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ESG

Charting a Course through ESG Challenges: Perspectives From the US, the UK, and Europe

By Andrew Otis and Sonali Siriwardena

On April 18th, Kramer Levin presented a hybrid program, "Charting a Course Through ESG Challenges: Perspectives from the U.S., the U.K. and Europe." Moderated by Kramer Levin partner Andrew Otis, the event was co-sponsored by Simmons & Simmons and designed for financial firms, including asset and investment managers, funds, and corporates.

In case you were unable to attend, below is a summary of key takeaways from the three-part panel discussion:

Part I: Key ESG Regulatory Developments

The first panel covered cross-border regulatory issues. The speakers were Kramer Levin partners Marissa Holob, Reid Feldman, and

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Andrew Otis is a Partner of Kramer Levin Naftalis & Frankel LLP and Sonali Siriwardena is a Partner and Global Head of ESG of Simmons & Simmons.

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Andrew Otis with Simmons & Simmons partners Benedikt Weiser and Sonali Siriwardena.

United States

There is a consensus among many investors and at the federal level that environmentally and socially conscious investments yield greater returns over the long run. However, there is an anti-"woke" backlash among some politicians and state legislators who view these concerns as political issues and ESG programs as the imposition of liberal priorities through nondemocratic means.

ERISA fiduciaries have unique considerations when determining whether, and to what extent, climate change and other ESG factors can be factored into their investment-related decisions. The Department of Labor's position has changed from time to time. It recently finalized regulations, Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, which replaces a 2020 regulation and allows ERISA fiduciaries to consider the economic impacts of climate change and other ESG factors when making investment-related decisions, subject to and in accordance with their fiduciary duties. This rule is currently being challenged in the courts.[1]

When final, proposed SEC climate disclosure rules will require public filers to disclose climate risk, climate management, and greenhouse gas emissions as well as audit and report on how that risk was assessed.[2] Rule opponents argue that it would require nonreporting entities to track emissions and that it goes beyond the SEC's legal authority. The final rule will likely be subject to litigation.

Europe

In general, Europe is further along in terms of issuing guidance related to ESG. The panel noted that one of the goals expressed in the EU treaty is to improve, protect and preserve the environment. There is a conscious effort to reorient capital to sustainable activities, and the European Union is debating issues around taxonomy (vocabulary and criteria for ESG activities) and the Corporate Sustainability Reporting Directive (which requires companies to report and audit detailed information on the impact of corporate activities on the environment and society). These developments may prompt companies to change their behavior in order to have more palatable info to share.[3]

United Kingdom

The U.K. has asserted its independence from EU rules by issuing its own Sustainability Disclosure Requirements to clamp down on "greenwashing." The requirements include the investment labels "Sustainable Impact," "Sustainable Focus" and "Sustainable Improvers," which don't fully align with U.S. categories.[4]

The landscape in the U.K. includes litigation against the board of directors of Shell Corp., alleging that it failed to manage the material and foreseeable risks climate change would have on the company—essentially, that it had not prepared a net-zero strategy in line with the Paris Agreement. This is the first time such ESG-related litigation has been brought.

Part II: Risks of Litigation and Congressional Investigations

The second panel consisted of Kramer Levin partners Barry Berke, Dani James, and Andrew Otis; Kramer Levin counsel Laurie Rubenstein; and Simmons & Simmons partner Sonali Siriwardena.

United States

Panelists expect several House committees to take an active oversight interest in ESG issues this congressional session. With different parties controlling the two houses of Congress, the

House majority will have little ability to enact its legislative priorities, but it will have significant incentive to hold hearings and conduct investigations that will amplify messages on which many 2024 congressional and presidential campaigns will be run. Such hearings can sometimes be surprisingly effective at influencing outside behavior, as well as the way in which agencies implement their rules or pursue enforcement actions.

ESG-focused investing—and disclosure of ESG risks—is anathema to those who embrace anti-“woke capitalism” views. As a result, some House committees have already expressed interest in pursuing the issue—for example, the House Financial Services Committee established an ESG Working Group and the House Judiciary Committee initiated an investigation into claims that climate groups pushing ESG are committing antitrust violations. It is hard to know precisely who will be targeted beyond federal agency representatives.

If a fund or company receives a congressional request for information, it should seek counsel before responding—it may be hard to discern what lies behind the request, and properly managing the response can mean the difference between working quickly and well with a committee and getting sucked into a lengthy, costly and unpleasant investigation. It is important to know that even if a committee’s majority is anti-ESG investing, other committee members likely will want to disseminate positive messages that reflect the value of ESG investing, and it would be important to work with them.

ESG enforcement is a priority for the SEC. One area of focus is “greenwashing”—companies overstating or misrepresenting their ESG accomplishments or investment strategies. Since 2021, the commission has pursued at least half dozen cases based on a company’s lack of internal controls or measurable standards for decision-making and follow-through on ESG claims and commitments.

In response, companies need to have procedures in place to ensure compliance with any stated ESG objectives and documentation supporting any ESG claims. In addition, companies must continually assess the impact of climate-related risk on the results and operations of the business and whether and when such risk requires disclosure.

Europe

As with U.S.–based companies, Europe-based companies should avoid being flag bearers and exercise care in marketing their ESG credentials. Regulators are watching and using enforcement as necessary. More aggressive investigations and enforcement are expected in the next 12–18 months. Companies need to set out what they plan to do, have policies and programs to support that, and then provide evidence of how they achieved those goals.

Part III: Responding to Regulation and Risks

The final panel featured Kramer Levin partners Jamie Kocis, Yasho Lahiri, Alexandre Omaggio, and Andrew Otis with Simmons & Simmons partner Benedikt Weiser.

This panel discussed the question of how an investment qualifies as “green” in the absence of regulation or SEC guidelines. Currently, people use green bonds principles, which encompass the use of proceeds, project evaluation, management of proceeds, and reporting (ideally done by an outside party to confirm benefit to the climate or energy savings).[5] The key takeaway here is that if you say you’re going to do something, you have to do it. Don’t overpromise. Build in metrics and processes, and then document your work and its impact.

On the investment management side, there is an increased demand for metrics, reporting, and proving assertions. Outside parties are proliferating to certify companies’ ESG claims (although a panelist predicted this work will likely fall to nonprofits in the future). With so much more

data produced and reported, the industry will see more digitalization of fund operations. Also, reporting requirements will influence whether fund managers classify their funds as Article 9, Article 8, or Article 6.

Private equity (PE) funds now employ ESG officers for risk management, who support the funds' investment teams in the application of ESG principles at each step of an investment process (due diligence prior to the letter of intent, management of portfolio, exit). PE transactions require more assessment in light of the ESG principles, and ESG due diligence is now a key matter.

ESG undertakings from companies and managers (such as compliance with ESG principles, ESG action plans, and reporting) are increasingly included in the legal documentation supporting the investment. KPIs need to be put in place to ensure the monitoring of compliance by portfolio companies in accordance with the investor's ESG policies and requirements.

Finally, a growing number of PE funds, in particular impact funds (Sustainable Finance Disclosure Regulation Art. 9) are linking a portion of the general partner's compensation to the performance of the portfolio companies on ESG issues.

Notes

1. *https://www.federalregister.gov/documents/2022/12/01/2022-25783/prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights*.

2. *https://www.sec.gov/news/press-release/2022-46*.

3. *https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en*.

4. *https://www.fca.org.uk/publications/consultation-papers/cp22-20-sustainability-disclosure-requirements-sdr-investment-labels*.

5. *https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/green-bond-principles-gbp/*.

California Climate Disclosure Bills Would Have Far-Reaching Implications for Companies Doing Business in the State

By Jennie Morawetz, Alexandra N. Farmer, Abbey Raish, and Paul Barker

On January 30, 2023, two bills containing broad climate-related disclosure obligations for large companies were concurrently introduced to the California Senate. The bills—the Climate Corporate Data Accountability Act (CCDAA) (SB 253) and the Climate-Related Financial Risk Act (CFRA) (SB 261) (together, the "California Bills")—would apply to certain large U.S. companies that "do business in California."

The CCDAA would require subject companies to publicly disclose and verify their Scopes 1, 2, and 3 greenhouse gas (GHG) emissions. The CFRA would require subject companies to prepare and publicly disclose a climate-related risk report in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD, the "TCFD Recommendations"). Because the TCFD Recommendations call for reporting of Scope 1 and 2 emissions and material Scope 3 emissions (and encourage broader Scope 3 emissions reporting), the CCDAA is largely duplicative of the CFRA, though its Scope 3 emissions disclosure requirement is arguably broader.

The California Bills differ slightly in the scope of companies they would affect, and both propose reporting obligations that differ in important ways from the SEC's proposed rules to enhance and standardize climate-related disclosure for investors (the "Proposed SEC Rule").[1] In this article, we discuss the California Bills' provisions, how they compare to the Proposed SEC Rule and potential implications for entities with business ties to California.

Jennie Morawetz, Alexandra N. Farmer, Abbey Raish, and Paul Barker are attorneys of Kirkland & Ellis LLP. *We thank Tony Moller for his valuable research in support of this article.*

CCDAA—Emissions Reporting

The CCDAA would require U.S.–organized entities[2] that "do business in California" and have total annual revenues in excess of $1 billion to calculate, independently verify,[3] and publicly disclose their Scopes 1, 2, and 3 emissions to a state-administered registry annually.

The CCDAA would task the California State Air Resources Board (CARB) with developing, on or before January 1, 2025, regulations to support the bill's disclosure obligations in consultation with state officials, investors, stakeholders from consumer and environmental justice groups, and companies already voluntarily reporting emissions. The regulations would have to require companies to use the Greenhouse Gas Protocol Corporate Accounting and Reporting Standard and the

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Greenhouse Gas Protocol Corporate Value Chain (Scope 3) Accounting and Reporting Standard when reporting. The CCDAA specifies that Scopes 1 and 2 emissions reporting would begin "starting in 2026 on or by a date to be determined by [CARB]" for the calendar year 2025. The deadline for reporting Scope 3 emissions would be 180 days later.

The CCDAA is intended to provide Californians with detailed data on emissions generated by major corporate players in the state, many of whom are not currently subject to GHG emissions reporting laws.[4] The CCDAA is nearly identical to the California Corporate Climate Accountability Act, which was introduced in January 2021 and failed to pass the California Assembly during the 2022 legislative session.[5]

CFRA—TCFD-Aligned Reporting

The CFRA would require U.S.–organized entities[6] that "do business in California" and have total annual revenues in excess of $500 million to prepare, beginning no later than the end of 2024, an annual report disclosing (1) the entity's climate-related financial risk[7] in line with the TCFD Recommendations[8] and (2) measures adopted to reduce and adapt to those risks.[9] It is unclear whether "in line with the TCFD Recommendations" would be interpreted to mean in line *with each* of the TCFD's Recommendations consistent with the latest TCFD guidance, but if interpreted that way, the CFRA would go well beyond current practice for most companies.

As detailed in the 2022 TCFD Status Report, based on a review of TCFD reports for 1,400 large global companies, 80% disclosed in line with at least one of the TCFD Recommendations, but only 4% disclosed in line with all of the TCFD Recommendations.

The CFRA-required disclosures would have to be submitted to CARB and made publicly available on organizations' websites, and subject entities would also be required to issue a statement to the California Secretary of State affirming that the report properly discloses risks in accordance with the CFRA's requirements.

"Doing Business in California"

Neither the CCDAA nor the CFRA defines what it means to "do business in California," but the California Tax Code uses similar language and defines "doing business" as actively engaging in any transaction for the purpose of financial gain within California, being organized or commercially domiciled in California, or having California sales, property or payroll exceed specified amounts. One of the CCDAA's sponsors, Rep. Scott Wiener (D-San Francisco), has indicated that the CCDAA's revenue threshold would capture approximately 5,400 entities; the CFRA, with its lower revenue threshold, would presumably capture even more.

The California Bills do not explicitly address whether asset managers or other financial institutions with offices in or marketing to investors in California are within the scope of the bills, so it remains to be seen how the California Bills will be applied to such entities; however, based on the California Bills' text, it seems possible that such entities could be considered within scope if they meet the revenue thresholds.[10]

Comparison with Proposed SEC Rule

The California Bills' reporting obligations in some respects would go beyond the Proposed SEC Rule, which has received over 15,000 comments and is expected to be finalized soon, albeit potentially in a different form than its proposal.[11] Most notably, the California Bills would apply to both public and private entities meeting each bill's annual revenue threshold, while the Proposed SEC Rule would apply only to publicly listed companies.

CCDAA

With respect to emissions disclosures, several aspects of the CCDAA differ from the current version of the Proposed SEC Rule, including:

- *Mandatory Scope 3 disclosure*: The CCDAA would require mandatory disclosure of Scope 3 emissions for all reporting entities, while the Proposed SEC Rule would require Scope 3 disclosure only when Scope 3 emissions are determined to be "material" or if the company has set a GHG emissions reduction target or goal that includes Scope 3 emissions. The Proposed SEC Rule's Scope 3 requirement has been the subject of significant debate, so it is unclear what form the final rule will take on this point. Also of note, unlike the current Proposed SEC Rule, the CCDAA does not include any sort of "safe harbor" for Scope 3 disclosures, and in fact, authorizes the California Attorney General to bring a civil action seeking civil penalties against reporting entities found to violate the bill's reporting requirements.

- *Independent verification for all emissions*: The CCDAA would require "independent verification" by a CARB-approved verifier for Scopes 1, 2, and 3 emissions. It does not specify the level of assurance required; CARB is expected to develop more detailed regulations. Although Scope 3 coverage remains uncertain (see above), the Proposed SEC Rule would require independent attestation of Scopes 1 and 2 emissions for large accelerated and accelerated filers, starting at the limited assurance level and progressing to reasonable assurance in subsequent years.

- *Organizational boundaries*: The CCDAA would require companies to disclose emissions in line with the GHG Protocol, which allows disclosing entities to set organizational boundaries using *either* an equity share or a control approach.[12] In contrast, the current version of the Proposed SEC Rule would require companies to set organizational boundaries in line with the accounting principles used in preparing their consolidated financial statements.

CFRA

With respect to climate-related financial risk, the CFRA appears to fully embrace the TCFD Recommendations as its disclosure requirements. As noted above, if the CFRA is interpreted to require reporting in line with each of the TCFD's Recommendations consistent with the latest TCFD guidance, it would go well beyond current practice for most companies. Further, although the SEC drew heavily on the work of the TCFD, the Proposed SEC Rule as drafted departs from the TCFD Recommendations in certain respects, including[13]:

- *Transition plans*: The current version of the Proposed SEC Rule would require disclosure of transition plans only if they have been adopted as part of an entity's climate-related risk management strategy. The TCFD has indicated that the TCFD Recommendations related to strategy "implicitly cover the key aspects of transition plans," and has said that entities should disclose transition plans if they have made GHG reduction commitments, operate in jurisdictions that have made such commitments or have agreed to meet investor expectations regarding emissions reductions.

- *Scenario analysis*: The TCFD Recommendations require organizations to conduct scenario analysis to assess their climate-related risks and opportunities. The current version of the Proposed SEC Rule would not require organizations to conduct scenario analysis; rather, it would require organizations that *have conducted* scenario analysis to disclose the parameters, assumptions, analytical choices, and projected financial impacts of that analysis. Therefore, publicly listed entities fulfilling the requirements of the CFRA could have to disclose information about their scenario analysis to the SEC.

- *Climate-related opportunities*: The TCFD Recommendations require entities to consider and report climate-related opportunities in addition to risks, while the Proposed SEC Rule would make disclosure of climate-related opportunities optional.

- *Sector-specific reporting*: While the Proposed SEC Rule is sector-agnostic, the TCFD has published supplemental guidance for specific sectors such as financial institutions, energy, transportation, materials and buildings, and agriculture and forestry. Entities in sectors for which the TCFD has issued additional guidance could arguably be required to make sector-specific disclosures under the CFRA.

- *Financial statement metrics*: Assuming threshold requirements are met, the current version of the Proposed SEC Rule requires companies to provide climate-related financial metrics addressing the impact of various climate-related events and mitigation and transition expenditures on line items in the financials, together with related estimates and assumptions, in a note to the company's audited financial statements. This requirement goes beyond the TCFD Recommendations and, presumably, the CFRA, but is another area of significant debate, making it uncertain what, if any form, it will take in the final SEC rule.

Notably, the CFRA provides that, if a federal law or regulation is passed that requires an entity to disclose information that is "materially similar" to the CFRA's requirements, then a copy of the entity's relevant federal climate risk disclosure may be submitted to CARB in lieu of a California-specific report. It remains to be seen whether the final SEC rule would be determined to meet this bar.

Key Considerations

Since their introduction, both California Bills have passed through an initial review by the California Senate Environmental Quality Committee. However, it remains unclear whether either of the California Bills will be signed into law. In order to do so, the California Bills must survive multiple rounds of committee and full chamber votes in both the California Senate and Assembly and be signed by Governor Gavin Newsom before October 15, 2023. Future review and revision of the California Bills may lead to significant changes in their requirements.

If passed, the California Bills would apply to entities outside and require reporting beyond the scope of the Proposed SEC Rule, as currently drafted. Private and public companies that fall (or likely fall) within the definition of a "reporting entity" under either of the California Bills can start preparing for the possibility of enactment by taking measures such as:

- Conducting an enterprise-wide[14] GHG inventory across their Scopes 1, 2, and 3 emissions;

- Engaging with a CARB-approved verifier to understand their typical scopes of work, timing and costs, and whether they are also capable of meeting the independent attestation requirements in the Proposed SEC Rule; and

- Conducting a gap analysis against the TCFD Recommendations.

Companies that would not directly be subject to the CCDAA or CFRA but that lie within the value chains of reporting entities, if the California Bills are enacted, could be pressured to report their emissions and other climate-related information in order to help a reporting entity fulfill its disclosure obligations. Many large companies that would be subject to the California Bills' reporting obligations have supply chains or investments encompassing thousands of individual companies across multiple global jurisdictions.

Certain companies may wish to consider participating in the political process in addition to monitoring the progress of the CCDAA, the CFRA, the Proposed SEC Rule, and other climate reporting legislation that could impact

them. Additionally, companies should expect that if either or both of the California Bills is signed into law, they could—like the Proposed SEC Rule—be the subject of litigation that extends the period of regulatory uncertainty.

Notes

1. We discuss the Proposed SEC Rule in our March 24, 2022, *Kirkland Alert*, "SEC Proposes New Climate Disclosure Requirements," available at *https://www.kirkland.com/publications/kirkland-alert/2022/03/sec-proposes-new-climate-disclosure-requirements*.

2. This requirement captures all partnerships, corporations, limited liability companies, or other businesses formed under the laws of any state or the District of Colombia, or under an act of Congress.

3. Reported emissions inventories would have to be independently verified by a third-party auditor approved by the California Air Resources Board (CARB). A list of CARB-accredited verifying bodies and individual verifiers—as well as the criteria and process for accreditation—can be found at *https://ww2.arb.ca.gov/verification*.

4. Industrial sources, fuel suppliers, and electricity importers are required to report their annual GHG emissions to CARB under the state's Regulation for the Mandatory Reporting of Greenhouse Gas Emissions, available at *https://ww2.arb.ca.gov/mrr-regulation*. Those reporters subject to the California Cap-and-Trade Program are required to seek independent, third-party auditing of their emissions inventories by a CARB-approved verifier. The Act expands similar requirements to additional firms.

5. The CCDAA is also similar to a New York State Senate Bill introduced in January 2023. *See https://www.nysenate.gov/legislation/bills/2023/s897*.

6. The CFRA defines "covered entities" the same as the CCDAA, except that it expressly exempts insurers, likely because on April 8, 2022, the National Association of Insurance Commissioners, which includes California's Insurance Commissioner, adopted a new standard requiring insurers to report climate-related risks in line with the TCFD Recommendations. *See https://content.naic.org/sites/default/files/inline-files/2022ProposedClimateRiskSurvey_0.pdf?msclkid=e24cf6f2b47211eca09ac1c752e22857*.

7. The CFRA defines "climate-related financial risk" as "material risk of harm to immediate and long-term financial outcomes due to physical and transition risks, including, but not limited to, risks to corporate operations, provision of goods and services, supply chains, employee health and safety, capital and financial investments, institutional investments, financial standing of loan recipients and borrowers, shareholder value, consumer demand, and financial markets and economic health."

8. We explore the TCFD Recommendations in our November 10, 2021, *Kirkland Alert*, "TCFD Issues New Guidance as Its Climate Reporting Framework Continues to Gain Traction," available at *https://www.kirkland.com/publications/kirkland-alert/2021/11/tcfd-new-guidance-on-climate-reporting-framework*.

9. The second requirement is somewhat redundant, as the TCFD Recommendations include disclosure of how an organization "identifies, assesses, and manages climate-related risks."

10. *Cf*. Bill Myers, "California ESG Bill Gets Closer" (Mar. 27, 2023) ("[The CCDAA] would cover nearly 5,400 companies — including private fund advisers and their portfolio companies."), available at *https://www.newprivatemarkets.com/california-esg-bill-gets-closer*. During a March 15, 2023, Senate Environmental Quality Committee Hearing, Senator Stern, a sponsor of the CFRA, indicated that the intent of the CFRA is to cover alternative asset managers.

11. The SEC's latest Reg-Flex agenda suggests final action in April 2023. *See https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202210&RIN=3235-AM87*.

12. Under equity share GHG accounting as defined by the GHG Protocol, companies report emissions from other entities based on their percentage ownership of that entity. Under control-based GHG accounting, companies claim the full emissions inventory of entities over which they hold either operational or financial control, between which companies are allowed to choose.

13. During a March 15, 2023, Senate Environmental Quality Committee Hearing, Senator Stern, a sponsor of the CFRA, indicated that the intent of the CFRA is to fill gaps in the Proposed SEC Rule, suggesting it is meant to be broader than the Proposed SEC Rule in at least some respects.

14. Companies preparing to disclose in line with the Proposed SEC Rule should be aware that they may be required to report emissions to the California Secretary of State along different organizational boundaries than those reported to the SEC.

SEC Adopts Amendments to Enhance Company Stock Repurchase Disclosure Requirements

By Ronald O. Mueller, James J. Moloney, Lori Zyskowski, Tom Kim, and Maggie Valachovic

On May 3, 2023, the Securities and Exchange Commission ("SEC" or "Commission"), in a 3-to-2 vote, adopted amendments to the disclosure requirements relating to companies' repurchases of their equity securities.

The amendments will require companies to (i) disclose daily repurchase data in a new table filed as an exhibit to Form 10-Q and Form 10-K, (ii) indicate by a check box whether any executives or directors traded in the company's equity securities within four business days before or after the public announcement of the repurchase plan or program or the announcement of an increase of an existing share repurchase plan or program, (iii) provide narrative disclosure about the repurchase program, including its objectives and rationale, in the filing, and (iv) provide quarterly disclosure regarding the company's adoption or termination of any Rule 10b5-1 trading arrangements. The new amendments will invite enhanced scrutiny of companies' share repurchase practices and rationales.

While reflecting a prescriptive and perhaps quixotic approach to a perceived potential for abuse that the SEC acknowledges is not present in many, or perhaps even most, share repurchases, the final rules reflect a significant paring back from the SEC's initial proposal, which would have required daily reporting of repurchases on a next-day basis.

The SEC also confirmed that companies that rely on recently amended Rule 10b5-1 will not be subject to a cooling-off period, any limitation on the use of multiple overlapping plans, any limitation on the use of single-trade plans, or any disclosure regarding so-called "non-10b5-1 trading arrangements." These changes reflect the SEC's responsiveness to constructive and pragmatic comments received on its rule proposals, offering a sign of hope for other pending SEC rulemaking initiatives.

The final rules will become effective 60 days after publication in the Federal Register.[1] For companies that file on domestic forms, the disclosure requirements will apply to Forms 10-K or 10-Q filed for the first full fiscal quarter beginning on or after October 1, 2023. For calendar year companies, this means that the new disclosures will first appear in their 2023 Form 10-K, showing any repurchases made (and disclosing any related Rule 10b5-1 trading arrangements entered into or terminated) during the fourth quarter. Later effective dates apply for foreign private issuers (FPIs) and listed closed-end funds, but there are no delays for other categories such as for smaller reporting companies.

Set forth below is a summary of the amendments and some considerations for companies in connection with these SEC rule amendments.

Summary of Amendments

New Periodic Reporting Requirements for U.S. Companies. The amendments introduce the following new periodic reporting requirements:

1. *Daily Quantitative Transaction Disclosure, Reported Quarterly*. Prior to the adoption of these amendments, Item 703(a) of Regulation S-K required companies to include in their Forms 10-Q and 10-K a table reporting specified information on company repurchases of equity securities during each month of the previous quarter, on an aggregated monthly basis. The new amendments require tabular disclosure of the company's

Ronald O. Mueller, James J. Moloney, Lori Zyskowski, Tom Kim, and Maggie Valachovic are attorneys of Gibson, Dunn & Crutcher LLP.

daily repurchase activity during the prior quarter.

The tabular disclosure will be filed as an exhibit to a company's Form 10-Q or Form 10-K, with FPIs required to report the information quarterly on a new Form F-SR, and listed closed-end funds reporting the information in their semiannual and annual reports on Form N-CSR. There are no exceptions to the reporting requirements, including for smaller reporting companies or for classes of equity securities that are not exchange-traded. A copy of the required format for this table, which will appear as Exhibit 26, is included as an Exhibit to this client alert. The exhibit must be provided in XBRL-tagged format, and must report, for each day on which shares were repurchased:

- the date that the purchase of shares is executed,
- the class of shares repurchased,
- the average price paid per share,
- the total number of shares purchased, including the total number of shares purchased as part of a publicly announced plan,
- the aggregate maximum number of shares (or approximate dollar value) that may yet be purchased under a company's publicly announced plan,
- the number of shares that were purchased on the open market,
- the number of shares purchased in transactions intended to qualify for the safe harbor in Rule 10b-18, and
- the total number of shares purchased pursuant to a plan that is intended to satisfy the affirmative defense conditions of Rule 10b5-1(c), together with a footnote disclosing the date of adoption or termination of the Rule 10b5-1(c) plan.

2. *Check the Box Disclosure*. Companies will be required to include a checkbox preceding the tabular disclosure, indicating whether any Section 16 officer or director purchased or sold shares that are the subject of a publicly announced plan or program within four business days before or after the company's announcement of the stock repurchase plan or program, or the announcement of an increase in the number or amount of securities to be purchased under an existing plan or program.

3. In response to comments, the SEC confirmed that a company may include additional disclosure to provide context to investors regarding any purchases or sales that trigger the checkbox requirement, and the SEC even noted that such disclosure would be required if material and necessary to prevent the required disclosures from being misleading.

4. *Narrative Disclosure*. In addition to requiring tabular disclosures, the new amendments expand upon the existing requirement for narrative disclosures of repurchases in periodic reports. In the section of their Forms 10-Q and 10-K where companies currently report aggregated monthly data on their share repurchases, companies will be required to disclose the following information, and to refer to the particular repurchases in the exhibit table that correspond to the different parts of this narrative:

   - the objectives or rationales for each share repurchase plan or program,
   - the process or criteria used to determine the amount of repurchases,
   - the number of shares purchased *other* than through a publicly announced plan or program, and the nature of the repurchase transactions, such as whether the purchases were made pursuant to equity compensation arrangements, tender offers, etc., and

- any policies and procedures relating to the purchases and sales of the company's securities during a repurchase program by its officers and directors, including whether there are any restrictions on such transactions.

As is currently the case, if a company's repurchase plan or program was publicly announced, the disclosure also must state:

- the date each plan or program was announced,
- the dollar or share amount approved,
- the expiration date, if any, of the plan or program,
- each plan or program that has expired in the relevant period, and
- each plan or program that the company has determined to terminate prior to expiration, or under which the company does not intend to make further purchases.

4. *Disclosure Requirements for 10b5-1 Plans*. In rules adopted last December, the SEC required companies to disclose in their periodic reports whether any executives or directors had entered into or terminated Rule 10b5-1 trading plans (including a modification that is treated as a termination and new plan) and to provide a description of the material terms of any such plans. The issuer repurchase rules adopted by the SEC require substantially similar disclosure regarding any Rule 10b5-1 plan adopted or terminated by the company.

   As with Rule 10b5-1 trading plans adopted by an executive or director, the company will be required to disclose the date on which it adopted or terminated a Rule 10b5-1 trading plan, the duration of the plan, and the aggregate number of shares to be purchased or sold pursuant to the arrangement. However, in contrast to the disclosure rules applicable to trading plans adopted by executives and directors, companies are not required to disclose whether they entered into an arrangement that meets the SEC's definition of a "non-Rule 10b5-1 trading arrangement."

   As noted above, the SEC also stated that it is not imposing additional conditions on the availability of the Rule 10b5-1 affirmative defense on companies, such as a cooling-off period, limitations on the use of multiple overlapping plans, or limitations on the use of single-trade plans.

New Periodic Reporting Requirements for Foreign Private Issuers and Listed Closed-End Funds. The amendments impose substantially similar requirements on FPI and listed closed-end funds as they do on domestic companies. The requirements that differ for FPIs and listed closed-end funds are described below:

1. *Foreign Private Issuers.* FPIs will be required to provide the disclosures described above under the new amendments quarterly in their Forms F-SR beginning with the first full fiscal quarter that begins on or after April 1, 2024. Prior to the adoption of these amendments, FPIs were required to annually disclose any company repurchases, aggregated on a monthly basis. Under the new amendments, any FPI that has a class of equity securities registered pursuant to Section 12 of the Exchange Act and does not file Forms 10-Q and 10-K will be required to file a Form F-SR within 45 days after the end of each quarter disclosing the aggregate stock repurchases made each day during the prior quarter. The narrative disclosures required of U.S. domestic companies will be required in FPIs' future Form 20-F filings.

   In his remarks dissenting from the adoption of the amendments, Commissioner Uyeda emphasized that the new requirements for FPIs represent a break from the SEC's traditional deference to home country disclosure standards.[2] Commissioner Uyeda expressed concern that these amendments

could signal to international partners that the United States no longer respects the principles of mutual recognition and international comity which facilitate streamlined access to international securities markets. As such, Commissioner Uyeda expressed concern that these amendments could lead to a decline in the number of foreign companies listed in the United States and increase compliance costs for U.S. companies with international operations, ultimately harming U.S. investors and consumers.

2. *Listed Closed-End Funds.* Listed closed-end funds will be required to provide the disclosures described above under the new amendments semi-annually beginning with the Form N-CSR that covers the first six-month period that begins on or after January 1, 2024. Prior to the adoption of these amendments, listed closed-end funds were required to disclose semi-annually any company repurchases, aggregated on a monthly basis.

Considerations and Next Steps

Expect interpretive issues and (hopefully) guidance. The SEC noted that companies can continue to rely on the Commission Staff's existing "Compliance and Disclosure Interpretations" addressing whether certain transactions are covered by the issuer repurchase disclosure rules. Thus, for example, a company's acquisition of shares that are tendered to pay the exercise price of an employee stock option will continue to be a reportable repurchase, whereas withholding shares to pay taxes on the option exercise or upon vesting of restricted stock units will not be.

Nevertheless, as with any new set of regulations, companies should expect a number of interpretive questions to arise. For example, while the instructions to the checkbox requirement state that companies generally can rely on Section 16 filings in determining whether they need to check the box, it is unclear whether transactions that are exempt from Section 16 reporting, such as dividend reinvestments and 401(k) plan transactions, trigger the checkbox requirement.

While the Division of Corporation Finance has continued to express its willingness to address questions arising under its rules, guidance on recently adopted rules has been slow and sparse. Therefore, companies should closely review the new disclosure requirements in the near term and assess whether there are questions on how the rules apply to their own particular repurchase practices so that the issues can be carefully vetted with in-house and outside counsel.

Companies will need to carefully consider and appropriately revise disclosures regarding the "objectives or rationales" for share repurchases. The SEC emphasized that a company's discussion of its objective or rationales for repurchases should not be a "boilerplate." Indeed, the rules contemplate that different objectives or rationales could apply to different repurchases reported in the same quarterly report.

For example, repurchases under equity compensation plans will have a different rationale than open-market repurchases designed to return excess capital to shareholders. Thus, it will be necessary for companies to tailor and adjust their disclosures from time to time as appropriate. In this regard, the SEC's adopting release provides some examples of the types of topics that may be included in such disclosures, such as discussing how repurchases fit within the company's capital allocation plans, whether repurchases were driven by a view that the company's stock was undervalued, or addressing the source of funds for repurchases (such as whether proceeds from the disposition of a business unit were utilized to fund repurchases).

We expect that for many companies with ongoing repurchase programs designed to return excess capital to investors, these "objectives or rationale" disclosures may not vary from quarter to quarter. Nevertheless, companies should establish disclosure controls to ensure that such disclosures are reviewed and confirmed or adjusted as appropriate each quarter.

In addition, companies will want to ensure that comments by their executives on earnings calls and at other venues regarding the company's share repurchases are consistent with the disclosures in their Forms 10-Q and 10-K.

Companies should document their processes for implementing share repurchases. The insider trading rule amendments adopted by the SEC in December 2022 require companies to file as exhibits to their Form 10-K any insider trading policies and procedures applicable to purchases and sales of the company's securities by the company.

While the SEC Staff has informally indicated that this insider trading policy exhibit requirement applies to calendar year companies starting with their 2024 Form 10-Ks, the new share repurchase rules require companies to disclose the "process or criteria used to determine the amount of repurchases" starting with calendar year companies' 2023 Form 10-K. Companies should therefore bear in mind these separate but related disclosure requirements as they prepare to describe their processes around share repurchases.

Companies should consider whether to establish policies or procedures relating to the purchase or sale of shares by officers and directors during the time that a company's repurchase program is active. Many companies with active and ongoing share repurchase programs do not preclude sales by executives and directors while the companies' repurchases are ongoing. We believe allowing insider transactions in this context is entirely appropriate, and view the potential for abuse in these situations as largely theoretical.

Moreover, compliance with Rule 10b-18, which is a safe harbor designed to prevent issuer repurchases from pushing up a company's stock price, should provide additional comfort that same-day insider sales and company repurchases are not designed to benefit insiders, as should the use of Rule 10b5-1 trading plans. However, with the advent of trade-day reporting by companies, companies should expect that there will be greater scrutiny by the SEC, shareholders, and the press of insider sales and company repurchases that occur on the same day. Therefore, to the extent they do not already do so, companies should monitor and keep track of their insiders' open market transactions, whether pursuant to Rule 10b5-1 plans or otherwise, so that they can evaluate the risks of corporate actions or significant announcements that might be viewed as questionable in hindsight.

Companies also may want to consider whether to develop policies or procedures addressing potential appearance issues that could arise if they are effecting relatively isolated or unusually large repurchases (other than pursuant to a company's Rule 10b5-1 buyback plan) on the same day as significant sales by insiders, particularly if those sales are effected by the CEO or by executives who might be expected to be involved in managing the company's repurchase program, such as the CFO.

Exhibit: Tabular Disclosure Format

Issuer Purchases of Equity Securities

Use the checkbox to indicate if any officer or director reporting pursuant to Section 16(a) of the Exchange Act (15 U.S.C. 78p(a)), or for foreign private issuers as defined by Rule 3b-4(c) (§ 240.3b-4(c) of this chapter), any director or member of senior management who would be identified pursuant to Item 1 of Form 20-F (§ 249.220f of this chapter), purchased or sold shares or other units of the class of the issuer's equity securities that are registered pursuant to section 12 of the Exchange Act and subject of a publicly announced plan or program within four (4) business days before or after the issuer's announcement of such repurchase plan or program or the announcement of an increase of an existing share repurchase plan or program.

(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
Execution Date	Class of Shares (or Units)	Total Number of Shares (or Units) Purchased	Average Price per Share (or Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	Aggregate Maximum Number (or Approximate Dollar Value of Shares or Units) that May Yet Be Purchased Under the Publicly Announced Plans or Programs	Total Number of Shares (or Units) Purchased on the Open Market	Total Number of Shares (or Units) Purchased that are Intended to Qualify for the Safe Harbor in Rule 10b-18	Total Number of Shares (or Units) Purchased Pursuant to a Plan that is Intended to Satisfy the Affirmative Defense Conditions of Rule 10b5-1(c)
[insert additional rows as necessary for each day on which a repurchase was executed]								
Total:								

Notes

1. The 200+ page adopting release is available at *https://www.sec.gov/rules/final/2023/34-97424.pdf* - and a Fact Sheet is available at *https://www.sec.gov/files/34-97424-fact-sheet.pdf*.

2. *https://www.sec.gov/news/statement/uyeda-statement-share-repurchase-disclosure-modernization-050323*.

Enterprise Risk Management: What Is It? Should You Care? Where to Start?

By Lenin Lopez

Corporate scandals and failures are ever-present. The last few years have provided us with examples from healthcare providers, life science, banking, cryptocurrency, and automotive manufacturing. With the benefit of hindsight, it's easy to see the root-cause risks associated with these scandals and failures. A lack of oversight, gaps in controls, or bad actors may have been to blame. The common theme is poor corporate governance and risk management.

We've addressed the importance of board-level monitoring of company risks—including why boards should identify their company's most important risks and ensure they have sufficient board-level compliance and reporting systems in place for the company's central risk and compliance issues. This article will peel back a few layers of that onion.[1]

Specifically, this article will:

- Describe challenges associated with the risk assessment process.
- Explain what an enterprise risk management (ERM) program is.
- Provide steps for developing your company's first ERM program.

Assessing Risks

A clear understanding of your company's risk profile will help you make informed decisions about how to allocate resources and develop strategies to manage risk.

Lenin Lopez is a corporate securities attorney for Woodruff Sawyer, a D&O insurance provider.

Easier said than done.

For example, consider life science companies. Top risks inherent in that industry may include product safety, data privacy, patent protection, cyber risks, changing or increased legislation, and the cost of litigation. The challenge comes when you attempt to assess the likelihood and potential impact of those risks, along with any other internal and external risks.

Every company with current operations performs some form of risk assessment. Internal audit, legal, treasury, compliance, and human resources are just a few of the functions that assess risk. While each is likely focused on the common goal of ensuring the success of the business, they are likely looking at risk through their own rubrics.

Early-stage companies may find that ad-hoc risk assessment works. As companies grow, so do complexities and the chance that employees are performing risk assessment and management within silos. This is all well and good, except when risks materialize and become a significant issue—and the matter continues to be addressed within those same silos. Risks abound in these situations, including delayed reporting to other relevant functions within the organization or regulators, as well as failure to elevate the issue to the board and management. This is where an ERM program can help.

Enterprise Risk Management: A Team Sport

Even though ERM programs and compliance programs tend to be spoken of interchangeably, they are not the same thing. A company's compliance program is generally focused on ensuring compliance with applicable laws, rules, and

regulations. A compliance program—or at least identifying the laws, rules, and regulations applicable to your company—is a necessary predicate to an ERM program.

It sounds similar, but here's how they are different. For example, for healthcare providers, compliance programs will typically focus on implementing the policies, procedures, and standards of conduct associated with ensuring compliance with the Health Insurance Portability and Accountability Act of 1996 (HIPAA). An ERM program, in contrast, can help identify **risks** that may impact the company's ability to comply with HIPAA (e.g., threats to information systems, third-party access to company data), assess the degree of each of those risks, and recommend how those risks can be prevented and more easily detected and managed should they materialize. It will also, among other things, evaluate the company's level of preparedness, identify opportunities to enhance its risk management process, and develop action plans to mitigate risks.

Collaboration between the compliance function and the ERM function can go a long way in a company's ability to identify and manage risks. For example, working together and sharing information can help to avoid redundancies and limit blind spots. For a further discussion of compliance programs, the Department of Justice (DOJ) has published a list of components of what it views as an effective compliance and ethics program for purposes of criminal investigations.[2] The DOJ has updated guidance on the subject over the years.[3]

As noted above, some companies manage risk in silos. Unfortunately, in the absence of thoughtful intervention, these companies typically end up approaching risk on an informal and uncoordinated basis. While these companies will be able to identify operational and compliance-related risks, they will likely lack the enterprise-wide view of risks that may impact their business. This enterprise-wide view of risks is imperative for the board and management in terms of their decision-making process and oversight responsibilities.

Developing Your First ERM Program

Most large private companies and all public companies want to implement and maintain an ERM program. The barrier to entry for many, however, maybe the perceived cost and resources necessary to implement such a program. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) released a thought paper discussing the importance and need for an ERM process in all types of organizations.[4] The paper also provides steps that a company can take in its effort to develop and implement its first ERM program. It's a good starting point given that COSO—which develops guidelines for businesses to evaluate internal controls, risk management, and fraud deterrence—also developed the COSO ERM–Integrated Framework, one of the most widely recognized and applied risk management frameworks in the world.

Below are a few keys to success and initial action steps associated with developing and implementing a tailored ERM program, adapted from the COSO thought paper:

1. *Don't Try to Boil the Ocean*

Out of the gate, avoid the trap of attempting to copy a company's mature ERM program. That should be a long-term goal rather than a company's first ERM initiative. Generally, the goal of a company's first ERM initiative should be enhancing existing risk management processes. That may mean improving the risk assessment process, identifying a few critical risks within the company that can be managed, and building upon that. An iterative approach works best, allowing you to enhance and/or develop processes around these risks and then expand them to include other risks.

2. *Secure Board and Management Support*

The board and management set the tone for a company's culture, including compliance and risk. Without their support, it's unlikely

an initiative to develop an ERM program will receive the necessary attention, resources, or buy-in from others within the company. Reasons for boards and management teams to support an ERM program are plentiful, including helping to improve decision-making and reducing the frequency and severity of loss.

3. *Establish a Working Group and a Leader to Drive the ERM Initiative*

An ERM program will require cooperation across the organization. Establishing a working group, as well as a leader or leaders to drive the initiative, will help ensure the project receives the appropriate attention and support within the organization.

For example, a pharmaceutical company may be best served by including representatives from each of the following functions within its ERM working group: compliance, human resources, legal, IT, supply chain, finance, manufacturing, R&D, and investor relations.

Your company can approach the assignment of an ERM initiative leader or leaders in various ways. Consider appointing an existing officer (e.g., chief financial officer or general counsel) or one of their direct reports. If it is a direct report, it's best that they are senior enough to be viewed as having authority within the organization and having the presence to present confidently to the board. For an overview of ERM practices, including different approaches to the assignment of risk management leadership, see this report from the ERM Initiative in the Poole College of Management at North Carolina State University.[5]

4. *Leverage Existing Risk Management Processes*

As noted earlier, many companies that lack an ERM program manage risk on an informal and uncoordinated basis. In other words, companies launching an ERM initiative typically don't start from scratch. Leveraging existing risk management processes and pulling them into the company's ERM initiative will allow the company to harmonize disparate processes and improve upon them.

5. *Conduct an Enterprise-Wide Risk Assessment*

With an ERM initiative leader and working group in place, companies are in a prime position to begin identifying their strategic business objectives and risks that could impair each of those strategies. This assessment will go beyond what many are familiar with when it comes to risk factors included in a company's annual report, which is generally focused on the probability and impact of risks. As noted earlier, an ERM program risk assessment will also, among other things, consider the company's level of preparedness, identify opportunities to enhance the risk management process, and develop action plans to mitigate risks.

6. *Develop Initial Risk Reporting*

Companies will also need to develop an approach to ERM program risk reporting, including how risks will be socialized within the organization, target audiences for the report, and reporting format. The format can be a simple list, tabular spreadsheet, scorecards, or heatmap. All said, the process of distilling multiple risks to those that are most pertinent to the board and management can be complex. For examples of common practices used by companies to communicate risks to the board, see this report from North Carolina State University's ERM Initiative. Companies will also want to consider how to report out on tracking and monitoring progress on action plans.[6]

7. *Develop the Next Phase of the ERM Program*

Once an ERM program is established, your company will need to maintain and continuously improve upon it. That may mean restructuring

working groups, changing risk management leaders, modifying reporting processes, appointing a chief risk officer, or having members of the board and management team participate in ongoing education offerings specifically focused on ERM.

Some questions worth asking might be:

- Does management view the ERM program as important to the company's success? If not, what steps can be taken to change that view?
- What assumptions are being made in the context of the company's ability to manage risks?
- Do those assumptions hold true?

Parting Thoughts

Implementing an ERM program may seem daunting, but it's manageable. Taking a proactive approach to risk management on an enterprise level can help mitigate risk—and enhance the company's reputation with stakeholders and regulators by showing its commitment to responsible risk management practices. The alternative is rife with risk.

Notes

1. *https://woodruffsawyer.com/do-notebook/board-level-monitoring/*.

2. *https://guidelines.ussc.gov/gl/%C2%A78B2.1*.

3. *https://www.mofo.com/resources/insights/230309-doj-revises-its-guidance-on-corporate-compliance-programs*.

4. *https://www.coso.org/Shared%20Documents/Embracing-ERM-Getting-Started.pdf*.

5. *https://erm.ncsu.edu/az/erm/i/chan/library/2022-risk-oversight-report-erm-ncstate.pdf*.

6. *https://erm.ncsu.edu/az/erm/i/chan/library/2015-erm-reporting-key-risk-information-to-board-directors.pdf*.

Now You See Them, Now You Don't: Regulatory Risks of Ephemeral Messages

By Dave Anderson, Alexa Poletto, David Silva, and Felicia Ng

Corporate use of ephemeral messaging applications (communications that disappear after a set time) has become increasingly common across the globe in recent years, with companies recognizing its value in decreasing data storage costs and providing employees a convenient method for communicating quickly with customers and clients. However, the prevalence of these messaging applications in the corporate context has caused regulators to grow concerned about how encrypted and ephemeral messaging might affect regulatory obligations related to data preservation, employee monitoring, and compliance.

In the United States, the Department of Justice (DOJ) and Securities and Exchange Commission (SEC) have increasingly focused on how companies can implement controls around these applications that fit their particular risk profile.[1] Similarly, other global regulators—including the European Union (EU), the United Kingdom (UK), and Hong Kong—have adopted their own policy requirements for corporate use of ephemeral messaging. Companies operating outside the United States cannot assume that U.S. compliance will meet the requirements of these diverse jurisdictions and must tailor their approach to the regulations and messaging culture of each jurisdiction.

This article considers recent U.S. regulatory developments, canvasses the approach and regulations adopted outside the United States around ephemeral messaging, and urges a global assessment of this emerging risk.

Dave Anderson, Alexa Poletto, David Silva, and Felicia Ng are attorneys of Sidley Austin LLP.

Recent Developments in the United States

In 2017, the DOJ took the position that companies under investigation for violations of the U.S. Foreign Corrupt Practices Act were at risk for not receiving full credit for timely and appropriate remediation if they did not prohibit ephemeral messaging. However, by 2019, DOJ policy updates contemplated providing cooperation credit to such companies if they could prove that they had established appropriate safeguards to properly retain and prevent the improper destruction of business records, including implementing guidance and controls on the use of ephemeral messages.

More recently, the DOJ and SEC have signaled that ephemeral messaging is a prime focus for regulators, and when making decisions about corporate liability for misconduct and future settlements, their focus will be on whether the controls implemented around these communications are sufficient in light of a company's unique risk profile.

In September 2022, Deputy Attorney General (DAG) Lisa Monaco issued a directive to study corporate best practices regarding the use of personal devices and third-party messaging platforms, including ephemeral and encrypted messaging.[2] Just days later, the SEC announced the imposition of over US $1.1 billion in penalties on over a dozen financial institutions resulting from their failure to implement and maintain proper controls over business-related communications, including those conducted over such "off-channel" mediums as WhatsApp and Signal.[3] Continuing this trend—and in response to DAG Monaco's directive—on March 3, 2023, the DOJ issued updated guidance on the evaluation of corporate compliance programs in which employees' use of ephemeral messaging was

specifically highlighted as a factor for consideration by prosecutors.[4]

Global Regulatory Developments

While the scrutiny on employees' use of ephemeral messaging is generally framed from the U.S. perspective, the implications of ephemeral messaging usage are much more widespread. For instance, WhatsApp has over 2.24 billion users per month. In 2022, WeChat reached 811 million users in China, accounting for over 57% of its population, and KakaoTalk reached 47 million users in South Korea, accounting for over 90% of its population. In its November 23, 2020, resolution on encryption, the EU observed that encrypted communications—which tend to include ephemeral messaging functionality—protect data privacy and confidentiality and are an "important tool" for the protection of data transfers out of the EU.[5]

However, much as in the United States, global regulators have expressed reservations about the use of ephemeral messaging and its impact on the retention of business information for investigative purposes. In its 2020 resolution on encryption, the EU noted that despite its benefits, encrypted communications make accessing and analyzing communications "extremely challenging or practically impossible" even when such access would be lawful. Similarly, in January 2021, the UK Financial Conduct Authority (FCA) released a newsletter on market conduct and transaction reporting issues that directed businesses to implement "a rigorous monitoring regime" to ensure that business-related telephone conversations and electronic communications are "recorded and auditable," noting that business-related communication are increasingly conducted outside the office environment.[6]

And, in relation to financial institutions' obligations to retain client orders for two years, the Securities and Futures Communication of Hong Kong released a circular on May 4, 2018, that required intermediaries using instant messaging technology to implement adequate measures and controls, including prohibiting employees from sending to or receiving from clients electronic communications unless the financial institution has full control over the recording and retention of such messages.[7]

Global regulatory authorities have also been active in scrutinizing the record retention obligations of highly regulated financial institutions. In May 2022, the German Federal Financial Supervisory Authority requested that a global financial institution clarify how its employees use private messages for business purposes after suspicions that senior executives and board members of the bank used WhatsApp, other messaging tools, and private email accounts for business communications. And more recently, it was reported in October 2022 that the FCA issued information requests to several global financial institutions regarding the frequency and content of employee communications through texting and applications such as WhatsApp.

What Now?

In light of the ever-increasing global developments and potential enforcement of ephemeral messaging practices, an immediate reaction may be to err on the side of caution and simply prohibit employee use of ephemeral messaging applications. While this may be an appropriate response for some corporations, it may not be feasible for certain international companies where it is common practice for business partners and customers to communicate using ephemeral messaging applications. And in certain industries, there may be a legitimate need for such usage—for example, to avoid theft of intellectual property or cutting-edge technology when bringing a new product to market.

Given these tensions, many companies will need to conduct a more nuanced review of their employees' use of ephemeral messaging and consider appropriate next steps given the practical realities of such use. Notably, DOJ's

new guidance specifically directs prosecutors to move beyond merely reviewing a company's official messaging policy and instead probe more deeply into employees' *actual* use of ephemeral messaging applications as well as "the rationale for the company's approach to determining which communication channels and settings are permitted."

More fundamentally, prosecutors are now expected to understand at a granular level "how does [the use of ephemeral messaging] vary by jurisdiction and business function, and why," what precise "preservation or deletion settings are available to each employee under each communication channel, and what do the company's policies require with respect to each."

If these are not questions that your company is equipped to answer or address to a regulator upon request, it may be time to engage counsel and conduct a more fulsome self-assessment of your corporate policies and employee practices to help limit future liability. Such an effort could include:

- conducting an assessment to understand your company's risk profile based on DOJ guidance around the evaluation of corporate compliance programs and including in that assessment a review of your company's use of encrypted and ephemeral messaging both domestically and abroad

- reviewing and revising your corporate policies to satisfy your legal obligations and the varying record retention requirements of the global jurisdictions in which you operate

- for highly regulated companies, ensuring that your policies explicitly address the use of ephemeral messaging and taking into account the common messaging applications employees use to communicate internally or with business partners, including the nature of the ephemeral functionalities in those applications

- adopting clear policies tailored to your business's needs, conducting trainings, and consistently monitoring to ensure employee compliance with ephemeral messaging policies

Tackling this is no simple task, especially with the myriad considerations to account for (e.g., the differing standards on ephemeral messaging internationally; the practicalities of monitoring employee usage of messaging applications; and avoiding any inadvertent contraventions of local data privacy or labor laws). We invite you to contact us with any questions you may have as you begin the process to evaluate your company's communication practices.

Notes

1. Notably, the use of ephemeral messaging can violate SEC rules, and the SEC has brought significant enforcement actions in this area. This Sidley Update does not address the many developments related to the SEC's treatment of this topic for companies and investment firms subject to the SEC's rules and regulations. *See https://www.sidley.com/en/insights/newsupdates/2022/01/sec-encourages-self-reporting-recordkeeping-violations-from-employees-use-personal-devices-bus-comms*; *https://www.sidley.com/en/newslanding/newsannouncements/2022/11/sec-continuing-focus-on-offchannel-communications-what-investment-advisers-need-to-know-and-do-now*.

2. *https://www.sidley.com/en/insights/newsupdates/2022/09/making-sense-of-us-dojs-new-monaco-memo-on-corporate-enforcement*.

3. *https://www.sec.gov/news/press-release/2022-174*.

4. *https://www.justice.gov/criminal-fraud/page/file/937501/download*.

5. *https://data.consilium.europa.eu/doc/document/ST-13084-2020-REV-1/en/pdf*.

6. *https://www.fca.org.uk/publications/newsletters/market-watch-66*.

7. *https://www.elegislation.gov.hk/hk/cap571O?xpid=ID_1438403476580_003*.

As Shareholder Proposals Proliferate, Boards Might Consider this Framework to Evaluate Voting Results

By Lawrence A. Cunningham and Ross S. Clements

The shareholder meeting season just ended, which means the proxy votes were rolling in. As corporate boards receive these results of shareholder votes, a framework on how to respond may be helpful. After all, these days corporate ballots may include shareholder proposals on any issue of social significance, without regard to its significance to the company, from animal rights to zoning. Moreover, there are no rules in this area of advisory shareholder votes, leaving it to the board's judgment whether a proposal should be deemed passed and what action, if any, should be taken.

In theory, the shareholder proposal process is simple and valuable. Shareholders communicate priorities to boards, such as severance packages for directors or rewarding employee safety records, and boards benefit from hearing their views. Proponents provide written explanations of their proposal for fellow shareholders and boards deliver a written response. At its best, the board gains information from what is in effect a non-binding referendum on the contending positions.

Neat as it sounds, the reality is more complex and the value less certain. For one, proposal topics now cover the waterfront, from those intertwined with a company's business, such as product categories at a drugstore chain, to those wholly outside it, such as abortion at a bank. In addition, constituents increasingly use the proposal process for parochial aims—anyone holding $25,000 worth of shares for one year (or $2,000 for three) can require a company to present its proposal.

A further complication: shareholders have diverse voting practices. Large index funds follow general guidelines on how they vote on designated topics for all companies while active stock pickers focus on investee companies rather than topics. Institutions exercise far more voting power than that exercised by a company's individual and employee shareholders, although the corporation's performance may be more important to the latter.

Lawrence A. Cunningham and Ross S. Clements are attorneys of Mayer Brown LLP.

Perspectives

Without rules to help interpret voting results on shareholder proposals, boards must evaluate them through the perspectives of their fiduciary duties, accountability to shareholders in annual elections, and reputations for faithful corporate stewardship.

Starting with duties, directors must make decisions in good faith, with full information, and using independent business judgment. They may not act based on their personal views on the topic of a shareholder proposal, but only in the honest belief that they are acting in the best interests of the corporation and its shareholders, taken as a whole—which would permit rejecting a proposal even if voted for by an overwhelming percentage of shares.

On the other hand, most director elections now are by majority vote and directors rejecting landslide proposals run the risk of being ousted the next year. Today's majority voting in director elections is new in the past two decades, a change from the historical practice of director elections won by a mere plurality of the vote. It would therefore be reasonable for directors to make a majority vote their baseline in determining what percentage to recognize as "passing" a shareholder proposal.

Director reputations are influenced by their discharge of duty and accountability, as well as broader manifestations of integrity. Directors do well to act with conviction on behalf of the corporation, and explain their positions publicly, even when disagreeing with powerful forces pushing other interests. To the contrary, catering to the whims of small blocs of shareholders—say implementing a proposal that passes with only a 20% vote—may damage a reputation not only of the director but of the corporation.

A Framework

With those perspectives in mind, consider a framework to assess shareholder proposal voting results. Start with the easy cases. The simplest rules of thumb might be: if more than 90% approve a proposal, adopt it, but if less than 10% approve, reject it. Absent special reasons, such rules are likely consistent with legal duties, majoritarian elections, and reputational stakes.

Switching to the hardest cases, consider votes down the middle, split near 50%-50%, or those within the ambit of a split vote, perhaps 66% to 33% either way. It's possible to declare rules of thumb in these cases too—requiring a majority to win. But a bit more analysis of the votes and subtlety in the response may be valuable.

First, count the number of shareholders (not just shares) voting each way. This gives a different and additional perspective on weighing contending interests. Since institutions with large stakes invariably vote while many dispersed individuals with small holdings do not, it is common for proposals to carry a greater percentage of shares than number of shareholders. Adding that data point can be illuminating, particularly in cases where a proposal is approved by a majority of the shares but opposed by a majority of the shareholders.

Second, follow the common practice when tallying shareholder votes to exclude those of large block shareholders. Doing so offsets the effects of concentrated voting positions where the raw vote is carried by a small number of large holders. For example, the three largest index funds control some 25% of the vote at many companies; examining the vote by excluding their shares would reveal the preferences of a larger cross section of shareholders.

Third, a director would do well to classify the substance of the proposal and calibrate the required voting threshold accordingly. Topics run from investment issues (like dividends) and governance power (staggered boards) to social issues which may intertwine with the company (say selling tobacco products) or those extraneous to it (abortion). With such classifications, it would be reasonable to use ascending threshold percentages for a vote to be deemed passed. To illustrate without being prescriptive, thresholds could be 51% for investment issues, 61% for governance, 71% for intertwined social topics and 81% for extraneous ones.

Fourth, directors should appreciate that a company has a range of responses available, not a simple binary of acceptance or rejection. With this in mind, a board could adapt a sliding scale voting threshold here as well. For one, a proposal the board sees as unworkable as proposed might be modified to a form acceptable to its supporters and the company alike, an effort that may be warranted for proposals with as little as 40% of the vote in favor.

Also, shareholder proponents unable to attract a critical mass of votes often settle for other terms, such as meeting with directors to discuss the topic, a courtesy the board might grant with as little as 33% of the vote in favor (though some vocal shareholder proponents suggest a threshold for that as low as 20%).

Finally, and above all, whatever the vote and whatever the analysis under a framework such as this, boards must evaluate each proposal on its merits, considering the potential benefits and drawbacks of implementation to the company and its shareholders and how the proposal aligns with the company's overall strategy.

All voting outcomes—perhaps even those that are 90% to 10%—must be assessed solely in terms of the best interests of the corporation. That is why these are non-binding votes and why corporate policy is set by the board, not shareholders. Accordingly, the board must carefully and loyally consider each proposal and voting outcome and should communicate its assessment and rationale to the shareholders. As shareholder proposals proliferate, using a framework such as this one can help directors in both the analysis and the outreach.

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