant institutional reforms. For example, the UK Office of Financial Sanctions Implementation (OFSI) now imposes civil monetary penalties under strict liability (similar to U.S. sanctions). Also, the European Commission introduced measures to harmonize enforcement of EU sanctions across Member States, including a pending proposal for fines on companies of at least 5% of worldwide turnover and imprisonment of individuals for violations of EU sanctions against Russia.

It is thus imperative that boards be aware of the increasingly complex and extensive reach of sanctions across jurisdictions, potential countermeasures from sanctioned jurisdictions and the resulting compliance and business risks.

[1] For additional details, *see* our "Sanctions Developments Resulting From the Conflict in Ukraine" resource center here.

Similarly, close coordination between U.S., EU and UK sanctions authorities over the past 10 months have established new, and strengthened existing, channels that may facilitate future coordination in both the imposition and enforcement of sanctions (including, for example, through the reestablished U.S. Office of Sanctions Coordination at the U.S. Department of State). Of course, such cooperation extends as far as sovereign interests are largely aligned, and even then, as demonstrated by the current conflict in Ukraine, certain divergences between jurisdictions in the scope or timing of sanctions may be unavoidable for technical, legal or political reasons. It is thus imperative that boards be aware of the increasingly complex and extensive reach of sanctions across jurisdictions, potential countermeasures from sanctioned jurisdictions and the resulting compliance and business risks.

Boards should also expect law enforcement and sanctions authorities to continue to take an aggressive enforcement posture with respect to violations of existing sanctions against Russia and to continue to seek novel avenues of asset seizures and forfeitures of sanctions targets.

Entering the new year, as the conflict in Ukraine continues into its second year, new measures against Russia could include additional designations of Russian financial institutions and major businesses, oligarchs, government officials and their close associates; additional designations of sanctions evaders, wherever located; the extension of existing sanctions such as the services bans to new sectors of the Russian economy; and the continued tightening of export controls against Russia (including greater harmonization across partner countries). Boards should also expect law enforcement and sanctions authorities to continue to take an aggressive enforcement posture with respect to violations of existing sanctions against Russia and to continue to seek novel avenues of asset seizures and forfeitures of sanctions targets. Should the situation in Ukraine further deteriorate, the possibility cannot be ruled out that the Russian government may impose strategic limits on the country's export of certain critical minerals and other natural resources, which could impact supply chains ranging from battery manufacturing to automotive and aerospace industries, given Russia's significant share of global supply of such materials. Ultimately, the direction and intensity of further sanctions and other trade controls will be driven by battlefield realities and the prospects for a negotiated settlement to the conflict. Boards of companies with business exposure to Russia and Russian parties—including those continuing to wind down or maintain operations in Russia—should continue to monitor the situation.

Boards should also be aware of the increasing interplay between economic sanctions and energy markets, as demonstrated by recent actions by sanctions authorities. At a high level, such actions demonstrate an aim by western countries to deprive certain regimes of energy revenues while avoiding destabilization of energy prices.

Energy Sector Developments

Boards should also be aware of the increasing interplay between economic sanctions and energy markets, as demonstrated by recent actions by sanctions authorities. At a high level, such actions demonstrate an aim by western countries to deprive certain regimes of energy revenues while avoiding destabilization of energy prices. Such actions include Russia-related measures, as well as the potential easing of U.S. oil-related sanctions on Venezuela and the continuation of sanctions targeting the Iranian oil sector and sanctions evasion efforts.

On December 5, 2022, a new maritime services ban and related price cap targeting Russian-origin crude oil entered into effect among an international coalition of countries comprised of the G7, European Union and Australia.[2] While each coalition member has enacted its own measures to effectuate the ban, persons subject to the jurisdiction of each member are generally prohibited from providing certain services related to the maritime transportation of Russian-origin crude oil unless such oil was sold below a certain price level—initially set at USD $60 per barrel. A similar ban and price cap with respect to Russian-origin petroleum products is scheduled to enter into effect on February 5, 2023. In response, on December 27, 2022, Russian President Vladimir Putin signed a decree that prohibits the supply of Russian-origin oil and oil products to any foreign person with respect to a contract that directly or indirectly presupposes the application of the price cap, unless an exemption is granted by President Putin.

Meanwhile, with respect to Latin America, on November 26, 2022, the U.S. Department of the Treasury, Office of Foreign Assets Control (OFAC) issued two general licenses related to oil activities in Venezuela, in recognition of certain progress that the Maduro regime and the Venezuelan opposition platform made in political negotiations.[3] General License 41 authorizes Chevron Corporation to resume certain joint-venture activities with Petróleos de Venezuela, S.A. (PdVSA), including the production of petroleum and petroleum products and the import of such products into the United States (sales to other jurisdictions remain prohibited). With respect to certain other western oil companies, General License 8K renews an existing general license authorizing limited maintenance and wind down operations involving PdVSA.

Lastly, while negotiations concerning Iran's nuclear program continue to stall, the U.S. government has continued to target Iranian oil distribution channels, including the November 17, 2022 designation of

[2] For additional details on the maritime services ban, *see* our September 2022 and January 2023 blog posts here and here.

[3] For additional details on these developments, *see* our December blog post here.

13 companies for facilitating the sale of Iranian petrochemicals and petroleum products to East Asia, and the December 8, 2022 designation of a prominent Turkish businessman and related persons and entities for facilitating the sale of Iranian oil for the sanctioned Islamic Revolutionary Guard Corps-Qods Force.

Contingency Planning

As demonstrated in the initial weeks of the conflict in Ukraine, economic sanctions and export controls can significantly disrupt a company's operations and require executives and boards to make consequential decisions based on technical rules under significant uncertainty and time constraints. In particular, as the United States and certain allies and partners shift to a more direct policy of containment toward China, and as tensions mount in the Taiwan strait, advanced contingency planning can be invaluable to streamline such decision-making, minimize the risk of sanctions violations and mitigate operational disruptions.

Additional trade restrictions against China are a near certainty in light of the shift in U.S. policy and current political climate.

Given the significant economic interdependence between the U.S. and Chinese economies, a complete embargo between the countries similar to U.S. sanctions against Iran or Cuba is improbable. However, even in the absence of a significant escalation of conflict between the two countries, boards should be aware that, in addition to the measures already taken by the United States during 2022 highlighted below, additional trade restrictions against China are a near certainty in light of the shift in U.S. policy and current political climate, particularly with new political leadership in Congress and the establishment of a new U.S. House Select Committee on China with the stated aim to "restore supply chains and end critical economic dependencies on China," among other priorities.[4]

— On June 21, 2022, the Uyghur Forced Labor Prevention Act entered into effect, imposing a rebuttable presumption that any goods produced in whole or in part from the Xinjiang region of China were made with forced labor and thus prohibited from import into the United States.

— In July and August 2022, Congress passed additional legislation that proscribes certain Chinese-linked entities or items from government subsidies relating to semiconductor manufacturing and electric vehicle batteries.[5]

— On September 15, 2022, President Biden signed an Executive Order identifying national security risks—largely targeting but not explicitly naming China—for CFIUS to consider in its review of inbound investment.[6]

— On October 7, 2022, the U.S. Department of Commerce issued significant new export controls—that include expansive restrictions capturing certain items manufactured outside of the United States using certain U.S. technology—designed to restrict China's ability to obtain advanced computing chips, develop and maintain supercomputers and manufacture advanced semiconductors.[7]

New measures in the coming year could include executive or congressional action to implement a much-discussed national security screening mechanism for outbound investments (*i.e.*, covering investment by U.S.

4 In recent years, U.S. trade controls against China have been primarily limited to sanctions against government officials, sanctions evaders, and Chinese military-linked companies; export control restrictions against specific companies and information and communications technology and services relating to China; and heightened scrutiny by the Committee on Foreign Investment in the United States (CFIUS) in its review of inbound Chinese investments.

5 *See* provisions relating to "foreign entities of concern" under the CHIPS and Science Act, Pub. L. 117167, and the Inflation Reduction Act of 2022, Pub. L. 117169.

6 For additional details, *see* our September blog post here.

7 For additional details, *see* our October blog post here.

persons in China);[8] the expansion of export controls to new sectors, such as quantum computing, artificial intelligence, and biotechnologies; the continued designation of Chinese military-linked companies on export controls and sanctions lists; and the engagement of additional U.S. allies and partners to impose similar export controls and sanctions against China. Such actions may, in turn, increase the likelihood of Chinese countermeasures, including the imposition of sanctions under the Chinese Anti-Foreign Sanctions Law adopted in 2021.[9]

In anticipation of the above and potentially more significant actions and changes, boards may consider preparing advanced contingency plans by identifying key touchpoints to external parties (including suppliers, customers and end-users), outlining potential trade-restriction scenarios and retaliatory countermeasures, evaluating vulnerabilities to their businesses, operations and investments, and, as necessary, mitigating such risks by preparing contingency and crisis response plans.

[8] For additional details, *see* our March 2022 and January 2023 blog posts here and here.

[9] For additional details, *see* our June 2021 blog post here.

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