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NY BUSINESS LAW JOURNAL

Table of Contents

HeadNotes

As this issue was going to press, President Trump had just imposed a new round of tariffs on some $50 billion of goods from China, and predictably China promptly retaliated, unsettling the markets. But while controversy swirls around the Administration in this and a number of other areas related to business and economics, to date Mr. Trump's appointments to head the bank regulatory agencies have been remarkably non-controversial, as they have been generally perceived as qualified and moderate in terms of their policy views. While he chose not to reappoint Janet Yellen to another four-year term as Chair of the Board of Governors of the Federal Reserve when her term expired in January, Mr. Trump's selection of sitting Governor Jerome Powell was widely praised and greeted favorably by the markets. Mr. Powell, an attorney, is a moderate Republican who was appointed to the Board by President Obama in 2012 and, in his tenure on the Board to date, has been supportive of Ms. Yellen's monetary policy. Mr. Trump also appointed Randal Quarles, a moderate Republican and veteran of the Treasury Department, to the Board as Vice Chair in charge of bank supervision. As we went to press two other appointees, Columbia Professor Richard Clarida and Kansas bank commissioner Michelle Bowman, had been cleared by the Senate Banking Committee and appeared headed for approval by the full Senate. Mr. Clarida, an economist respected by both Republicans and Democrats, is seen as complementing Mr. Powell's lack of a doctorate in economics. As Vice Chair, he would preside over the Board in Mr. Powell's absence. Another Trump nominee, Marvin Goodfriend, has encountered significant resistance – both from the Democrats, who remain unanimously opposed, and from Senator Rand Paul (R-KY). As this issue went to press, his appointment was in doubt.

Previously Mr. Trump appointed Richard Otting, a career banker, as Comptroller of the Currency (in which capacity he oversees the national bank system, including nearly all of the nation's largest banks); Mr. Otting was confirmed by the Senate in November. And on May 24 the Senate approved, 69 to 31, the nomination of Jelena McWilliams, chief legal officer of Fifth Third Bancorp in Cincinnati and a former member of the staff of Senator Mike Crapo (R-ID), chair of the Senate Banking Committee, to head the Federal Deposit Insurance Corporation (FDIC). Ms. McWilliams replaces Obama appointee Martin Gruenberg, who has generally been resisting attempts to roll back provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") favored by the other regulators.

In particular, Mr. Gruenberg has opposed any weakening of the eponymous "Volcker Rule," named for former Fed Chairman Paul Volcker, which is aimed at preventing banks from engaging in speculative trading for their own accounts, as distinguished from trading on behalf of customers. The Volcker Rule is simple enough to state in principle; but as implemented by the regulators, the final Rule comprises 297 pages of three-column fine print in the Federal Register, imposing substantial compliance costs and burdens even on smaller banks that were not to blame in causing the global financial crisis. Part of the reason for the complexity of the final Rule is that with five regulators responsible for its drafting and implementation—the three bank regulators, plus the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) —the final Rule is the proverbial "horse designed by a committee." Nonetheless, Mr. Gruenberg had remained steadfast in his opposition to reforming the Rule, and as a general matter it is unusual for a major change in bank regulatory policy to move forward unless the Fed, OCC, and FDIC all agree. So it is not a coincidence that, just one week after Ms. McWilliams was confirmed, the three bank regulators, along with the SEC and CFTC, published for comment a proposal to reform the Volcker Rule, mainly aimed at easing the compliance burden for smaller banks.

David L. Glass

And the same day Ms. McWilliams' nomination was confirmed by the Senate, President Trump signed into law the Economic Growth, Regulatory Relief, and Consumer Protection Act, a bipartisan measure that provides some welcome relief from Dodd-Frank, especially for small community banks. Predictably, the Democratic left has portrayed the new law as a rollback of critical provisions necessary to protect "Main Street" from the presumed depredations of "Wall Street" but the reality is more nuanced. In our lead article, "Banking Regulation: The Pendulum Swings Back (Slowly)," David L. Glass discusses both the new law and some of the other significant reductions in regulatory burden that have been proposed. Mr. Glass, who serves as editor in chief of the *Journal*, is a Division Director in the Risk Management Group of Australia's Macquarie Group Ltd. and special counsel to Hinman, Howard & Kattell, Binghamton.

One of the principal rewards of serving as editor in chief has been the opportunity to identify and promote talented law students through the Annual Student Writing Competition. And that satisfaction is that much greater when one's own student achieves this recognition. In "Too Big for the CRA: Why Benefit Corporations Provide a Better Legal Framework for Banks to Serve Their Communities," adapted from a paper submitted in the Banking Law course at Pace University's Elizabeth Haub School of Law taught by the editor, Monica Lindsay makes the case for a new and different approach to enable banks and thrift institutions to serve their local communities, as required under federal (and, in New York and certain other states, state) law. The Community Reinvestment Act (CRA), a federal law dating back to 1978, mandates that all banking institutions that take deposits insured by the FDIC serve their local communities by making mortgage and small business loans or by providing other services. Banks have long complained that CRA takes a "one size fits all" approach and is really about paperwork— "proving" a bank is actually serving its community, rather than taking innovative approaches to doing so. The benefit corporation, or "B-Corp," is a comparatively recent development, dating from 2007, whereby a company can organize under a charter under state law that explicitly recognizes that it has a fiduciary duty to broader constituencies than just shareholders. Thus, a bank that organizes as a B-Corp under state law has a freer hand to pursue strategies that will maximize its service to its community. Thoroughly researched and well-reasoned, Ms. Lindsay's article provides a clear and concise discussion of B-Corps and CRA, and a compelling argument on how the B-Corp structure can be used to enable a bank to fulfill its statutory obligations under CRA. Ms. Lindsay is a candidate for the JD degree at Pace University's Elizabeth Haub School of Law.

Perhaps the dominant issue for businesses and their attorneys today is cybersecurity—certainly there are few areas that pose greater risks, not only in terms of reputation and financial loss, but also to a firm's ability to continue in business. The massive Equifax breach last fall, potentially compromising the financial privacy of more than 150 million people, is just one graphic example. To date, regulatory responses to the potential for cyberattacks have been sporadic and not well coordinated. In "Cybersecurity Guidance With No Teeth: SEC Recommendations Alone Are Not Enough to Protect Investors," Melanie Lupsa addresses one such regulatory response—recent guidance by the Securities and Exchange Commission (SEC) aimed at protecting investors in publicly traded companies by enhancing disclosure requirements regarding a company's cybersecurity exposure. The objective of the guidance is to provide greater transparency regarding the SEC's expectations of the disclosures that are required in filings submitted by public companies. While the new guidelines expand upon previous guidance released in 2011, Ms. Lupsa, a candidate for the J.D. degree from Seton Hall Law School and an editor of its *Law Review*, argues that they are inadequate in relation to the actual risks presented. She notes that 48 of the 50 states, as well as foreign jurisdictions such as the European Union, have imposed requirements that are more stringent and more effective. Her article includes an analysis of the Equifax breach, and is well worth the attention of attorneys who advise public companies—as well as those who recognize the need to stay abreast of developments in this critical area.

Another area of rising importance to publicly held companies and their attorneys is the increasing activism of shareholders, particularly with respect to the environmental, social and governance (ESG) aspects of corporate behavior. In "Review and Analysis of 2017 Shareholder Activism," Melissa Sawyer and Marc Trevino present a comprehensive and exhaustive analysis of developments in this area in 2017. Beginning with an analysis of the institutional and other activist investors behind these developments, they then review the size and nature of target companies; types and objectives of activist campaigns; proxy contests; settlement agreements; and other activism developments. They conclude with suggested measures that a company should take in anticipation of activist campaigns. Ms. Sawyer and Mr. Trevino are partners in Sullivan & Cromwell; we are indebted to them and the firm for their generosity in sharing with us this extraordinarily valuable and insightful research.

"What happens if the attorney's work product is rendered orally, rather than in writing? Is the protection lost?"

And speaking of generosity, the attorneys of Skadden Arps have once more shared with our readers their incomparable "Inside the Courts," a compendium of substantially all significant litigation currently in the federal courts that affects or could affect the practice of corporate and securities law. For each such case they have provided a thorough, yet concise, description of the issues involved and their significance. Whether or not one is a litigator, "Inside the Courts" is an invaluable heads-up of trends and new developments in these rapidly changing areas of law.

The attorney work product doctrine essentially protects an attorney's written advice to her client, especially in the litigation context, from disclosure to the other side. As noted by our ethics guru, Evan Stewart, its purpose is to prevent a litigant from gaining an advantage "on wits borrowed from the adversary," and to avoid "discourag[ing] companies from seeking legal advice and candidly disclosing that information to independent auditors." But what happens if the attorney's work product is rendered orally, rather than in writing? Is the protection lost? In "Mom (as Always) Was Right: Don't Talk to Strangers," Mr. Stewart discusses the recent case of *SEC v. Herrera*, in which General Cable Corporation (GCC) had retained a law firm to investigate suspicious doings at an overseas affiliate. The law firm disclosed its investigation to the Securities and Exchange Commission (SEC), which then launched its own investigation. The law firm cooperated with the SEC by giving it an "oral download" of its witness interviews. But in so doing, did it waive the attorney work product doctrine—which generally protects documents, not oral statements? In his usual clear and entertaining fashion, Mr. Stewart, a partner of Cohen and Gresser in New York, puts the resolution of the case in the context of existing precedent. Along the way, he entertains us with his usual erudition regarding popular music—footnote 3, in particular, is a *tour de force* well worth the reader's attention.

The past year has witnessed a sea change in the treatment of sexual harassment in the workplace. As women—and in some cases, men—have felt increasingly empowered to come forward and the #MeToo movement has gained momentum, powerful men in every field of endeavor are being held to account for behavior ranging from the inappropriate to the outright abusive. For businesses of all types, preventing sexual harassment and dealing with victims and perpetrators have emerged as one of the most critical challenges in employment law.

Concluding this issue, in "Strategies for Preventing Sexual Harassment," Jeffrey S. Klein, Nicholas J. Pappas, and Larisa K. Ramsini, attorneys with Weil Gotshal in New York, provide useful and practical guidance to businesses and their attorneys regarding measures they can take to minimize the occurrence of sexual harassment. They note that the starting point is a "loud and clear statement from senior leadership" articulating the employer's commitment to respecting the rights of all employees. But "tone at the top" is only the starting point.

The firm should adopt fact-gathering methods suited to its size and business model, including, for example, establishing focus groups to get input from employees and assess whether existing reporting channels are adequate. They caution against pitfalls, such as having a double standard for higher performers or the "Graham Rule," which states that a man should never be alone in a room with a woman, even for legitimate business reasons, since this can deprive women of mentoring opportunities and create a culture of distrust.

As recent well-publicized cases have shown, with respect to sexual harassment an ounce of prevention is indeed worth a pound of cure—and then some.

Banking Regulation: The Pendulum Swings Back (Slowly)

By David L. Glass

I. Introduction

On May 24, President Trump signed into law the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "Act"),[1] two days after it was passed by the House by a broad bipartisan margin (258-159). The Senate had passed the bill in March by a margin of 67-31. Last year the House passed a more far-reaching reform bill, the Financial Choice Act, but that bill had no chance in the Senate, primarily because of Democratic opposition to its reforms of the Consumer Financial Protection Bureau (CFPB) created under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (DFA) and proposed repeal of the eponymous "Volcker Rule," originally proposed by and named for former Federal Reserve Chairman Paul Volcker.[2]

Recognizing this, House Financial Services Committee Chair Jeb Hensarling (R-TX), who is retiring from Congress at the end of the year, agreed to allow the bill as passed by the Senate to be voted on in the House without amendment, on the stipulation that further deregulatory measures would be considered later.

The Act actually had originated in the Senate, as Mike Crapo (R-ID), Chair of the Senate Committee on Banking, Housing and Urban Affairs, was able to negotiate with key moderate Democrats to achieve a bipartisan package (rumors that the word "bipartisan" had been officially outlawed on Capitol Hill apparently were false). The compromises required to achieve Democratic backing were 1) primarily focusing on smaller, community banks, at least one of which every Congressperson has in his or her district; 2) dropping any mention of the CFPB; and 3) preserving the Volcker Rule, sacrosanct to many Democrats, albeit eliminating its application to smaller banking organizations that meet certain criteria (discussed below). Thus, while far from being a "repeal and replace" of the DFA, the Act nonetheless provides significant relief, especially for smaller banking organizations, from some of DFA's more onerous requirements.

Apart from the new legislation, recent developments in the regulatory agencies presage further gradual reshaping of some of the more onerous burdens imposed on the banking industry by the DFA. With Senate confirmation in June of Jelena McWilliams to head the Federal Deposit Insurance Corporation (FDIC), Mr. Trump's appointments now head the three bank regulatory agencies—the FDIC, the Board of Governors of the Federal Reserve System ("Fed"), and the Office of the Comptroller of the Currency (OCC). Predictably, the Democratic left, led by Senator Elizabeth Warren (D-MA), has sounded the alarm, asserting that "Main Street" is about to fall victim to the presumed depredations of "Wall Street." But the reality is more nuanced. The backgrounds of the new regulators, and their actions and pronouncements to date, suggest that their approach will be more a fine-tuning of the current regime than a wholesale deregulation of the protections built into the banking system by the DFA and earlier legislation.

This article reviews the major provisions of the new Act that relieve regulatory burden, especially for smaller banking institutions, and provides some historical context for the changes it makes. The next section reviews the President's new appointees to the three regulatory agencies, and briefly discusses the role of each agency in regulating the banking system. The final section discusses several noteworthy recent actions and statements by regulatory officials, which collectively suggest that regulatory priorities, while no doubt moving toward a less restrictive regulatory environment overall, will continue to maintain a focus on preventing the kinds of excesses that led to the global financial crisis.

II. The Economic Growth, Regulatory Relief, and Consumer Protection Act

The Act is noteworthy in that it was passed with significant support from moderate Democrats as well as substantially all Republicans. By contrast, the DFA was enacted in 2010 along strictly partisan lines, in response to the global financial crisis. With the Democrats in control of both houses of Congress as well as the Presidency, and the recent global financial crisis fresh in memory, in certain respects DFA was something of a high water mark in regulatory overkill—especially in its impact on smaller banking organizations, which do not pose a systemic threat to the US financial system and generally were not implicated in the events that triggered the global financial crisis.

Accordingly, in both the House and the Senate, a principal impetus for reform legislation was the recognition that DFA imposed massive new compliance burdens on substantially all banking organizations, including those that are too small to have any systemic impact on the U.S. financial system, unduly hampering their ability to meet the credit needs of consumers and small businesses. The Act accomplishes this goal in four principal ways:

- Raising the $50 billion threshold that triggers the requirement for "enhanced prudential standards" under DFA;
- Easing capital requirements, borrowing restrictions, and examination schedules for smaller bank hold-

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ing companies (BHCs) and savings and loan holding companies (SLHCs) that meet certain requirements;

- Exempting most banking entities with less than $10 billion in assets from the Volcker Rule, which prohibits "proprietary ["prop"] trading"—i.e., trading by a bank for its own account, rather than to serve the needs of a client—and easing the Volcker Rule's restriction on name sharing between a fund and its sponsor; and
- Creating a "safe harbor" under the "ability to repay" requirement for qualifying banks, thrifts, and credit unions.

The following discussion reviews each of these changes in more detail. It should be recognized that the Act covers numerous additional matters that are less germane to the issue of regulatory burden for banks, and thus are not addressed herein.

A. Relief from Enhanced Prudential Standards

The DFA required that all BHCs and SLHCs with more than $50 billion in assets, along with nonbank companies designated as "systemically important financial institutions" (SIFIs)[3] be subjected to "enhanced prudential standards" (EPS).[4] DFA generally mandates that banking entities that meet the criteria for EPS shall be subject to "more stringent" requirements than those that do not, and that the stringency of these requirements should be ramped up based on a list of considerations.[5] Foreign banks that engage in banking in the U.S. by operating a branch or agency, or by owning a U.S. bank subsidiary (collectively "foreign banking organizations" or FBOs) are deemed to be BHCs for this purpose, and under DFA are subject to EPS if they have more than $50 billion in worldwide assets (albeit the standards are less stringent for those with less than $50 billion in U.S. assets).[6]

As it does in many other areas, the DFA gave very broad discretion to the regulatory authority, in this case the Fed as the regulator of BHCs and SLHCs, to write rules fleshing out the requirements of EPS. In 2014, the Fed published its final rule codifying its expectations for entities subject to EPS.[7] Especially as applied to smaller banking organizations, many aspects of the final rule are quite burdensome. For U.S. bank holding companies with total consolidated assets of $50 billion or more, the final rule incorporates the previously issued capital planning and stress testing requirements as an enhanced prudential standard. It also requires such a U.S. bank holding company to comply with enhanced risk-management and liquidity risk-management standards, conduct liquidity stress tests, and hold a buffer of highly liquid assets based on projected funding needs during a 30-day stress event.[8]

With respect to FBOs, the Fed rule imposed on FBOs with more than $50 billion in U.S. assets a requirement to hold all U.S. assets (other than the branch of the foreign bank itself) under a well-capitalized intermediate holding company (IHC). This reversed a long-standing Fed interpretation, dating from the more laissez-faire regime of Chairman Alan Greenspan, that if an FBO itself was well-capitalized, it did not need to separately capitalize a subsidiary IHC in the US.[9] The result was to compel a number of the largest FBOs to either raise massive amounts of new capital in the U.S., or to reduce assets held in the U.S. or shift them offshore.[10]

The Act ameliorated some of the more draconian effects of EPS as implemented. Immediately upon its enactment, the Act raises the DFA threshold of $50 billion for applying enhanced prudential standards. Going forward, all BHCs with less than $100 billion in assets will now be exempt from EPS, while banking organizations over $250 billion will continue to remain fully subject to the requirements of EPS. As such, the Act adopts the sensible approach of keeping the largest, internationally active banking organizations—those that pose potentially significant risks to the U.S. financial system—fully subject to the DFA EPS regime, while substantially alleviating its impact on smaller, less risky institutions.

What about those organizations between $100 and $250 billion? Again, the Act adopts a more sensible, risk-based approach, with a phase-in. Within 18 months after the Act's enactment, BHCs with assets between $100 and $250 billion will be subject to a revised framework, as follows.

- First, the Fed will retain discretion to "claw back" BHCs in this category into the full EPS, if it determines this is necessary for safety and soundness purposes or to mitigate a threat to the financial system.
- Second, the Fed will be required to undertake periodic "stress testing" of BHCs in this category to determine if they have adequate consolidated capital to absorb losses resulting from adverse economic conditions. Presumably the periodic stress tests will inform the Fed's decision as to whether to continue to subject entities in this size category to EPS. Note that, for this purpose, the definition of a BHC does not include foreign banks, unless they actually own a U.S. domestic bank subsidiary. Thus, those in this size category (globally) with only branches or agencies in the U.S. would be exempt.

Under DFA, banking entities with more than $50 billion in assets were also subject to both company-run and supervisory stress tests, as part of the EPS. The Act raises to $250 billion the threshold at which company-run tests are required, providing welcome relief for smaller entities. Likewise, supervisory stress tests will not be required for banking entities below $250 billion—except that, as noted, the Fed will undertake "periodic" stress tests for those between $100 and $250 billion. Presumably, "periodic" implies a less rigorous schedule than the annual requirement under DFA.

B. The Volcker Rule

The Volcker Rule originated with the testimony of former Fed Chairman Paul Volcker before the House Financial Services Committee early in 2010, as Dodd-Frank was taking shape. As stated by Mr. Volcker, the concept of the rule is easy to grasp and intuitively appealing: banks that benefit from the federal safety net, by having FDIC insurance or access to Federal Reserve credit, should not be allowed to speculate for their own account with deposits and other funds that are implicitly backed by the U.S. Government. Based on the same reasoning, banks should not be allowed to invest in or sponsor hedge funds that engage in risky trading. As enacted in DFA, the Rule provides that, subject to certain exceptions, "a banking entity shall not engage in proprietary trading; or acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund."[11] The term "banking entity" is defined broadly to include all FDIC-insured banks and thrift institutions and their holding companies, as well as FBOs.

> *"Thus, while far from being a 'repeal and replace' of the DFA, the Act nonetheless provides significant relief, especially for smaller banking organizations, from some of DFA's more onerous requirements."*

Thus, under DFA, all FDIC-insured banks and thrifts, regardless of size, as well as all bank and thrift holding companies and FBOs, were prohibited from engaging in "proprietary ('prop') trading" and from investing in or sponsoring certain hedge funds, known as "covered funds" to distinguish them from ordinary mutual funds which do not engage in speculative trading.[12] The DFA contained an exemption from the Volcker Rule for asset managers that simply manage a fund, which is a permitted activity for banks and BHCs, but the exemption only applied if the covered fund did not share its name with the investment adviser. This restriction, while not eliminated, was softened as discussed below.

There is little, if any, empirical evidence supporting the core thesis of the Volcker Rule, namely that prop trading caused or contributed to the global financial crisis of 2007-2009. (In fairness, Chairman Volcker himself suggested that the Rule was aimed more at the next crisis than at the last one.) Furthermore, there is evidence that it is detrimental to the economy. In 2012, as the agencies were developing the Rule, Douglas Elliot, an economic research fellow at the Brookings Institution, testified before Congress that the Volcker Rule "is fundamentally flawed and will do considerably more harm than good for the economy." Emphasizing that he was generally a supporter of DFA otherwise, Mr. Elliott nonetheless detailed what he saw as the flaws in the Volcker Rule.[13]

- First, it focuses on the *intent* of an investment, rather than the *risk* of that investment, which can be (and is being) better addressed through the risk-based capital requirements applied to internationally active banks. And by focusing on "prop trading," it implicitly assumes that lending risk is preferable to trading risk. Lending is, of course, the bread and butter of most banks and their greatest source of risk in routine course.
- Second, the concept of "proprietary investments" is a very subjective and arbitrary one. In fact, a large part of the final rule as adopted by the five agencies is devoted to attempting to define prop trading in a way that does not interfere with "legitimate" activities such as market-making or making hedging trades on behalf of customers.[14]

In a similar vein, a Fed economic research staff study in 2016 examined the effect of the Volcker Rule on market-makers, particularly in times of stress. In part due to uncertainty as to what trading was and was not considered "proprietary," the study determined that the effect, albeit unintended, of the Rule was to diminish the willingness of market-makers to maintain liquid markets in times of stress, precisely when greater liquidity is most needed. The study concluded that "the illiquidity of stressed bonds has increased after the Volcker Rule."[15]

While the Democratic left continues to cling to the Volcker Rule, there is nonetheless a widespread awareness that the Rule as promulgated imposes an unnecessary and highly burdensome compliance regime on community banks, even though they do little or no prop trading and were not responsible for the crisis. Accordingly, the Act ameliorates the impact of the Rule as applied to smaller banking entities, by looking at both the size of the banking entity and the extent to which it engages in prop trading. Specifically, banking entities with less than $10 billion in total assets and total trading assets and liabilities that comprise no more than 5 percent of total assets will now be exempt from the Volcker Rule. In a statement released in April, Fed Governor Lael Brainerd—a Democrat appointed to the Board by President Obama—while continuing to support the Rule in principle, voiced her support for relieving smaller firms from its burdens, noting that 98 percent of prop trading is conducted by the largest firms and would continue to be captured under the new regime.[16]

The Act also softened the "name sharing" restriction under the Volcker Rule's asset management exemption. To clarify, while the prohibition under DFA on sponsoring or advising a hedge fund was not meant to preclude banking organizations from acting as advisors or asset managers for traditional funds,[17] the concern was that if the bank and the fund had similar names, the public could conflate the two so that a problem afflicting the advisor or fund could cause reputational damage to the bank. This concern dates back to at least 1979, when a real estate investment trust (REIT) sponsored and advised by Chase Manhattan Bank went bankrupt, causing reputational harm to the bank[18] and leading the Fed to modify its regulation allowing BHCs to sponsor and advise funds.[19] Going forward, a covered fund will not be prohibited from sharing a name with its investment adviser, provided the adviser does not share its name with a banking organization or use the word "bank" in its name.[20]

Apart from the Act, in April the House passed a bill, by a surprisingly wide bipartisan margin of 300-104, to streamline the Volcker Rule by giving exclusive rule-making authority to the Federal Reserve, rather than sharing the authority among five agencies as stipulated by DFA, and giving sole enforcement authority to each trading entity's primary regulator.[21] But this provision was not included in the Senate bill that later became the Act. It is possible it will be reintroduced in the next Congress, but for now all five agencies will have to agree to any regulatory changes to the Rule. As discussed below, in July the agencies released for comment a proposal to further streamline the application of the Rule.

C. Mortgage Relief

In enacting the DFA in 2010, Congress had determined that a principal cause of the housing bubble and subsequent financial crisis was that lenders were using lax lending standards in making mortgages, knowing they could then transfer the risk by selling the mortgages into securitization vehicles. Accordingly, DFA imposed a stringent "ability to repay" (ATR) requirement on mortgage lenders. Under CFPB rules promulgated in 2013, a lender can comply with the ATR requirement in different ways, one of which is by originating a "Qualified Mortgage" (QM). When a lender originates a QM, it is presumed to have complied with the ATR requirement, which consequently reduces the lender's potential legal liability for its residential mortgage lending activities. But QMs are limited in size and must meet certain other requirements. If a particular mortgage does not qualify as a QM, the lender must generally investigate and consider a borrower's assets, employment, credit history, and monthly expenses, and must take into account the impact of the interest rate of a variable rate mortgage going up in later years on ability to pay in order to meet its ATR obligation.[22]

The Act provides an exemption from ATR for banks and other lenders under $10 billion in assets, provided the mortgages are retained in their portfolio. The presumption is that, since the lender will be retaining the risk on the loan, it will have an incentive to apply more conservative lending standards. It thus addresses one of the root causes of the crisis—what economists refer to as "moral hazard," in this example the disconnect between the entity originating a mortgage and the ultimate holder of the mortgage who takes the risk of repayment.

D. Community Bank Relief

Apart from EPS, the Volcker Rule, and the reform of the ATR requirement for mortgages, the Act provides significant relief to community banks in a number of areas.

Capital—banking organizations with less than $10 billion in assets can satisfy their capital requirements and be considered "well capitalized" with a leverage ratio of 8 to 10 percent, unless their primary regulator determines a higher ratio is required, thereby relieving them of the burden of compliance with the extensive requirements under the Basel risk-based capital framework. To clarify, since the original Basel Accord in the 1980s, regulators around the world have adopted a risk-based capital model, whereby the amount of capital a bank was required to hold was based upon the presumed riskiness of the assets it holds. This both required complex calculations and created incentives to hold less-risky assets like U.S. Government bonds, rather than to make loans. The leverage requirement, by contrast, is a simple percentage of the bank's total assets, without regard to the riskiness of any particular asset. For smaller banks that do not pose systemic risk, this reduces an existing disincentive to making loans that serve their local communities.

Small bank and savings and loan holding companies—The Fed has generally disfavored the use of debt in the acquisition of a bank or holding company, since excessive debt at the parent level could compromise the ability of the parent to serve as a "source of strength" to its subsidiary bank or banks. However, the Fed has also recognized that, especially for smaller organizations, the use of debt may be necessary to effect a merger or acquisition. Thus, the Fed has long had a policy statement applicable to small holding companies allowing them to take on greater levels of holding company debt, if their total assets are $1 billion or less and certain other criteria are satisfied.[23] The Act raises this threshold to $3 billion. This change is likely to lead to increased merger and acquisition activity among smaller institutions—a trend that actually has been well underway for years, in part driven by rapidly increasing costs of compliance and the economies of scale inherent in combining smaller institutions.

Exam frequency—currently, regulatory rules require all banking institutions with more than $1 billion in assets to be examined annually. Especially for smaller institutions, on-site bank examinations impose significant costs and other burdens. Assuming the institution is well-capitalized, such frequent examinations seem unnecessary, given that the institution is too small to be a threat to the financial system. Accordingly, the Act raises, to $3 billion from the current $1 billion, the threshold for allowing the exam cycle to be lengthened to 18 months from the current 12 months, provided that the institution is well-capitalized. Again, this change recognizes that smaller institutions do not pose a significant risk to the financial system.

III. The Agencies: Who's in Charge?

In an industry as highly regulated as banking, a key question regarding the future direction of regulation will always be, who is in charge of the agencies? In this regard, President Trump's appointments to date generally suggest that the three bank regulatory agencies are likely to favor ongoing, but gradual and risk-based, reductions in the current regulatory burden. The following discussion reviews his appointments to the agencies to date, and briefly explains the role of each agency in the regulatory process.

A. The OCC

The most obscure of the three agencies to the general public, the Office of the Comptroller of the Currency (OCC), nonetheless plays a key role in the U.S. regulatory system. It was created originally during the Civil War as an office within the Treasury Department; its role was to charter and oversee a new class of federally chartered but privately owned banks, known as "national" (as distinguished from state-chartered) banks. While the majority of banks in the U.S. continue to be state-chartered, the largest banks are almost all national banks, especially since the onset of interstate branching in the 90s[24]—the reason being, of course, that by adopting the national charter they are subject to one set of federal banking law and rules, rather than the laws of each individual state in which they operate. Thus, while they comprise less than 20 percent of the roughly 5,300 banks in the United States, national banks hold 69 percent of the total banking assets.[25]

Of the three agencies, the OCC is the only one that actually charters banks, and it is charged with supervising the national banking system. In order to preclude interference by the states in their affairs, the National Bank Act gives the OCC exclusive "visitorial" powers over national banks.[26] Furthermore, the DFA abolished the separate regulatory authority for federal thrift institutions (savings and loan associations and savings banks), known as the Office of Thrift Supervision (OTS), and transferred its authority to charter and regulate federal thrifts to the OCC.[27]

The officer in charge of the OCC is the Comptroller of the Currency, a somewhat archaic title dating to the original concept of President Lincoln and his Secretary of the Treasury, Salmon P. Chase, that the notes issued by the new national banks would become the nation's currency. The Comptroller is appointed by the President with the advice and consent of the Senate, and he or she serves at the pleasure of the President.

Last November, the Senate confirmed, by a vote of 54-43, President Trump's selection of Joseph M. Otting as Comptroller. Mr. Otting has spent his entire career in banking, including serving as CEO of OneWest Bank, N.A., from 2010 to 2015, during which time it transitioned from being a federal savings bank that primarily made residential mortgage loans to a full-service national bank. Not coincidentally, Mr. Otting worked closely with Steven Mnuchin, the Bank's founder, who is now Mr. Trump's Secretary of the Treasury.

B. The FDIC

The Federal Deposit Insurance Corporation was established in 1934 as part of the New Deal reforms enacted during the term of President Franklin Roosevelt. It serves three primary functions within the regulatory system. First, in its corporate capacity, it insures the deposits in all national banks and substantially all state banks, up to the applicable insurance limit per account, currently $250,000. Second, it is the primary federal regulator of all state-chartered banks and thrift institutions that are FDIC-insured but not members of the Fed (which comprise the majority of state-chartered institutions). Third, it acts as receiver when an FDIC-insured bank or thrift is declared insolvent, with a mandate to marshal the failed bank's assets for the benefit of its creditors.[28]

The FDIC is overseen by a five-member Board of Directors, no more than a simple majority of whom can be from any one political party. In April the Senate confirmed Jelena McWilliams to Chair the FDIC by a broad bipartisan vote of 69-24. Ms. McWilliams was most recently General Counsel of Fifth Third Bancorp in Cincinnati; previously she served on the staff of the House Banking Committee and as a lawyer at the Fed. She replaces Martin Gruenberg, a Democrat appointed by President Obama. Mr. Gruenberg has chosen to remain on the FDIC Board. The other members are Comptroller of the Currency Richard Otting, ex officio, and Mick Mulvaney, director of the CFPB. While one vacancy remains to be filled, it is clear that the three Trump appointees will command a majority that will move away from the strongly anti-deregulation stance taken by Chairman Gruenberg.

C. The Fed

The Fed is the nation's central bank, responsible for formulating monetary policy. In addition, however, the Fed's role as a supervisor of banks has grown over the years, to the extent that it is now the most powerful regulator of all. In addition to supervising those state-chartered banks that are members of the Federal Reserve, its only supervisory role under the original Federal Reserve Act of 1913, the Fed over the years has acquired authority to oversee all BHCs, including FBOs treated as BHCs, and under DFA was given oversight over all SLHCs as well.

The Fed's decision making body at the policy level is the Board of Governors, consisting of seven members appointed for staggered 14-year terms; in theory, the purpose is to limit the power of any president to "pack" the Board with his appointees. In practice, however, most Governors do not remain on the Board for a full term, electing instead to return to academic or private sector positions. Since the 1990s, there have been one or more vacancies on the Board more than 90 percent of the time, largely due to the Senate holding up persons nominated by a president of the opposite party for political reasons. The Chair is appointed by the President for a four-year term.

During the 2016 election the incumbent Chair, Janet Yellen, was subjected to frequent criticism by President Trump, who ultimately decided not to reappoint her when her term as Chair expired in January 2018. Ms. Yellen's 14-year term as a Governor ran until 2022 so in principle she could have remained on the Board of Governors. But as has been the case with past Chairs who were not reappointed, she elected to retire, thereby creating another vacancy on the Board. In addition to Ms. Yellen, Vice Chair Stanley Fisher, a Democrat, and Daniel Tarullo, an Obama appointee who was the Fed's point person on tougher bank regulatory measures following the global financial crisis and the Dodd-Frank Act, have also resigned from the Board within the past year.

The result was to give Mr. Trump a rare opportunity to dramatically reshape the Fed. But the President's nominees to date have been people with solid credentials and backgrounds, suggesting they will take a generally moderate and thoughtful approach to implementing bank regulatory as well as monetary policy. Jerome Powell, appointed as the new Chair to succeed Ms. Yellen, was already a member of the Board, having been appointed by President Obama in 2012. He is considered a moderate Republican with a successful prior career in law and investment banking, and as a Board member generally supported Ms. Yellen's monetary policy positions. Randal Quarles, also a moderate Republican with a successful career in investment banking who served in the Treasury Department under President George W. Bush, has now replaced Daniel Tarullo in the key role of vice chair in charge of bank supervision (Mr. Tarullo was never formally appointed to that role by President Obama but served in that capacity de facto).

Richard Clarida, a moderate Republican economist and monetary policy specialist, has been nominated to serve as vice chairman to Fed Chairman Jerome Powell. Mr. Clarida has taught at Columbia University since 1988 and is a managing director at Pacific Investment Management Co. (PIMCO), a well-known firm specializing in fixed income investment management. He is viewed more as a pragmatist than an ideologue, and is generally well regarded by both conservative and liberal economists. He was the Treasury Department's chief economist under President George W. Bush, and earlier served in the Treasury Department under President George H.W. Bush as well. He will be the highest ranking academic on the Fed board and would serve as the vice chair to Fed Chairman Jerome Powell. As such, he is an ideal complement to Chairman Powell, who is the first Fed chair since G. William Miller, appointed by President Carter in 1978, who does not hold a doctorate in economics.

Another nominee, Michelle Bowman, has been Kansas's bank commissioner since the beginning of last year. Ms. Bowman was previously a vice president at Farmers & Drovers Bank, a Kansas bank that reported $181 million in assets in 2017. One seat on the Fed's seven-member Board is normally reserved for a community banker; Ms. Bowman would fill that seat. She has also served as counsel or adviser to several individual Congress members and congressional committees, followed by stints with the Department of Homeland Security and Federal Emergency Management Agency (FEMA) during the administration of President George W. Bush.

On June 12, the Senate Banking Committee approved both Mr. Clarida and Ms. Bowman, by bipartisan votes of 20-5 and 18-7, respectively.[29] President Trump has also nominated Marvin Goodfriend, a Carnegie Mellon professor and former senior vice president of the Federal Reserve Bank of Richmond. The Senate Banking Committee approved his nomination along party lines in February by a narrow 13-12 margin, but as of this writing Mr. Goodfriend's confirmation by the full Senate was in doubt. He is currently opposed by every Democrat, primarily because he was an outspoken inflation "hawk" beginning in 2008, advocating that the Fed should raise interest rates in the post-global financial crisis environment, and because he was considered to have performed poorly during his hearing before the Senate Banking Committee in February.[30] In addition, Senator Rand Paul (R-KY), a self-described libertarian who is generally an opponent of the Fed, also has announced his opposition to Mr. Goodfriend.

The nominations of Ms. Bowman and Messrs. Clarida and Goodfriend had not been acted upon by the full Senate as this went to press. While Mr. Goodfriend's confirmation remains in doubt for the reasons stated, however, it appears likely Ms. Bowman and Mr. Clarida will eventually be confirmed, and that the Board accordingly will be comprised largely of moderate, well-qualified and generally non-dogmatic Governors. Pending confirmation of these nominees, there are only three currently sitting members of the Board, which is worrisome in the event major policy decisions are called for in a crisis scenario. The Fed has changed its quorum rules to allow for a simple majority of the sitting Governors to act, thereby averting a quorum issue. But this also creates the anomaly that even a casual conversation between two Governors could constitute an official "meeting" requiring public disclosure.[31]

IV. Recent Regulatory Developments

While it is obviously too early to make broad predictions regarding likely changes in bank regulation, a number of recent regulatory actions and pronouncements reinforce the notion that wholesale deregulation is not in the offing. Rather, these actions suggest continuity in existing regulatory approaches, with fine-tuning to lessen unnecessary regulatory burden and focus on areas of actual risk to the financial system. This section discusses three of the more significant such developments: 1) The Fed's surprisingly strong actions taken against the management of Wells Fargo & Co., one of the largest BHCs; 2) Governor Quarles' recent testimony before Congress setting forth the Fed's regulatory agenda; and 3) the proposed simplification of the Volcker Rule recently announced by the five agencies charged with its enforcement.

A. The Wells Fargo Case

Earlier this year the Fed took a series of unusual actions against Wells Fargo Corporation (WFC), one of the Big Four U.S. bank holding companies (along with Citigroup, JPMorgan Chase, and BankAmerica Corporation).[32] The actions are the culmination of the Fed's review of the well-publicized scandal at Wells Fargo Bank which came to light in 2016. The underlying facts involved the opening of some 3.5 million fake accounts, apparently as a result of setting unrealistic sales targets and a culture that induced employees to believe that their compensation, and indeed their jobs, would be dependent on attaining these targets. The bank also allegedly purchased insurance for some 570,000 auto loan customers, and charged them for it, without their knowledge—including, in some cases, where the customer already had purchased his or her own insurance.[33]

The bank had already been fined for these violations, and its CEO had resigned under pressure. With a new chair, CEO and general counsel, WFC apparently believed it was "out of the woods." Thus, the Fed following up with these additional actions—characterized as "unprecedented" and "no slap on the wrist"—was noteworthy and apparently caught the bank by surprise, in addition to causing WFC's stock to drop by 9 percent.[34] Following is a summary of the Fed's additional actions and their significance.

In common with the other bank regulators, the Fed has power to impose a wide range of remedies through Cease and Desist (C&D) Orders.[35] However, the party receiving such an order has specific legal remedies, including the right to a hearing and judicial review. Thus, it is common for such orders to be issued "on Consent" as in this case—the equivalent of a plea bargain in the criminal context—whereby the charged party gives up its right to invoke these remedies in return for negotiations over the terms of the Order. In this case, the Order has two principal components:

1) WFC's assets are effectively capped at their current level, just under $2 trillion, until the Fed lifts the cap. It is estimated that this will cost WFC about $400 million in reduced net earnings this year.

2) WFC is required to undertake substantial improvements in its risk management structure, particularly in compliance. The Order requires a Board plan for enhanced governance, a firm-wide plan for strengthening compliance and operational risk, and independent third party reviews of both plans and how they are implemented. The asset cap will not be lifted until the Fed is satisfied.[36]

Apart from the Order itself, the Fed took two highly unusual actions.

First, it sent (and publicly released) strongly worded letters to the former CEO, John Stumpf, and the former lead independent director, Stephen Sanger, under the signature of the Fed's head of supervision. Both letters explicitly state that the individual did not competently perform his job and fundamentally failed in his oversight responsibilities.[37]

The Fed could have sought to have each individual barred from the banking industry, either permanently or for some period of time. However, to do so through the mechanism provided by law is a lengthy and uncertain process.[38] The courts have held that, in order to impose a lifetime ban, the regulator must show egregious and self-serving conduct that goes beyond mere negligence.[39] The Fed thus apparently chose to issue these letters instead, both to "shame" the individuals involved and to make clear to the banking industry that it regards them as unsuitable to fill similar roles in the future—thereby largely achieving the objective of a ban without going through the legal process.

Second, while WFC had already replaced a number of directors, as well as its CEO, as has been widely reported three additional directors agreed to depart immediately and one more before the end of the year. This is not required by the Order itself but apparently was part of the negotiations preceding the Order. Had the Fed tried to do this through the Order, it would have triggered the legal process discussed above and could not have been accomplished before Janet Yellen's term ended. So apparently these departures were part of the negotiations.

These departures appear to have been intended to underscore the regulators' increased emphasis on "culture" and improved governance. Last fall the Fed published for comment a guidance regarding its supervisory expectations for the Board of Directors of banking organizations.[40] Around the same time, Jerome Powell, the new Fed Chairman, spoke publicly on this subject.[41] The WFC case thus gave the Fed a vehicle to send the message that directors will have personal consequences for failure to supervise. On the political side, the Fed has been under fire, particularly from Senator Elizabeth Warren (D-MA), for not compelling the dismissal of directors in general and WFC directors in particular.

With her term as Chair expiring, this was something of a legacy item for Ms. Yellen, and no doubt the timing of these actions reflects her impending departure. Still, they would not have happened without the support of new Chairman Powell. While Mr. Powell's concurrence in the action implies continuity in the Fed's approach, at the same time the completion of this action in the Yellen regime presumably gives him more flexibility in any future case. But together with his earlier statements on governance, it appears that Chairman Powell will continue to favor an approach of coming down hard on individual bad actors, rather than enacting new rules that penalize the innocent as well as the guilty.

B. Governor Quarles' Testimony

Last fall President Trump appointed Randal Quarles to be Vice Chairman of the Federal Reserve Board for Supervision, filling the vacancy created by the departure of Daniel Tarullo (discussed above). In April, Mr. Quarles had his first opportunity to present the semiannual testimony of the Vice Chairman for Supervision. Whereas Mr. Tarullo was an aggressive regulator, Mr. Quarles took the occasion to outline a number of measures aimed at reducing regulatory burden.[42] Following is a summary of the key points, with the *caveat* that pointing the Fed bureaucracy in a new direction is like turning around a battleship—it does not happen overnight.

The *key principles* underlying Fed regulatory policy are safety and soundness and financial efficiency. These are seen as not in conflict but as "mutually reinforcing." Mr. Quarles cited such factors as the 120 percent increase in common equity capital ratios of the largest banks since the crisis, reduction in short term debt, and increased holdings of liquid assets in support of the thesis that the regulatory burden can be reduced without compromising safety and soundness.

Another key principle is *transparency*—avoid needlessly complex regulations. He took particular aim at the Volcker Rule, which in its final form comprises 297 pages of three-column fine print, noting that it is "unarguable" that the Rule has hurt capital-raising, especially for smaller companies (as noted above, a study by the Fed's independent economic research staff earlier had reached this conclusion). He noted that the Fed is discussing with the other four regulators (SEC, CFTC, OCC, FDIC) how to reduce its burden, especially on institutions that do minimal prop trading and are not seen as presenting systemic risk; the actual proposal was released in July and is discussed below.

Capital/Leverage

The Fed and OCC recently proposed an "enhanced supplementary leverage ratio" (eSLR) to apply to systemically important bank holding companies and their lead bank subs (which are all national banks, and thus under the OCC).[43] Basically, the proposal applies a leverage ratio requirement in addition to the risk-based capital framework. While not proposing to drop this requirement, Governor Quarles noted that leverage should serve only as a "backstop" to risk-based capital, and that too much emphasis on leverage can encourage risky behavior, since it does not distinguish based on the riskiness of different asset classes. Thus, while the Act allows smaller banking organizations to rely on the leverage ratio rather than on more complex risk-based calculations, for larger organizations it seems clear the regulators will continue to emphasize the risk-based approach.

> *"The proposed rule seeks to 'tailor' the requirements of the Volcker Rule to the nature of the entity, so that its more onerous requirements would apply only to entities with significant trading assets and activity."*

"Controlling Influence"

One specific proposal likely to prove welcome, especially to investment funds and others that may want to invest in bank shares, is to clarify the Fed's "opaque" and highly restrictive approach to determining "control" under the Bank Holding Company Act (BHCA). The BHCA provides that a company "controls" a bank, and thus is deemed to be a BHC, if 1) it owns 25 percent or more of the voting equity; or 2) it has the power to appoint a majority of the directors; or 3) the Fed determines, under all the facts and circumstances, that the company exercises a "controlling influence" over the management of the bank.[44] The first two are irrebuttable presumptions—they constitute control as a matter of law, regardless of whether the investor actually controls the bank's decision-making processes. The third ostensibly puts the burden on the Fed to demonstrate "control," but as a matter of administrative law, given how vague this standard is, the Fed really only has to show that it reasonably interpreted the law, not that it was "right" in any absolute sense.[45]

Over the years the Fed has taken a highly restrictive approach to the latter standard—basically, any investment over 5 percent is going to be scrutinized.[46] Generally speaking, investments of not more than 10 percent of a bank's equity, including not more than 5 percent of its voting equity, will pass muster, provided that there are no other indicia of control, such as the power to appoint directors or executive officers.[47] But in practice, the Fed will often require parties to enter into "passivity commitments"—specific, enforceable undertakings designed to assure that they cannot exercise control.[48] The need to make such commitments will often deter a non-bank investor, such as a hedge fund, from making an otherwise attractive investment in a banking organization. Standards that are both more transparent and less restrictive thus could be quite helpful in future investment scenarios and could assist smaller banking organizations in raising capital.

For example, to conserve cash a small BHC might want to pay an advisory fee in stock to its investment bank; but the latter will be unable to accept stock representing more than a de minimis percentage of the bank, for fear of being deemed to "control" the bank and thus inadvertently becoming a BHC. By providing clearer guidelines as to what might be deemed a "controlling interest," the Fed can significantly enhance the ability of nonbank investors to invest in banks. In turn, this could help the regulators to dispose of troubled banks by broadening the base of prospective investors to acquire them.

C. Volcker Rule Simplification

On June 5, the five agencies charged with enforcement of the Volcker Rule (the Fed, OCC, FDIC, CFTC and SEC) issued a press release confirming their intention to simplify the application of the Volcker Rule.[49] The timing was hardly coincidence; the announcement came less than a week after the confirmation of Jelena McWilliams as FDIC Chair. The outgoing FDIC Chair, Martin Gruenberg, had been publicly and adamantly opposed to any changes in the Volcker Rule; it would be unusual for a major regulatory initiative to proceed if one of the regulators was not on board. So Ms. McWilliams' confirmation essentially provided the green light to move forward.

The agencies published the proposed rule for comment on July 17.[50] In broad outline, the proposed rule seeks to "tailor" the requirements of the Volcker Rule to the nature of the entity, so that its more onerous requirements would apply only to entities with significant trading assets and activity. For this purpose, it would divide all trading entities into three categories: those with "significant," "moderate," or "limited" trading assets and liabilities. Among other things, those in the "moderate" category would no longer need to establish elaborate compliance programs with respect to market-making and underwriting activities. They would, however, have to provide an annual CEO attestation of compliance—a requirement which, at present, would only apply to banking entities with more than $50 billion in assets. Those in the "limited" category would be entitled to a presumption of compliance, effectively alleviating them from compliance with the Rule entirely, except that the presumption could be rebutted by the regulator. The proposed rule would also eliminate entirely the existing, and highly prescriptive, "enhanced compliance program" required for entities with more than $50 billion in assets or more than $10 billion in trading assets.[51] The enhanced compliance program, contained in an Appendix to the existing regulation, contains literally hundreds of specific requirements, and has been widely criticized as unnecessarily complicated and costly to implement.

The proposed rule makes other noteworthy changes. It would eliminate entirely the so-called "intent" prong of the current definition of a trading account, which defines a "trading account" to include an account held for the purpose of purchasing or selling financial instruments with an intent to generate short-term profits. The "intent" prong has been widely criticized as subjective and impractical to apply. And it would eliminate entirely the existing rebuttable presumption that any position held less than 60 days is deemed to be in a trading account (and thus to encompass potentially illegal prop trading). Under the existing Rule, in effect the only way to rebut the presumption would be to "prove" that short-term profit-related intent was not, in fact, the basis for the transaction—as noted, a subjective and impractical standard at best.

IV. Conclusion: The Pendulum Swings Back (Slowly)

Major changes in banking regulation generally occur in response to crisis conditions. The national banking system was a product of the Civil War; the Federal Reserve of the monetary panic of 1907; the FDIC of the Great Depression, during which one-third of the nation's banks closed their doors. The Dodd-Frank Act of 2010 was no exception; it was enacted as a direct response to the global financial crisis of 2007-2009. But DFA differed from the earlier enactments in one significant respect: much of its prescriptive content consisted of broad and sometimes vaguely worded mandates, calling upon the regulators to flesh out its substance through the rule-making process.

Given the nature of the crisis and the political climate at the time, it is not surprising that the regulatory pendulum swung to an extreme. The Volcker Rule, to cite one prominent example, evolved from a few simple sentences to nearly 300 pages of three-column fine print in the Federal Register. So it is also not surprising that, a decade after the crisis and with Republicans now in control, the pendulum has begun to move in the opposite direction. The good news is that, both in the new Act and in the pronouncements of the regulators to date, the reaction has been thoughtful and measured. The reforms enacted and proposed to date have several common elements.

First, they reflect a risk-based approach—not abandoning the safeguards of DFA, but rather recognizing that it is neither necessary nor productive for them to be applied indiscriminately. As Governor Brainerd noted in her recent remarks, relieving smaller banking entities that do little or no prop trading from the compliance requirements of the Volcker Rule still insures that 98 percent of the actual prop trading will be captured. Similarly, the Act retains the concept of enhanced prudential standards, but applies a risk-based approach by narrowing its application to capture only the largest, internationally active institutions.

Second, they move away from one-size-fits-all regulatory mandate toward an approach of tailoring regulatory requirements more specifically to the nature of the particular institution. The proposed regulatory changes to the Volcker Rule are a good example. Apart from the size of the institution, they distinguish among those that engage in trading to a "significant" extent from those that do so to a "moderate" or "limited" extent. And they eliminate the wooden application of a 60-day holding period to define what is meant by a "trading" account.

Third, they reflect a greater focus on personal, rather than just institutional, responsibility. To the extent individual bad actors are not held responsible, penalties for noncompliance with law can come to be seen as a cost of doing business. In the Wells Fargo case, the Federal Reserve went beyond the usual panoply of fines and remedial actions, to calling out individual executives by name and compelling resignations from the bank's Board of Directors. In a similar vein, the proposed changes to the Volcker Rule, while alleviating the need for a bank in the "moderate" trading category to implement an enhanced compliance program, would call for the CEO of the bank to attest to its compliance.

The safety of the banking system has always been based on a balance between regulation—rules of general applicability—and supervision—after-the-fact oversight of a bank's actual conduct through the bank examinations process. In reaction to the financial crisis, the pendulum swung quite far in the direction of regulation. The reforms to date reflect a welcome, if moderate, swing back in the direction of more emphasis on supervision, recognizing that individual banking institutions can and do present very different risk profiles.

Endnotes

1 Pub.L. 115–174, S. 2155 (May 24, 2018).

2 Pub.L. 111–203, H.R. 4173, commonly referred to as the Dodd–Frank Act, was signed into law by President Barack Obama on July 21, 2010, and is codified in various sections of the United States Code pertaining to banking, securities, and commodity futures.

3 The DFA created a new super-regulatory body, the Financial Stability Oversight Council (FSOC), with the authority among others to designate certain non-bank financial institutions as SIFIs. Three companies—AIG, Prudential, and GE Capital—were initially so designated; the FSOC's attempt to designate MetLife to date has been defeated in court. AIG and GE Capital have subsequently restructured their operations to get out from under the SIFI designation, leaving Prudential as the only nonbank company to which the EPS apply. *See* "As FSOC rethinks SIFIs, will any nonbanks remain on the list?" American Banker, Dec. 28, 2017, p.a. at https://www.americanbanker.com/news/as-fsoc-rethinks-sifis-will-any-nonbanks-remain-on-the-list.

4 Dodd-Frank Act § 165, codified at 12 U.S.C. § 5365.

5 12 U.S.C. § 5365(a)(1).

6 Federal Reserve Press Release dated February 18, 2014, p.a. at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20140218a.htm. On behalf of the FBOs, the Institute of International Bankers (IIB) argued for an interpretation that EPS would apply only if the FBO had $50 billion in U.S. assets; however, the Fed's final rule applies EPS to all FBOs with worldwide assets of $50 billion or more, obviously a much larger group.

7 Federal Reserve Press Release dated February 18, 2014, p.a. at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20140218a.htm.

8 *Id.*

9 Board of Governors, Supervision & Regulation (SR) Letter 01-1, Jan. 5, 2001.

10 *See* Kreicher, L., and McCauley, R., "The new US intermediate holding companies: reducing or shifting assets?," BIS Quarterly Review, March 2018, p.a. https://www.bis.org/publ/qtrpdf/r_qt1803u.htm.

11 Dodd-Frank Act § 619, codified at 12 U.S.C. § 1851.

12 12 CFR § 248.10(b).

13 Elliott, Douglas J., *The Volcker Rule and Its Impact on the US Economy*, April 12, 2012 (p.a. at https://www.brookings.edu/testimonies/the-volcker-rule-and-its-impact-on-the-u-s-economy/).

14 The Volcker Rule as promulgated appears at 12 CFR Part 248. A large portion of Subpart B of the Rule, which defines proprietary trading, is devoted to attempting to define exceptions for market-making, hedging, and other permitted activities. *See* 12 CFR §§ 248.4-248.7.

15 Bao, Jack, O'Hara, Maureen, and Xing Zhou, *The Volcker Rule and Market-Making in Times of Stress*, Finance & Economics Discussion Series (FEDS), September 2016, p.a. at https://www.federalreserve.gov/econresdata/feds/2016/files/2016102pap.pdf.

16 Federal Reserve Press Release, *Statement on the Volcker Rule Proposal by Governor Lael Brainard*, May 30, 2018, p.a. at https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20180530.htm.

17 In general, providing investment advice is an activity long determined by the Fed to be "so closely related to banking . . . as to be a proper incident thereto," within the meaning of the BHC Act, and thus permissible for non-banking subsidiaries of BHCs. 12 CFR § 225.28(i).

18 *See Chase REIT Files Plans for Bankruptcy*, https://www.washingtonpost.com/archive/business/1979/02/23/chase-reit-files-plans-for-bankruptcy/6492028b-9c10-45a2-ac24-95a25b30eab9/?noredirect=on&utm_term=.81654aa32fd7.

19 12 CFR § 225.28(i).

20 Act § 204.

21 https://www.reuters.com/article/us-usa-congress-volcker/house-passes-bill-to-streamline-volcker-rule-idUSKBN1HK2QY.

22 https://www.consumerfinance.gov/ask-cfpb/what-is-the-ability-to-repay-rule-why-is-it-important-to-me-en-1787/.

23 12 CFR Part 225, Appendix C.

24 The Riegle-Neal Interstate Banking and Branching Efficiency Act, signed into law by President Clinton in 1994, for the first time authorized banks to branch across state lines. P.L. 103-328, Sept. 29, 1994.

25 FDIC, Statistics at a Glance, Historical Trends, p.a. at https://www.fdic.gov/bank/statistical/stats/2015dec/fdic.pdf .

26 12 U.S.C. § 484(a).

27 DFA § 312, codified at 12 U.S.C. § 5412.

28 *See generally* Felsenfeld and Glass, Banking Regulation in the United States (Juris, 3d Ed., 2011), at 165 *et seq.*

29 *Fed nominees Clarida, Bowman clear U.S. Senate panel hurdle*,p.a. at https://www.reuters.com/article/us-usa-fed-nominees/fed-nominees-clarida-bowman-clear-u-s-senate-panel-hurdle-idUSKBN1J81TL (June 12, 2018).

30 "Goodfriend Facing Close Vote for Fed After Senate Grilling," Bloomberg online, Feb. 7, 2018 (p.a. at https://www.bloomberg.com/news/articles/2018-02-07/goodfriend-faces-close-vote-for-fed-after-rough-senate-grilling).

31 *See* "Fed Changes Quorum Rules as It Deals With Vacancies," Nov. 17, 2017, p.a. at https://www.wsj.com/articles/fed-changes-quorum-rules-as-it-deals-with-vacancies-1511294061.

32 Although they are comparable in size and have been regulated as bank holding companies since the financial crisis in 2008, Goldman Sachs and Morgan Stanley have only small proportions of their assets devoted to commercial banking and thus are not directly comparable to these four.

33 *See* CNNMoney, p.a. at http://money.cnn.com/2017/08/08/investing/wells-fargo-auto-insurance-scandal/index.html?iid=EL.

34 *No Slap on the Wrist: Wells Fargo Plunges After Federal Reserve Bars Lender's Growth*, Feb. 5, 2018, p.a. at https://www.forbes.com/sites/antoinegara/2018/02/05/no-slap-on-the-wrist-wells-fargo-plunges-after-federal-reserve-bars-lenders-growth/#867d79b5f089.

35 12 U.S.C. § 1818(b).

36 Board of Governors of the Federal Reserve System, *In the Matter of Wells Fargo & Company*, Docket No. 18-007-B-HC, Order to Cease and Desist on Consent ("Order"), p.a. at https://www.federalreserve.gov/newsevents/pressreleases/enforcement20180202a.htm.

37 Letter dated Feb. 2, 2018 to John Stumpf from Michael Gibson, p.a. at https://www.federalreserve.gov/newsevents/pressreleases/files/enf20180202a4.pdf; Letter dated Feb. 2, 2018 to Stephen Sanger from Michael Gibson, p.a. at https://www.federalreserve.gov/newsevents/pressreleases/files/enf20180202a3.pdf.

38 12 U.S.C. § 1818(e).

39 *See, e.g.*, *Kim v. Office of Thrift Supervision*, 40 F. 3d 1050 (9th Cir. 1994).

40 Federal Reserve System, *Proposed Guidance on Supervisory Expectation for Boards of Directors*, 82 FR 37219 (Aug. 9, 2017).

41 "The Role of Boards at Large Financial Firms," remarks of Chairman Powell at the Large Bank Directors Conference, August 30, 2017.

42 Vice Chairman for Supervision Randal K. Quarles, Semiannual Supervision and Regulation Testimony, before the House Committee on Financial Services, April 17, 2018 (identical remarks were presented before the Senate Committee on Banking, Housing and Urban Affairs, April 19).

43 83 FR 17317 (Apr. 19, 2018).

44 12 U.S.C. § 1841(a)(2).

45 This is basic administrative law, tracing to the Supreme Court's 1984 decision in *Chevron Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984), in which the Court held that, unless the meaning of a statutory term is clear and unambiguous as applied to the facts at issue, a court must defer to the interpretation of the statute by the agency charged with its enforcement, as long as it is reasonable. Subsequently the Court has unanimously upheld the decisions of the bank regulators on several occasions, in each case based on the decision being a reasonable and rational interpretation of the statute at issue. *See NationsBank v. Variable Annuity Life Ins. Co.*, 513 U.S. 251 (1995); *Smiley v. Citibank (South Dakota) N.A.*, 517 U.S. 735 (1996).

46 The BHC Act contains a *de minimis* exemption, essentially allowing a BHC to own up to 5 percent of the voting stock of any entity. 12 U.S.C. § 1843(c)(6).

47 *See* Glass, D.L, *So You Think You Want to Buy a Bank?*, 73 Albany Law Rev. 447 (2010), for a discussion of the "controlling influence" test and how it has been applied by the Fed.

48 Policy statement on investments in banks and bank holding companies, 12 CFR § 225.144.

49 *Agencies ask for public comment on proposal to simplify and tailor the "Volcker Rule,"* June 5, 2018, p.a. at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180605a.htm.

50 83 FR 33432 (July 17, 2018).

51 12 CFR Pt. 248 App. B, *Enhanced Minimum Standards For Compliance Programs*.

Members of the Business Law Section leadership with the Foundation. Left to right: Deborah Auspelmyer, Foundation Executive; Anthony Q. Fletcher, Esq. Section Secretary; Kathleen A. Scott, Esq., Section Chair; Stuart B. Newman, Esq., *NY Business Law Journal* Editorial Advisory Board Chair and Advisor Emeritus; Peter W. LaVigne, Esq. , Vice-Chair of the Section; and Drew R. Jaglom, Esq., Treasurer.

New York Bar Foundation Receives Gift to Establish Business Law Section Small Business Support Fund

ALBANY—The Business Law Section of the New York State Bar Association has made a gift of $12,500 to The New York Bar Foundation to be used to provide funding for grant awards via the Foundation for programs that assist with business-related matters.

Through the fund and the Foundation's grant program, the Business Law Section assists military veterans, minorities and other underserved New York residents seeking to establish their own small business in New York on such matters as form of organization, basic commercial agreements, shareholder, partnership or operating agreements, and intellectual property.

"Stuart Newman has been a long-time member of and advisor to the Business Law Section, and he saw a need for a grant like this to provide legal advice to small business owners, and in particular targeting veterans establishing small businesses. When Stuart proposed setting up such a grant through The Bar Foundation, the Executive Committee immediately and enthusiastically endorsed it," said Section Chair Kathleen Scott. She noted that throughout 2018, Section leadership will be focusing on getting the word out about this opportunity to veteran organizations.

"I see this program as a triple win—for veterans, for the New York economy, and for the Bar Association," Newman added.

New York Bar Foundation President John H. Gross, said, "We are grateful to the Business Law Section for recognizing the need for this type of assistance and the impact business development can have on a community. This gift demonstrates the on-going collaborative efforts between The Foundation and the New York State Bar Association and our ability to work together to make a difference for those in need of legal services."

The Foundation presented nearly $700,000 in grants to more than 100 programs across New York State in 2018. Through the grant cycle, the Business Law Section small business support funds were allocated to Volunteers of Legal Services (VOLS) and Start Small. Think Big., Inc.

VOLS will receive support for its Microenterprise Project. Through the project, pro bono attorneys help low-income micro-entrepreneurs and small businesses overcome legal obstacles so that they can launch and grow their businesses, creating jobs and increasing incomes in struggling areas of New York City. Thousands of low-income entrepreneurs try to launch their own businesses in New York City each year, but many lack access to lawyers who can help them through the process of starting a business. Clients of VOLS' Microenterprise Project need legal assistance in a wide variety of areas of business law, including: business formation (incorporation); intellectual property; contracts; commercial real estate; and licensing and permitting.

Start Small. Think Big., Inc. will receive support for its Small Business Legal Project. The Small Business Legal Project is based on the idea that starting a business is a principal way for low-income people to accumulate assets and achieve personal financial stability. Successful self-employment can help people exit poverty and build wealth, and small businesses help to anchor communities by providing diverse goods and services responsive to local needs. Building a sustainable business requires legal assistance, but legal counsel is costly, so low-income entrepreneurs frequently go without. Businesses lacking a sound legal infrastructure are more vulnerable to business-related liabilities and less likely to profit from business relationships or to obtain loans, investments, and/or large contracts.

"Small business owners have great ideas, business savvy and the willingness to work hard. Start Small. Think Big adds a crucial ingredient: legal advice to set the business on the path to success. We are proud to support this great program," said Section Vice Chair Peter LaVigne.

The Business Law Section, with a membership of approximately 3,500, is one of the largest Sections of the New York State Bar Association. Its members consist of attorneys whose practice involves some aspect of commerce or finance although the focus of the practice of the members is quite diverse—ranging from securities to consumer finance.

To accommodate this breadth of practice, the Business Law Section is composed of committees that offer practitioners with commercial clients information in such diverse areas as: bankruptcy, banking, corporations law, franchise distribution and licensing, derivatives and structured products, securities regulation and the constantly evolving area of technology and venture law.

The New York Bar Foundation, a nonprofit, philanthropic organization, receives charitable contributions from individuals, law firms, corporations and other entities. It provides funding for the following purposes: increasing public understanding of the law; improving the justice system and the law; facilitating the delivery of legal services; and enhancing professional competence and ethics. For more information about The New York Bar Foundation, visit www.tnybf.org.

Too Big for the CRA: Why Benefit Corporations Provide a Better Legal Framework For Banks to Serve Their Communities

By Monica Lindsay

I. Introduction

The demand for corporate accountability is at an all-time high, with many consumers already aligning their financial transactions with their values.[1] For millennials, who place a significant value on work that serves a larger purpose, social responsibility is the new buzz word.[2] In a study conducted by The Intelligence Group, 64 percent of millennial respondents stated that it is a priority for them to "make the world a better place."[3] The recent development in corporate law, Benefit Corporations ("B-Corps"), is the market's response to the high demand for social responsibility in the workforce. The structure of benefit corporations may provide a better way for banks to fulfill their legal responsibility to serve their communities as well as serve constituencies outside of shareholders. More than 460 companies from 60 different industries have already become Certified B Corporations over the last four years.[4] One example, Sunrise Banks, based in St. Paul, Minnesota, is the first national bank to successfully become a certified Benefit Corporation.[5] Sunrise Bank is certified by the U.S. Treasury as a Community Development Financial Institution (CDFI), maintains an "outstanding" CRA performance rating[6], and has a mission that goes beyond the call of the Community Reinvestment Act. The bank's goal is "to radically change the way urban communities and underserved people thrive by empowering them to achieve their aspirations."[7] Becoming a benefit corporation has enabled Sunrise Bank to create people- and place-based products that make a difference in their communities.[8]

This article discusses the B-Corp concept as applied to banking and compares and contrast its purpose and effectiveness with the Community Reinvestment Act. In doing so, this article will argue that broader and stricter accountability standards make benefit corporation status the best structure to evaluate a bank's ability to meet the needs of its community.

II. History of the Community Reinvestment Act

The Community Reinvestment Act was enacted by Congress in 1977, subsequently revised in 1989,[9] and reassessed in 1993 by President Bill Clinton.[10] The CRA is a federal law that applies to all depository institutions that carry Federal Deposit Insurance Corporation (FDIC) deposit insurance. The 1989 revision required public disclosure of banks' CRA ratings and for the CRA examination to have a four-tiered system of performance levels (i.e., Outstanding, Satisfactory, Needs to Improve, or Substantial Noncompliance).[11] The CRA was designed to address the problems faced by minority and low to moderate-income groups (LMI) in obtaining credit and to put an end to redlining, the refusal by lending institutions to lend or invest in certain geographic areas.[12]

In a December 6, 1991 policy statement, the Federal Financial Institutions Examination Council (FFIEC),[13] which consists of representatives from each of the federal banking regulatory agencies (the Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and the former Office of Thrift Supervision), concluded that since an analysis of "the geographic distribution of credit applications, credit extensions and credit denials is an integral part of effective CRA management," banking institutions are now required to conduct comprehensive and accurate analysis of their lending activities. Furthermore, in enacting the CRA, "Congress required federal financial supervisory agenc[ies] to assess an institution's record of helping local communities in which the institution is chartered, consistent with the safe and sound operation of the institution, and to take this record into account in...evaluat[ing] an application for a deposit facility by the institution."[14] This was accomplished by "establishing the framework and criteria to assess a bank's record of helping to meet the credit needs of its entire community...consistent with the safe and sound operation of the bank," to be taken into account when banks apply to merge or engage in new activities.[15] This change was meant to help ensure that CRA policy goals and objectives are achieved and indicates congressional concerns that banking institutions were not complying with the intentions and mandates of the CRA. Despite being law for 40 years, some critics remain skeptical of the CRA's effectiveness.[16]

III. The Emergence of Benefit Corporations

While the Community Reinvestment Act is longstanding legislation, benefit corporations are fairly recent. In order to formalize B-Corp status, "[i]n 2007, a non-profit organization called B Lab was founded to establish and manage the [Benefit] Corporation certification system."[17] Unlike the federal CRA, the body of law surrounding B-Corps varies slightly by state. These distinct characteristics are captured in the Model Benefit Corporation legislation, the "Model Act."[18] The Model Act contains "[the] essential provisions for each state, both where the legislation

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has been enacted and in those states where it has been introduced, and collects the best features of the statutes enacted to date and represents the ideal legislation to create benefit corporations."[19] The Model Legislation lists seven non-exhaustive possibilities for specific public benefits: (1) providing low-income or underserved individuals or communities with beneficial products or services; (2) promoting economic opportunity for individuals or communities beyond the creation of jobs in the ordinary course of business; (3) preserving the environment; (4) Improving human health; (5) promoting the arts, sciences, or advancement of knowledge; (6) increasing the flow of capital to entities with a public benefit purpose; or (7) the accomplishment of any other particular benefit for society or the environment.[20]

In 2010, Maryland became the first state to enact legislation adopting benefit corporations.[21] Since Maryland's enactment, 25 additional states, including Delaware, the preeminent state for corporate law, have adopted some type of benefit corporation legislation, while others continue to introduce such legislation.[22] Registration as a benefit corporation is a legal status. A certified B-Corp is a business entity that has applied for and received voluntary certification from B Lab, the nonprofit from which the concept of benefit corporations first emerged.[23] Benefit corporations have two purposes, "generating revenue and pursuing a social mission."[24] There are three primary characteristics that differentiate benefit corporations from traditional corporations: corporate purpose, mandated director and officer accountability, and increased transparency requirements.[25] B-Corps voluntarily adopt the goal of making a material, positive impact on society and the environment. Practical examples include "using environmentally sustainable manufacturing processes and materials, donating a portion of goods and services to communities or countries in need, or contributing a portion of revenue to youth education programs."[26] Additionally, B-Corps focus on a broader range of stakeholders and "provide businesses with greater operational flexibility to pursue strategies that promote a social benefit instead of an exclusive focus on profit maximization."[27] Accordingly, the management of benefit corporations has different fiduciary duties than the management of traditional corporations, which allows for greater freedom to pursue public good.[28]

IV. Inconsistencies Among Regulators Weaken the Value of CRA Evaluations

The federal banking regulatory agencies—the Board of Governors of the Federal Reserve System exercising jurisdiction over state member banks, the FDIC exercising jurisdiction over state non-member banks, and the Office of the Comptroller of the Currency (OCC) exercising jurisdiction over national banks—currently implement the CRA. The regulators conduct examinations to evaluate how banks are fulfilling the objectives of the CRA and issue performance ratings. The CRA regulations contain different evaluation tests for different types of institutions: the lending, investment, and service tests for large retail institutions; the community development test for wholesale or limited-purpose institutions; the streamlined performance standards for small institutions; and the strategic-plan option for institutions with approved strategic plans.[29] All state member banks, state nonmember banks, national banks, and savings associations that are not small or special-purpose institutions are subject to the data collection and reporting requirements of the CRA.[30] Moreover, a bank's performance need not fit each aspect of a particular rating profile in order to receive that rating; exceptionally strong performance in one aspect may compensate for weak performance in others. The bank's overall performance must be consistent with safe and sound banking practices and generally comply with the standards of their rating profile.[31] The supervisory process of the CRA weakens the mandate of the CRA because no single federal agency is responsible for evaluating its overall effectiveness. Although regulators provide a variety of examples as guidelines for banks to determine the "innovativeness or complexity of qualified investments" as well as whether the bank has undertaken a sufficient amount of CRA activities, there is no set list of qualified activity, leaving much up to regulator discretion.[32] Generally speaking, the number of points some CRA-eligible investments receive relative to others is up to the regulator's judgment, given that no formal definition of "innovativeness" or "complexity" exists.[33] This lack of consistency and clarity among regulators creates market confusion regarding how much deference should be attributed to a bank's CRA performance and creates confusion regarding how banks measure up to one another.

V. The Depth and Detail of B-Corp Evaluation

Benefit corporations do not have a singular or consolidated system for regulation. But in 2007, in response to this fragmentation and confusion, B Lab, a 501(c)(3) not-for-profit organization, initiated a certification system for companies interested in distinguishing themselves in the marketplace.[34] B Lab developed a set of transparent, comprehensive and comparable standards designed to enable the marketplace to identify and support companies that meet rigorous third-party standards for social and environmental performance.[35] There are three major provisions in benefit corporation legislation that are consistent from state to state. These provisions address corporate purpose, accountability and transparency, and state that a benefit corporation has: 1) a corporate purpose to create a material positive impact on society and the environment; 2) expanded fiduciary duties of directors which require consideration of non-financial interests; and 3) an obligation to report on the corporation's overall social and environmental performance as assessed against a comprehensive, credible, independent and transparent third-party standard.[36] There are 536 registered certified B Corporations that meet rigorous standards of overall social and environmental performance, having 1) earned a verified score of 80 points (out of 200) on the B Impact Assessment; and 2) expanded the legal responsibility of the company's directors to include the interests of workers, community, and the environment.[37]

The Impact Assessment consists of five categories: the environment, workers, customers, community, and governance.[38] Each impact area is worth roughly 40 points, and achieving 80 points total indicates that the company has excelled in multiple areas in order to achieve B Corp Certification.[39] Each category is further broken into sub-categories: for example, the Community Impact Score evaluates community oriented products, suppliers and distributors, local involvement, diversity, job creation, and charity and service in the corporation's respective community.[40] The worth of each question and section depends upon the specific "Assessment track"—determined by industry, size, and geography—of the business taking the Assessment.[41] Given the complex rating system, the question remains whether these scores adequately give consumers and the market any more information about the safety, soundness, and social responsibility of an organization than the rating system under the CRA.

VI. The CRA Rating System Fails to Thoroughly Inform Consumers

Failure to comply with CRA requirements results in a low CRA rating that leaves banking institutions at a substantial competitive disadvantage. Regulators have issued penalties ranging from cease and desist orders to revisions of CRA compliance plans and rejections of mergers. Low ratings also expose banks to increased regulatory audits and supervision, community protests, and restrictions on growth.[42] Nevertheless, regulators have a difficult time incentivizing "Outstanding" CRA performances. The Federal Deposit Insurance Corporation's September 2016 monthly summary of CRA grades shows that only three of the 60 banks graded received an "Outstanding" rating.[43] The rest were rated "Satisfactory."[44] In 2014, for example, there were 1,213 CRA examinations—770 for small banks, 335 for intermediate small banks, and 93 for large banks.[45] Generally, 97 percent of all banks receive a composite Satisfactory or better rating regardless of the number of banks examined in a year.[46] However, the data reveals that between 2008-2014, the percent of banks receiving Outstanding was less than 10 percent, while 89 percent of banks in those same years received a Satisfactory rating.[47] Thus, it is difficult to know whether the consistently high ratings reflect the CRA's influence on bank behavior or if the CRA examination procedures need improvement.[48] Yet, CRA ratings are still taken into account when a bank wants to establish a domestic branch, merge, consolidate, or acquire assets under the Bank Merger Act[49] and Bank Holding Company Act.[50] Under Gramm-Leach Bliley, a Bank Holding Company cannot become a Financial Holding Company and engage in commercial activities unless its banks receive a Satisfactory or higher CRA rating.[51] The incoherence between the goals of the CRA and the requirements of regulators elicits questions about the usefulness of the CRA rating system.

VII. Is the CRA Successful at Combating Redlining?

The Lending Test examines a bank's loan activity for "geographic distribution, borrower characteristics, community development lending, and innovative or flexible lending practices."[52]

As a direct response to redlining, the Lending Test encourages banks "to develop and apply flexible underwriting standards for loans that benefit low- or moderate-income geographies or individuals, only if consistent with safe and sound operations."[53] Despite the importance of the lending test,[54] its effectiveness is gutted because the CRA does not require institutions to request or consider income information when making a loan.[55] If an institution does not consider income when making an underwriting decision in connection with a consumer loan, the institution does not need to collect income information.[56] On the other hand, if a banking institution gathers this information from borrowers, regulators expect them to collect the borrowers' gross annual income.[57] The purpose of collecting income data on consumer loans is to enable regulators to determine loan distribution based on borrower characteristics, including the number and amount of consumer loans to low-income borrowers as compared to loans to middle and upper-income borrowers.[58] Without requiring banks to request and disclose consumer income, it is difficult to determine if the CRA is effective in combating redlining. It is also unclear how the goals of the CRA are met when a regulator can consider a bank's application to merge based on a CRA performance score that does not take into account the income of its consumers, given that the ultimate goal of the CRA is to ensure equitable distributions of loans. Therefore, a bank's performance in the lending test should be met with skepticism by consumers and regulators.

VIII. Benefit Corporations Better Inform Consumers, Regulators, and the Market

The evaluation categories followed by B-Corps provide a cohesive set of evaluation categories, focusing on the environment, workers, customers, the community, and governance.[59]

The Annual Benefit Report contains a detailed explanation for the activities a corporation wishes to be counted under each evaluation category. The report is public, allowing a variety of stakeholders to clearly identify the "ways in which the Benefit Corporation pursued general public benefit during the year and the extent to which general public benefit was created."[60] Key to this report is the requirement of a third-party standard for assessing overall performance, and the process for selecting this third-party standard must be explained within the report. Placing banks on B-Lab "Assessment Tracks"[61] would provide clearer background information for consumers and regulators to better appreciate a bank's lending activity, notwithstanding the lack of borrower income information. Additionally, B-Lab evaluation would standardize the assessment categories and require banks to explain how their loan practices benefit the communities where they are located.

Non-compliance with B-Corp certification not only results in a revocation of status but also gives rise to an internal "benefit enforcement proceeding."[62] This proceeding creates a cause of action for specified shareholders, the corporation, or directors, if the B-Corp fails to "pursue or create general public benefit or a specific public benefit purpose set forth in its articles," or "violat[es] any obligation, duty, or standard of conduct under" the statute.[63] The benefit enforcement proceeding further establishes that the directors and officers of a benefit corporation have a duty to act in accordance with the purported benefit and will be held accountable for their pursuit of the benefits.[64] Increased accountability would motivate banks to maintain the highest level of community responsibility, which in turn maximizes CRA-eligible activity. B-Corp status also raises the reputational and economic cost of abandoning a corporation's social goals. The potential for economic losses will directly combat concerns about redlining and address criticism that banks are maintaining branches in lower-income areas solely for the purpose of receiving favorable CRA ratings.[65] Banks would no longer be able to hide behind Satisfactory ratings without demonstrating how their lending, investment, and services benefit their communities.

IX. The Cost and Risk Associated with the CRA Outweigh the Overall Benefit

Bankers have voted CRA the most burdensome regulation with which they must comply.[66] The Community Reinvestment Act requires documentation and generates costs associated with reporting CRA-qualifying activities.[67] A 1993 study estimated that the ongoing operating cost of complying with the law averaged $69,579 per financial institution.[68] Despite these costs, the CRA's impact on lending activity has been publicly debated. Some business observers are concerned that the CRA may induce banks to forgo more profitable lending opportunities in non-targeted neighborhoods by encouraging a disproportionate amount of lending in LMI communities.[69] Congressional concerns regarding the CRA stem from various perceptions of its effectiveness.[70] "Some contend that the CRA creates incentives for banks to make loans to unqualified borrowers likely to have repayment problems, which can translate into losses for lenders," and others have argued that "the CRA compels banks to make loans to higher-risk borrowers that are more likely to have repayment problems, which may subsequently compromise the financial stability of the banking system."[71] For example, some researchers have attributed the increase in risky lending prior to the 2007–2009 recession to banks attempting to comply with CRA objectives.[72]

Additionally, financial strain induces a shrinking customer deposit base, making it more difficult to meet CRA objectives (i.e., geographically matching deposit-taking with lending activity), particularly for small community banks that are only evaluated under the direct lending component of the CRA test.[73] By adopting benefit corporation status, small banks could create additional opportunities to serve their communities in periods of economic downturn. Broader opportunities would be available because B-Corps "balance the demands of social responsibility and fiduciary responsibility and allow directors to serve ethical and social missions set forth in the corporate charter without risk of breaching the fiduciary duty to shareholders or members."

Congress believed that the granting of a public bank charter should translate into a continuing obligation for that bank to serve the credit needs of the public where it was chartered.[74] However, data from the Home Mortgage Disclosure Act (HMDA) reveal "that the largest banks have significantly reduced their share of mortgage lending to low- and moderate-income (LMI) households."[75] Wells Fargo, Bank of America, and JPMorgan Chase "together originated about 9 percent of all [LMI] mortgages reported in the 2016 HMDA data and account for nearly one-third of all deposits in the United States."[76] Despite the disproportionate amount of deposits to lending in low-income communities, all three banks scored Outstanding or High Satisfactory for the Lending Test on their latest CRA examination.[77]

The fact that these banks can receive high ratings on the Lending Test without lending to LMI communities indicates the dramatic inadequacies of the CRA and leaves LMI communities without the services the CRA was intended to provide. Consequently, the fear that LMI loans are too "high risk" to be eligible as CRA qualifying activity[78] has led to non-bank lenders accounting for 31 percent of home purchase loans and 61 percent of refinance loans in LMI neighborhoods. Yet these entities are far less regulated than their bank-chartered peers and are not covered by the Community Reinvestment Act.[79]

This phenomenon raises three significant issues: whether there are enough loans in low income communities for CRA regulated banks to fulfill their CRA objectives, whether limitations on bank product offerings for consumer protection purposes contribute to the growth of the "shadow-banking sector,"[80] and most important, whether the CRA is accomplishing its intended goals. B-Corp transparency and broader freedom to pursue social benefit would eliminate regulator skepticism of loans to low-income borrowers, increase consumer trust, and enable banks to effectively and in good faith meet CRA objectives.

X. Transparency and Broader Freedom to Pursue Social Benefit

A benefit corporation is a comprehensive and flexible legal entity devised to address the needs of entrepreneurs, investors and, ultimately, the general public. "Benefit corporations offer clear market differentiation, broad legal protection to directors and officers, expanded shareholder rights, and greater access to capital than current alternative approaches."[81] Benefit corporations insulate and preserve the community engagement and accountability objectives of the Community Reinvestment Act.[82] If the goals of the CRA are to be fulfilled to the fullest extent, the responsibility of becoming a certified B-Corporation provides a legal framework necessary to do so. The expanded reporting requirements of B-Corps provide shareholders, regulators, and communities with ample information to determine if the business is achieving its stated social purpose. The benefit corporation structure would provide banking institutions with the freedom to explore innovative ways to serve their communities without fear that bank regulators will deem loans to LMI households as too risky. Under B-Corp status, banks could take a broader view of their responsibilities while maintaining safe and sound practices.

This legal freedom to pursue goals beyond shareholder profit is not without its consequences. Despite the popularity of benefit corporations, it can be difficult for these corporations to obtain funding because the entity is often perceived as a risky untested business model with unknown returns.[83] "Double bottom line corporations [like Benefit Corporations] struggle to raise capital because they do not fit the settled categories and expectations of existing sources of capital."[84] Corporate officers must decide between using more expensive but less environmentally harmful processes or delivering projected profits to shareholders. Banking institutions will not run into these difficulties for two reasons: all lending, investment and service activities must comply with the safe and sound operations of the bank, and the pursuit of a social benefit must be in accordance with the scope of the bank's authority to pursue CRA-eligible activities.

XI. Conclusion

The goals of the CRA are as important as they were 40 years ago, but the demands and innovations of the 21st century require a regulatory structure that generates more accountability and transparency from banks. Both the CRA and the benefit corporation seek to maximize benefits to society and stakeholders while decreasing the risk of discriminatory and inequitable practices. Inconsistencies among regulators, an inadequate rating system, competition from non-bank lenders, and the apprehension of banks to provide loans to LMI communities indicate the many shortcomings of the CRA. Benefit corporation status provides a 21st century response to these shortcomings. Certification as a B-Corp would place the responsibility on banking institutions to self-regulate, innovate, and drive business with their communities in mind. The illusive rating system of the CRA would be replaced by categories that expand the definition of what it means for banks to serve their communities. The benefits of this change would be significant: it would encourage communities to become more engaged with their local banking institutions; give banks more autonomy to determine the specific needs of their community and determine what products and services effectively meet those needs; and will ultimately give regulators and outside constituencies a cohesive and meaningful framework to assess whether a bank is fulfilling its CRA objectives.

Endnotes

1 *See* Doug Bend & Alex King, *Why Consider a Benefit Corporation*?, FORBES (May 30, 2014, 9:00 AM), http://www.forbes.com/sites/theyec/2014/05/30/why-consider-a-benefit-corporation.

2 *See id.*

3 Rob Asghar, *What Millennials Want in the Workplace (and Why You Should Start Giving It To Them)*, FORBES (Jan. 13, 2014), https://www.forbes.com/sites/robasghar/2014/01/13/what-millennials-want-in-the-workplace-and-why-you-should-start-giving-it-to-them/#253f95a64c40; *see generally* Morley Winograd & Dr. Michael Hais, *How Millennials Could Upend Wall Street and Corporate America*, BROOKINGS INSTITUTE (May 2014), https://www.brookings.edu/wpcontent/uploads/2016/06/Brookings_Winogradfinal.pdf.

4 WILLIAM H. CLARK, JR, ET AL., THE NEED AND RATIONALE FOR THE BENEFIT CORPORATION: WHY IT IS THE LEGAL FORM THAT BEST ADDRESSES THE NEEDS OF SOCIAL ENTREPRENEURS, INVESTORS AND ULTIMATELY THE PUBLIC 6l, available at http://benefitcorp.net/sites/default/files/Benefit_Corporation_White_Paper.pdf (hereinafter "RATIONALE FOR THE BENEFIT CORPORATION").

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Cybersecurity Guidance With No Teeth: SEC Recommendations Alone Are Not Enough to Protect Investors

By Melanie M. Lupsa

I. Introduction

Today, breaches in cybersecurity affect nearly one in three Americans every year, every 39 seconds.[1] In fact, each day from breaches there are 3,809,448 records stolen.[2] "Cyber security comprises technologies, processes and controls that are designed to protect systems, networks and data from cyber attacks" and the unauthorized exploitation of sensitive technologies and information.[3] Given that companies heavily rely on the digitally connected world, there are "ongoing risks and threats of cybersecurity incidents for all companies."[4] "Cyber crime is the greatest threat to every company in the world,"[5] yet only 38 percent of global organizations believe they are capable of managing a sophisticated cyber attack.[6]

To protect the interest of investors of publicly traded companies, in February 2018 the Securities and Exchange Commission (SEC) released new guidance related to disclosure and cybersecurity for senior executives and board members[7] that further reinforced and expanded on the Commission's prior guidance on the matter published in 2011.[8] The Commission believed that transparently communicating its views on cybersecurity risks and incidents would promote "clearer and more robust disclosure by companies . . . resulting in more complete information being available to investors."[9] While these 2018 recommendations are *more* rigid than those already put in place in 2011, they fell very short of what is necessary for the investing public.[10]

This article as a whole will identify and analyze issues related to the SEC's recent issuance of cybersecurity disclosure guidelines. Part II of the article will mention the specifics of the prior guidance on cybersecurity disclosure and compare those 2011 recommendations to the recently issued guidelines of 2018. Part III will discuss the issue of insider trading in connection with undisclosed cybersecurity breaches and specifically analyze the 2017 Equifax case. Part IV will analyze other comparable cybersecurity regulations in place and their extensive enforcement power. Part V will assert the need for thorough requirements and enforcement provisions from the SEC. Part VI will summarize the thoughts presented herein and conclude.

II. Specifics of the 2011 Recommendations and a Comparison to the Recent Guidelines

"[I]n 2011, the SEC's Division of Corporation Finance first published guidance about disclosing cybersecurity risks and incidents, which was necessary at the time because there were no existing disclosure requirements that specifically addressed cybersecurity issues."[11] Companies are to disclose the possibility of cyber incidents if they constitute significant factors that result in investment in the company being "speculative or risky."[12] Significant factors included: (i) aspects of a business that raise cybersecurity risks and costs and associated consequences, (ii) outsource functions, (iii) cyber incidents experienced, known, or threatened to take place, and (iv) incidents capable of remaining unknown for an extended period.[13]

The recommended disclosures aforementioned, however, did not require that companies disclose technical particulars that would increase their risk of cyber attacks.[14] In other words, "[w]hile not required to provide detailed information that would serve as a roadmap for hackers," companies must disclose any and all cybersecurity risks material to investors.[15] Moreover, the guidance failed to mention any means of enforcing the recommendations, an aspect of cybersecurity disclosure that the SEC cannot overlook.[16] As a result, disclosures after issuance of the 2011 guidance "rarely provided differentiated or actionable information for investors."[17] "Since the guidance was first released, there's been no significant changes in companies' disclosures . . . a sign that guidance alone is not enough."[18]

Despite the above, the 2018 recommendations for disclosures related to cybersecurity risks merely echo the 2011 guidelines.[19] Again, the recommendations highlight the same factors, including "the importance of the comprised information, impact on company operations, and range of harm an incident may cause" that companies should contemplate when deciding whether a cybersecurity risk or incident is material.[20] "Instead of recycling old advice, . . . the commission could have examined what it's learned since 2011 from reviews of hundreds of public company filings every year."[21] Moreover, the commission could have investigated recent technological advances used in cyber breaches as a means of formulating appropriate and necessary disclosure requirements.[22]

Moreover, the 2018 recommendations, like the 2011 guidance, provided no real enforcement mechanism to entice companies to strictly adhere to the guidelines.[23] "There is a great deal of information that companies can disclose that won't create additional security risks . . . [such as] 'vulnerability, breach, and risk management process information.'"[24] Still, the SEC, instead of mandating

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compliance, desired to "work with them 'to make sure they have protections in place.'"[25] The new guidelines, however, did address an aspect not mentioned in 2011—"the need for insider trading prohibitions...in relation to cybersecurity incidents."[26]

III. Insider Trading in Connection with Undisclosed Cybersecurity Incidents

Unlike the 2011 guidelines, the 2018 recommendations go on to warn "that corporate insiders must not trade shares when they have information about cybersecurity issues that isn't public yet."[27] This is likely a result of the insider trading litigation surrounding the Equifax data breach that compromised nearly 145 million personally identifiable records just five months prior to the issuance of the SEC's new guidance.[28]

Jun Ying, former USIS Chief Information Officer for Equifax, was indicted on federal charges of insider trading by a grand jury on March 13, 2018.[29] On August 25, 2017, Jun Ying "texted a co-worker that the breach they were working on 'Sounds bad. We may be the one breached'" and a few days later "exercised all of his available stock options . . . resulting in him receiving 6,815 shares of Equifax stock, which he then sold" for over $950,000, realizing a personal gain of over $480,000.[30] It was not until September 7, 2017 that "Equifax publicly announced its data breach, which resulted in its stock price falling."[31]

Although the outcome of the charges against Ying is unknown at this time,[32] the SEC has clearly taken a stand on such behavior.[33] This is evident in their warning against such trading incident to a cybersecurity breach in the new 2018 guidelines.[34] This warning, however, like much of the new guidance, falls short of any real deterrence effect given the complete absence of consequences associated with purposely ignoring the recommendations, especially in relation to the breach notification "warning."[35]

IV. Other Cybersecurity Regulations and Their Extensive Enforcement Power

Unlike the SEC's guidance in both 2011 and 2018, other cybersecurity regulations provide for weighty enforcement power.[36] For instance, 48 of the 50 states have security breach notification laws.[37] California was the first to implement such a law, and other states followed almost instantly.[38] In New Jersey, according to N.J. Stat. § 56:8-163, an "[e]ntity to which the statute applies shall disclose [in the most expedient time possible and without unreasonable delay] any breach of security of computerized records following discovery or notification of the breach to any customer who is a resident of NJ whose [personal information] was, or is reasonably believed to have been, accessed by an unauthorized person."[39] In New York, all banks, insurance companies, and regulated financial services institutions must "have a cybersecurity program in place, appoint a Chief Information Security Officer, and monitor the cybersecurity policies of their business partners."[40]

Cybersecurity regulations that have significant enforcement power do not stop at the state level. The European Union's (EU) General Data Protection Regulation (GDPR), approved by the EU Parliament in April 2016 with an enforcement date of May 2018,[41] "is a regulation that requires businesses to protect the personal data and privacy of EU citizens for transactions that occur within EU member states."[42] The GDPR replaces the EU's Data Protection Derivative in light of the popularity of online business.[43] As such, publicly traded companies, though they may comply with the SEC's new 2018 guidance, may need to rethink their policies and procedures regarding cybersecurity if they conduct business in EU states.[44] In fact, "[a]ccording to the PwC survey, 68 percent of U.S.-based companies expect to spend $1 million to $10 million to meet GDPR requirements."[45]

The breach notification requirement of the GDPR is likely to affect companies the most.[46] Under the GDPR, companies must report data breaches to both supervisory authorities and individuals whose personal information has been compromised due to the breach 72 hours from when detection of the breach initially took place.[47] If a company fails to do so, the data privacy regulation authorizes enforcement sanctions by the EU of "fines of up to 20 million euros or 4 percent of annual global revenues, whichever is higher."[48] The nature of these fines is so substantial that the EU can most definitely expect companies to comply with the new GDPR by its enforcement date.[49]

V. Analysis: The Need for More Thorough Requirements and Strict Enforcement Provisions

Although the Commission's five members[50] voted unanimously to approve the new recommendations, not all Commissioners were content with the final product,[51] and ultimately two were disappointed with the Commission's limited action.[52] First and foremost, one would assume that seven years later, the new guidance, even if not mandated and enforced, would be significantly more in depth given the hundreds of public company filings reviewed since 2011.[53] The SEC could have expanded its guidelines to include "rulemaking on . . . new requirements related to board risk management frameworks for cyber risks, minimum standards to protect the personally identifiable information of investors, Form 8-K reporting of cyberattacks, and development and implementation of . . . policies and procedures beyond just disclosure."[54]

Moreover, the "modest changes to the 2011 staff guidance"[55] did nothing in terms of *mandating* companies to develop and apply stronger cybersecurity policies and procedures.[56] Again, it merely *recommended* generally the same exact policies and procedures, which evidently is not enough.[57] All *guidance* in the interpretative release by the SEC must be *mandatory*[58] and so enforced by law.[59] Although through its interpretive guidance "the SEC is sending a strong message that companies need to take information security much more seriously," and consequently, is getting the attention of senior management,[60] a "strong message" will not entice companies to make the necessary disclosures to the investing public.[61] "'It's quite well and good to point out all these issues, . . . [h]owever, what they're not doing is saying what happens when a company fail[s] to meet these regulations. There's no bite.'"[62]

Even back in 2011, when the publication of the guidance initially took place, corporate information security practitioners, though they felt "encouraged by the SEC's guidance," questioned why "the SEC didn't make it a law."[63] "'The feds are on the right track, but they failed to make it a mandatory requirement'" . . . [and so] "[i]t simply does not carry any enforcement provisions should a company fail to conduct proper due diligence risk assessments on their assets."[64] Normally, "hard-and-fast legal regulations such as Sarbanes Oxley [and] HIPAA (the Health Insurance Portability and Accountability Act)" have substantial enforcement power, and surely SEC regulations concerning cybersecurity disclosure should be in the same category.[65]

VI. Conclusion

The SEC's recent issuance of cybersecurity disclosure guidelines proves toothless in the increasingly threatened, internet-driven world we live in today. The *new* guidelines of 2018 merely *recommend* the same exact policies and procedures that the 2011 guidelines had, irrespective of the fact that the SEC had in its possession seven years of data regarding company compliance. Following the Equifax data breach a short time ago, many were expecting and hoping for more stringent cybersecurity disclosure requirements as a means of protecting the investing public, but unfortunately they were disappointed.

Going forward, the SEC needs to follow the lead of the 48 states and the European Union regarding cybersecurity disclosure, particularly with respect to sanctioning the failure to appropriately execute breach notification. Ultimately, the SEC must enact through law thorough cybersecurity disclosure requirements that all publicly traded companies must abide by, and implement enforcement provisions if companies fail to adhere to the enacted cybersecurity disclosure requirements. Breaches in cybersecurity are on the rise, and since it is the SEC's duty to protect the investing public, toothless *guidance* related to disclosures is simply not enough.

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43 *Id.*

44 *See* Nadeau, *supra* note 41 ("Any company that stores or processes personal information about EU citizens within EU states must comply with the GDPR, even if they do not have a business presence within the EU.").

45 *See id.*

46 *See id.*

47 *See id.*

48 Korolov, *supra* note 7.

49 *See* Nadeau, *supra* note 45 ("And non-compliance could cost companies dearly.").

50 *See* Shu, *supra* note 11.

51 Korolov, *supra* note 7 ("'I am disappointed with the Commission's limited action,' said commissioner Kara Stein in a statement."); Shu, *supra* note 11 ("[B]oth of its Democratic commissioners said [the SEC] needs to take more action.").

52 Shu, *supra* note 11 (quoting Commissioner Stein). *See also* Public Statement, SEC Commissioner Robert J. Jackson Jr., *Statement on Commission Statement and Guidance on Public Company Cybersecurity Disclosures* (Feb. 21, 2018) ("I reluctantly support today's guidance in the hope that it is just the first step toward defeating those who would use technology to threaten our economy. The guidance essentially reiterates years-old staff-level views on this issue."), https://www.sec.gov/news/public-statement/statement-jackson-2018-02-21.

53 *See* Korolov, *supra* note 7 (quoting Commissioner Stein).

54 Lillian Brown, et al. , *SEC Guidance on Public Company Cybersecurity Disclosures*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Mar. 13, 2018), https://corpgov.law.harvard.edu/2018/03/13/sec-guidance-on-public-company-cybersecurity-disclosures/.

55 *Id.* (quoting Commissioner Stein).

56 *Id.*

57 *See* Jackson, *supra* note 52 (quoting the White Hour's Council of Economic Advisers that noted, "'The presence of externalities would lead firms to rationally underinvest in cybersecurity. . . . . For example, certain mandatory disclosure requirements were previously shown to incentivize firms to adopt better cybersecurity measures (see, e.g., Gordon et al. 2015, who conducted an analysis of externalities resulting from weak cybersecurity).'"

58 *See* Shawn Tuma of Scheef & Stone, L.L.P, *Guide to Responding to Data Breaches and Reporting Cybersecurity Incidents to Law Enforcement and Governmental Agencies*, Business Cyber Risk Blog: Analyzing the Global Impact of Cybersecurity, Law, and Business Risk ("There is a grave misunderstanding among many business leaders who believe that when their company has had a data breach, notifying the affected individuals and disclosing to appropriate governmental regulators is optional. It is not."), https://shawnetuma.com/cyber-law-resources/guide-reporting-cybersecurity-incidents-law-enforcement-governmental-regulatory-agencies/

59 *See* Deloitte, *CISOs Welcome SEC Cyber Security Disclosure Guidance But Struggle to Respond*, Wall Street Journal: CIO Journal (Aug. 29, 2012, 12:01AM) (mentioning information security practitioners that suggested "[t]heir only regret is that the SEC didn't make it a law"), http://deloitte.wsj.com/cio/2012/08/29/cisos-welcome-sec-cyber-security-disclosure-guidance-but-struggle-to-respond/.

60 Deloitte, *supra* note 59.

61 Korolov, *supra* note 7 (quoting SEC Commissioner Kara Stein's assertion that "guidance is not enough.").

62 Korolov, *supra* note 7 (quoting Ernest Badway, co-chair of the securities practice at Fox Rothschild LLP).

63 Deloitte, *supra* note 59.

64 *Id.* (quoting George Moraetes, an independent information security consultant).

65 *Id.* (quoting David Torre, a senior enterprise architect with a major computer gaming company).

Inside the Courts:
An Update From Skadden Securities Litigators

Appraisal

Delaware Supreme Court Reverses and Remands Appraisal of Dell Inc.

***Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd*, No. 565, 2016 (Del. Dec. 14, 2017)**

The Delaware Supreme Court reversed in part and remanded to the Court of Chancery for further proceedings the appraisal of Dell Inc. arising from a 2013 management-led buyout by a private equity firm.

The Court of Chancery relied exclusively on a discounted cash flow (DCF) valuation and determined the fair value of Dell shares was $17.62, approximately 28 percent above the merger price of $13.75, which itself represented a 37 percent premium over Dell's 90-day-average unaffected trading price. The Court of Chancery rejected arguments that the well-run and robust deal process that led to the merger price was the most reliable indicator of fair value, concluding, among other things, that the market for Dell stock was inefficient and that, because the transaction was a management-led buyout, the deal price could not be relied upon.

The Supreme Court reversed, holding that the Court of Chancery's decision to rely "exclusively" on its own DCF analysis was based on several assumptions that were not grounded in relevant, accepted financial principles. Specifically, the Supreme Court held that the trial court erred because its reasons for failing to give the deal price weight did not follow from the court's key factual findings, which supported a finding that the "deal price deserved heavy, if not dispositive, weight." In addition, the Supreme Court expressed doubt regarding the Court of Chancery's DCF calculation, noting that the facts suggested that a "strong reliance upon the deal price" was warranted with "far less weight, if any, on the DCF analyses" upon remand.

The Supreme Court concluded that, on remand, the Court of Chancery could enter an order deferring to the deal price without further proceedings, or, if it decides to weigh factors other than the deal price, the weight assigned to each factor must be reconciled with the factual record and accepted financial principles.

Class Certification

Second Circuit Clarifies Application of Presumption of Reliance

***In re Petrobras Sec.*, No. 16-1914-cv (2d Cir. July 7, 2017),**

***Waggoner v. Barclays PLC*, No. 16-1912-cv (2d Cir. Nov. 6, 2017) and *Ark. Teachers Ret. Sys. v. Goldman Sachs Grp., Inc.*, No. 16-250 (2d Cir. Jan. 12, 2018)**

The Second Circuit, in opinions by three different panels, has clarified the method by which plaintiffs may invoke, and defendants may rebut, the "fraud on the market" theory of reliance at the class certification stage.

In *In re Petrobras Securities*, decided last summer, the Second Circuit upheld the district court's finding that Petrobras securities traded in an efficient market — a prerequisite for plaintiffs to rely on the fraud-on-the-market theory and thus obtain the benefit of the presumption of classwide reliance established by *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). While declining to adopt a particular test for market efficiency, the Second Circuit held that the plaintiffs were not required to establish that the price of Petrobras securities increased in response to good news and decreased in response to bad news. Rather, it was sufficient to show that the price changed in response to significant events, regardless of the direction of the changes, and to offer "indirect" evidence of market efficiency, such as high trading volume, extensive analyst coverage and large market capitalization.

In *Waggoner*, the Second Circuit in November 2017 affirmed the district court's certification of a class of investors in a bank's American depositary shares (ADS) alleging claims in connection with the bank's operation of an alternative trading system, or "dark pool." The district court granted certification, finding that the plaintiffs were entitled to the *Basic* presumption of reliance based on indirect evidence that the ADS traded in an efficient market. On appeal, the Second Circuit affirmed, finding that the defendants had not met their burden to rebut, by a preponderance of evidence, the presumption of reliance. First, although there was an absence of direct evidence of price movement on the dates of the alleged misrepresentations, the plaintiffs proceeded on a price maintenance theory (*i.e.*, the statements affected stock prices by maintaining already existent price inflation), and thus a lack of price movement alone did not rebut the presumption of reliance.

Although defendants asserted that other market concerns impacted the stock price, they did not establish that the alleged misrepresentations did not also impact the price. Second, the court concluded that the ADS were traded in an efficient market. The court reasoned that evidence of price impact is not always necessary to establish an efficient market and was not necessary here in light of other factors, particularly the bank's status as "one of the largest financial institutions in the world." Separately, the court also found that the plaintiffs' damages model complied with U.S. Supreme Court guidance in *Comcast Corp. v. Behrend*, 569 U.S. 27 (2013), even though some of the price decline may have been attributable to other market factors, and even though the model failed to account for variations in inflation over time. The defendant has filed a petition for writ of *certiorari* with the Supreme Court.

In *Arkansas Teachers Retirement System*, the Second Circuit in January 2018 vacated an order certifying a class of investors. The district court found that the plaintiffs were entitled to the *Basic* presumption of reliance because the defendant had failed to prove "conclusively" the "complete absence" of an impact on stock price by the alleged misrepresentations. The defendant had presented evidence of 34 dates on which news media reported the alleged misrepresentations without an attendant decline in the stock's price. The Second Circuit held that the district court's finding did not comply with the holding in *Waggoner* that defendants need only rebut the presumption by a preponderance of the evidence, and it stated that the district court had erroneously construed the defendant's evidence of price impact (and lack thereof) as either a truth-on-the-market defense or evidence of a lack of materiality, neither of which would be appropriately considered at the class certification stage. To the contrary, the Second Circuit held that the defendant's evidence that the price had not reacted to news media reports regarding the alleged misrepresentations was competent evidence that the allegedly misleading statements "did not actually affect the stock's market price," as needed to rebut the presumption of reliance.

In *Petrobras*, *Waggoner* and *Arkansas Teachers Retirement System*, the Second Circuit addressed the practical application of the presumption of reliance first established by *Basic* and the standard for defendants to rebut it at the class certification stage. These cases remind litigants that plaintiffs are likely entitled to invoke the *Basic* presumption where the hallmarks of an efficient market are present, but defendants are afforded a meaningful opportunity to rebut any and all prerequisites of the presumption with competent evidence. In doing so, defendants need only meet a preponderance of the evidence standard to successfully rebut the presumption. The long-term impact of these opinions will be observed as the district courts apply them in coming years.

Northern District of California Denies Class Certification, Finds Defendants Successfully Rebutted Fraud-on-the-Market Presumption

***In re Finisar Corp. Sec. Litig.*, No. 5:11-cv-01252-EJD (N.D. Cal. Dec. 5, 2017)**

The district court denied a motion for class certification, holding that the plaintiffs failed to satisfy the predominance requirement under Rule 23(b)(3) of the Federal Rules of Civil Procedure using the fraud-on-the-market theory of reliance.

The theory is "a rebuttable presumption of classwide reliance on public, material misrepresentations when shares are traded in an efficient market." *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, 568 U.S. 455, 463 (2013). A defendant may rebut this presumption by showing with direct evidence that the alleged misrepresentation did not actually affect the stock's market price.

Here, the defense expert used an event study to show that the defendant corporation's stock price did not experience a statistically significant price increase following the alleged misrepresentations. Rather, the increase occurred before the alleged misstatements, as a result of the defendant's press release and earnings call the previous day, neither of which contained statements that the plaintiffs challenge.

While the court recognized that other courts have inferred price impact from the alleged corrective disclosure even where the alleged misstatement has no price impact, such an inference was unwarranted in this case because several analyst reports were issued between the alleged misrepresentation and the alleged corrective disclosure. Those reports served to "sever the link" between the alleged misstatement and any increase in the price of the corporation's stock.

Therefore, because the defendant met its burden to show by a preponderance of the evidence that the alleged misrepresentation did not impact the stock price, it successfully rebutted the presumption of reliance, and the plaintiffs could not satisfy the predominance requirement of Rule 23(b)(3).

SDNY Denies Plaintiffs' Motion for Leave to Amend Claims Because Proposed Amended Claims Would Not Prevail at Class Certification

***Youngers v. Virtus Inv. Partners Inc.*, No. 15cv8262 (S.D.N.Y. Dec. 4, 2017)**

Judge William H. Pauley III denied a motion for leave to file a third amended complaint claiming that an investment management company and certain of its officers violated Section 10(b) of the Securities Exchange Act. Although the plaintiffs moved to amend after the close of fact discovery and after the court had denied class certification, the plaintiffs argued that amendment was warranted because of certain new facts that had arisen during discovery. Specifically, the company had produced transcripts of deposition testimony given by its officers in the context of an enforcement action brought by the Securities and Exchange Commission. The plaintiffs claimed that the testimony revealed that the company had been aware of certain calculation errors in the records of mutual fund indices at issue in the case and therefore had a duty to correct the records that they knew were false. Although the court had previously denied class certification on the grounds that individual issues predominated over issues common to the class, the plaintiffs argued that their new claim, based on the company's duty to correct, satisfied the predominance requirement because plaintiffs would be entitled to the presumption of reliance pursuant to *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972).

The defendants argued, *inter alia*, that the court should deny leave on futility grounds because such amendment would not enable plaintiffs to prevail on a renewed motion for class certification. The court agreed. Relying on a recent decision, *Waggoner v. Barclays PLC*, 875 F.3d 79 (2d Cir. 2017), the court noted that the "*Affiliated Ute* presumption of reliance should be applied sparingly in cases involving primarily a failure to disclose." The court found that this case primarily involved a failure to disclose, "namely, that the Defendants misrepresented the back-tested nature of the track records and the calculations underlying them." The court declined to extend the *Affiliated Ute* presumption to the plaintiffs and denied leave to amend.

Southern District of California Grants Class Certification, Finding Defendant Failed to Rebut Fraud-on-the-Market Presumption of Reliance

Baker v. SeaWorld Entm't, Inc., 14cv2129-MMA (AGS) (S.D. Cal. Nov. 29, 2017)

Blackfish was a 2013 documentary about killer whales in captivity. It purported to reveal the dangers that trainers of killer whales face at places like SeaWorld, and the physical and mental strain that captivity and capture methods place on the whales. The documentary received widespread media attention, and led companies and performers to end relationships with SeaWorld. The 11 SeaWorld parks saw a 13 percent decline in attendance following the film's release. SeaWorld, however, initially attributed the drop in attendance to weather, school and holiday schedules, and a new pricing strategy — even though other theme parks in the same locations did not suffer similar attendance drops. SeaWorld officers stated that the documentary "has had no attendance impact" and that SeaWorld could "attribute no attendance impact at all to the movie."

On August 13, 2014, SeaWorld charted a new course, issuing a statement that "the Company believes attendance in the quarter was impacted by demand pressures related to recent media attention surrounding proposed legislation in the state of California" — legislation prompted by *Blackfish* — that would ban killer whale breeding and captivity programs. SeaWorld's stock price dropped 33 percent following the statement.

Shareholders brought claims under Sections 10(b) and 20 of the Securities Exchange Act and later moved for class certification. In opposing the plaintiffs' motion, the defendants attempted to rebut the fraud-on-the-market theory of reliance, a rebuttable presumption that class members relied on public, material misrepresentations if the shares are traded on an efficient market. They relied on an event study by their expert that concluded there was no statistically significant evidence of price inflation on the six dates the defendants made the alleged misrepresentations. The plaintiffs countered by asserting the price maintenance theory, which posits that price impact in a securities fraud case can be quantified either by the price increase on the dates of the misrepresentation or by the drop in price when the truth is revealed.

While district courts within the Ninth Circuit have disagreed as to the viability of the price maintenance theory, the court noted several decisions in the Second, Seventh and Eleventh circuits that have accepted it. Agreeing with those decisions, the court concluded that a stock price change upon either the misrepresentation or the alleged corrective disclosure was sufficient to maintain the fraud-on-the-market presumption of reliance. Thus, even if the alleged misrepresentation did not cause the stock price to rise, the subsequent drop in stock price in connection with the alleged corrective disclosure prevents defendants from rebutting the presumption of reliance.

District of Massachusetts Rejects Disclosure as Curative

In re AVEO Pharm., Inc. Sec. Litig., No. 13-11157 (D. Mass. Nov. 14, 2017)

The district court allowed the plaintiffs' motion for class certification in an action alleging that AVEO Pharmaceuticals, Inc. and certain of its officers violated Section 10(b) of the Securities Exchange Act by failing to disclose certain of the Food and Drug Administration's (FDA) concerns about AVEO's new drug application. The plaintiffs' proposed class period extended to when an advisory committee to the FDA met to hear the FDA's concerns, and the defendants argued that the class period should end a few days earlier, when the FDA released public materials for that meeting. The defendants asserted that the earlier-released materials contained the FDA's concerns about AVEO's new drug application and, as a result, the FDA's disclosure made public any previously concealed information, which led to a decline in the company's share price.

The court disagreed, explaining that "[if] disclosures 'fail[] to convey the extent' of a piece of information, they cannot be considered curative for class certification purposes." The court found that the FDA's public materials did not convey the full extent of the FDA's concerns because they only served as a starting point for discussion and the materials stated that they did not contain all the information on the new drug application. The court concluded that the FDA's concerns about the new drug application were not fully revealed to the market until the FDA's meeting with its advisory committee.

Core Operations Theory

Southern District of California Holds That Scienter Was Adequately Alleged Based on the Core Operations Theory

3226701 Canada, Inc. v. Qualcomm, Inc., No. 15cv2678-MMA (WVG) (S.D. Cal. Oct. 20, 2017)

Judge Michael M. Anello denied in part a motion to dismiss a putative securities fraud class action, holding that the plaintiffs adequately alleged scienter under the core operations theory.

Qualcomm is a technology company that makes microprocessors often used in smartphones. The Snapdragon 810 is a microprocessor that was slated to be used in Samsung's Galaxy S6 model. Following its release in other smartphones, Qualcomm's CEO made statements that the microprocessor was "performing well" or "as expected." Ultimately, Samsung decided not to use the Snapdragon 810 because of alleged overheating and performance issues.

The plaintiffs sought to establish scienter on the part of the CEO under the core operations theory. Under that theory, "scienter may be inferred where the facts critical to a business' 'core operations' or important transactions are known to key company officers." Here, the plaintiffs alleged that the CEO had direct knowledge of the overheating issues through "contemporaneous reports or data and through attendance of meetings," allegations that were supported by confidential witness statements. The complaint identified five types of reports that were regularly generated and all of which related to the Snapdragon 810 and its performance issues. The plaintiffs also alleged that one of the CEO's direct reports was aware of the overheating problems, received daily reports on it and therefore must have conveyed that information to the CEO.

The plaintiffs further alleged that the Snapdragon 810's overheating issue was such a prominent fact for Qualcomm that it would be absurd for the CEO to be unaware of it. Samsung accounted for 10 percent of Qualcomm's revenues, and the Snapdragon 810 was the subject of extensive media coverage as Qualcomm's premier microprocessor.

The court accordingly found that the plaintiffs had adequately pleaded a strong inference of scienter as to the CEO under the core operations theory, which the court then imputed to Qualcomm.

Fiduciary Duties

Books and Records

Delaware Court of Chancery Rejects *Corwin* Defense in Books-and-Records Action

***Lavin v. West Corp.*, C.A. No. 2017-0547-JRS (Del. Ch. Dec. 29, 2017)**

Vice Chancellor Joseph R. Slights III granted a books-and-records request brought by a stockholder of West Corporation, holding that the Delaware Supreme Court's decision in *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015)—which insulates mergers approved by a fully informed, uncoerced stockholder vote (absent a conflicted controller) from post-closing challenges other than on grounds of waste—could not be raised as a defense in a books-and-records action.

The case arose from a merger between West Corporation and affiliates of Apollo Global Management that was approved by approximately 86 percent of the company's shares. Prior to the stockholder vote, the books-and-records plaintiff sought documents to investigate potential wrongdoing and mismanagement in connection with the merger, as well as the independence and disinterestedness of the members of West Corporation's board of directors. In the ensuing books-and-records litigation, the company's primary defense was that the merger had been approved by a disinterested, fully informed stockholder vote, and the *Corwin* doctrine therefore would limit any post-closing challenge to waste claims, which were not a stated basis for the Section 220 inspection.

The Court of Chancery rejected this argument, ruling that a *Corwin* defense was premature in a books-and-records action and would "invite defendants improperly to draw the court into adjudicating merits defenses to potential underlying claims."

After finding that it could not consider the *Corwin* defense, the Court of Chancery found that the plaintiff had satisfied the "low Section 220 evidentiary threshold" to demonstrate that the directors may have breached their fiduciary duties such that the plaintiff had stated a proper purpose for the inspection. The court reduced the categories of documents for production from the 13 demanded to five but ordered production of board minutes, banker presentations, offer letters and deal documents exchanged with bidders, communications (including emails) about a sale of one or more of West Corporation's business segments, and director independence questionnaires.

Delaware Court of Chancery Denies Books-and-Records Request Where Purpose Belongs to Counsel Rather Than Plaintiff

***Wilkinson v. A. Schulman, Inc.*, C.A. No. 2017-0138-VCL (Del. Ch. Nov. 13, 2017)**

Vice Chancellor J. Travis Laster denied a request for books and records pursuant to Section 220 of the Delaware General Corporation Law, finding that the purpose for the inspection belonged to the plaintiffs' counsel and not to the stockholder plaintiff himself, and thus the plaintiff lacked a proper purpose for the demand.

After trial, the court found, among other things, that the stockholder plaintiff had admitted the articulated purpose in the demand was not his purpose and that his counsel had identified each of the categories of documents sought in the demand; had never reviewed the company's response to the demand or any additional response letters after signing his initial demand letter; had verified the complaint without taking steps to confirm the accuracy of the allegations; did not participate in drafting responses to interrogatories; and had served as a nominal plaintiff for his counsel in at least seven other lawsuits, most of which settled for supplemental disclosures.

In finding that the plaintiff lacked a proper purpose, the court explained that while a stockholder may use counsel to seek books and records, doing so "is fundamentally different than having an entrepreneurial law firm initiate the process, draft a demand to investigate different issues than what motivated the stockholder to respond to the law firm's solicitation, and then pursue the inspection and litigate with only minor and non-substantive involvement from the ostensible stockholder principal."

Controlling Stockholder Litigation

Court of Chancery Expands MFW Business Judgment Protections to Transactions Outside the Merger Context

***IRA Trust FBO Bobbie Ahmed v. Crane*, C.A. No. 12742-CB (Del. Ch. Dec. 11, 2017)**

Chancellor Andre G. Bouchard dismissed breach of fiduciary duty claims asserted against board members and a controlling stockholder challenging approval of a stock reclassification because the defendants had followed the framework of *Kahn v. M&F Worldwide* (*MFW*), 88 A.3d 635 (Del. 2014).

The plaintiff, a stockholder of NRG Yield, Inc. (Yield), alleged that NRG Energy, Inc. (NRG), the controlling stockholder of Yield, caused Yield to approve a reclassification to prevent the company from diluting its position.

Chancellor Bouchard held that the reclassification was subject to the entire fairness standard of review. Distinguishing cases holding that pro rata treatment of stockholders warrants business judgment review, the chancellor held that the ability to maintain its control position by preventing further dilution of its ownership interest through the use of the reclassification was a benefit of the reclassification that was enjoyed by NRG but not shared by the other stockholders. Therefore, entire fairness review was the appropriate standard of review.

Chancellor Bouchard then held that the framework adopted by the Delaware Supreme Court in *MFW* — which lessens the standard of review for evaluating mergers involving a controlling stockholder from entire fairness to business judgment review when certain procedural protections are used — also applied to the reclassification. The court highlighted prior cases in which the Court of Chancery has endorsed using the *MFW* framework outside of the context of a merger, including the sale of a controlled company to a third party and other corporate transactions, and concluded that no rationale exists for treating mergers and other corporate transactions differently under *MFW*.

Finally, Chancellor Bouchard determined that the plaintiff had failed to plead facts sufficient to call into question the satisfaction of any of the six elements of the *MFW* framework: (1) the transaction is conditioned *ab initio* on the approval of both a special committee and a majority of the minority; (2) the special committee is independent; (3) the special committee is empowered to select advisers and to say no definitively; (4) the special committee meets its duty of care in negotiating a fair price; (5) the vote of the minority is informed; and (6) there is no coercion of the minority. The plaintiff had made no effort to overcome the business judgment rule, and therefore the court dismissed the fiduciary duty claims against both the Yield directors and NRG.

Derivative Litigation

Delaware Supreme Court Affirms Dismissal of Wal-Mart Derivative Litigation on Issue Preclusion Grounds

Cal. State Teachers' Ret. Sys. v. Alvarez, No. 295, 2016 (Del. Jan. 25, 2018)

The Delaware Supreme Court affirmed the Court of Chancery's ruling holding that a federal court's prior dismissal of derivative litigation on demand futility grounds precluded the plaintiffs in the Delaware action from attempting to re-plead demand futility.

The case arose from the discovery of an alleged bribery scheme and cover-up by Wal-Mart's Mexican subsidiary, Walmex. Widespread multiforum litigation followed. Numerous actions were filed in Arkansas federal court and in the Delaware Court of Chancery. The Arkansas litigation proceeded ahead of the Delaware litigation, which was slowed by protracted books-and-records litigation. Ultimately, the Arkansas action was dismissed pursuant to Federal Rule of Civil Procedure 23.1 for failure to establish that a demand on the board to initiate litigation was futile.

Chancellor Andre G. Bouchard's initial opinion dismissed the Delaware action, finding that the Arkansas decision on demand futility carried preclusive effect. However, the original opinion did not expressly focus on federal due process concerns as a "separate issue." The Delaware Supreme Court remanded the original opinion, requesting the chancellor to supplement his opinion by focusing on due process considerations. On remand, he concluded that under the current state of the case law, there was no due process violation. Chancellor Bouchard nevertheless advocated for a different approach, based on *dicta* in a prior Court of Chancery opinion, that would have required a prior judgment to have survived a motion to dismiss under Rule 23.1 before it would carry preclusive effect in a subsequent derivative action.

The Supreme Court affirmed the original opinion and declined to adopt the new approach embraced by the Court of Chancery. The Supreme Court emphasized that three federal circuit courts concluded that there is no due process violation to giving preclusive effect to a Rule 23.1 dismissal so long as the plaintiffs' interests were aligned with, and were adequately represented by, the prior plaintiffs. The Supreme Court explained that each element of the applicable issue preclusion standard (here, Arkansas law) was met and that the plaintiffs' interests were aligned.

In finding the Arkansas representation adequate, the Supreme Court rejected the argument that failure to pursue a Section 220 action for company books and records *per se* rendered the Arkansas representation inadequate. The Supreme Court characterized not pursuing a Section 220 action as a "tactical error" that did not render the representation inadequate "*in this instance*" because the Arkansas plaintiffs had access to various internal company documents from a news report.

Director Compensation

Delaware Supreme Court Addresses Stockholder Ratification of Director Compensation

In re Investors Bancorp, Inc. Stockholder Litig., No. 169, 2017 (Del. Dec. 13, 2017)

The Delaware Supreme Court reversed and remanded to the Court of Chancery the dismissal of a complaint challenging director compensation awards as excessive and unfair to the corporation.

The Court of Chancery dismissed the complaint based on prior case law holding that the directors' decision to grant themselves compensation was subject to business judgment review if the incentive plan under which the compensation was granted had been approved by the stockholders and contained "director-specific" limits on the amount of compensation the directors could award themselves. The Supreme Court reversed, holding that stockholder ratification could not be used to lower the standard of review of discretionary awards from entire fairness to the business judgment rule. Because the plan at issue had received stockholder approval only over the broad parameters and limits of the equity incentive plan but allowed for director discretion in making compensation decisions, stockholder ratification was unavailable and the grant of stock awards remained subject to entire fairness review.

The Supreme Court also concluded that demand was excused as to all directors because it was "implausible" that the 10 nonemployee directors who approved the grant of stock awards to both themselves and the two executive directors could have independently considered a demand when doing so would have required them to call into question the grants of stock they had made to themselves.

Mergers and Acquisitions

Court of Chancery Rejects *Corwin* Defense but Dismisses Claims Against Directors for Failure to Plead a Nonexculpated Breach of Fiduciary Duty

***Van der Fluit v. Yates*, C.A. No. 12553-VCMR (Del. Ch. Nov. 30, 2017)**

Vice Chancellor Tamika Montgomery-Reeves rejected a *Corwin* defense based on a disclosure violation in the proxy statement issued in connection with a merger transaction, but she ultimately dismissed claims asserted against directors based on the plaintiff's failure to plead a nonexculpated breach of fiduciary duty.

The plaintiff, a former stockholder of Opower, Inc., alleged that Opower directors breached their fiduciary duties by permitting a purported controlling stockholder to orchestrate an unfair tender offer and subsequent merger with subsidiaries of Oracle Corporation. The defendants moved to dismiss on multiple grounds.

As an initial matter, the Court of Chancery rejected the defendants' attempt to rely on the Delaware Supreme Court's decision in *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015), which requires dismissal of challenges to mergers that are approved by a fully informed, uncoerced stockholder vote. The court rejected the plaintiff's arguments that a controller extracted personal benefits in the transaction (a fact that would bar *Corwin* from applying) because the complaint failed to adequately allege the existence of a control group. However, the court found that disclosures in advance of the stockholder decision to tender their shares were materially deficient, and thus the stockholder vote was not "fully informed." Specifically, the court held that the tender offer solicitation failed to disclose the role the two alleged controllers and company co-founders (who were also the CEO and president, respectively) played in the transaction negotiations. Importantly, each individual received post-closing employment and the conversion of unvested Opower options into unvested Oracle options following the transaction. The court found that the "vague language" in the disclosures about who led the negotiations prohibited Opower stockholders from determining whether the fiduciaries who negotiated the deal had interests that deviated from stockholders.

Although dismissal was inappropriate under *Corwin*, the court dismissed the action for failure to plead a nonexculpated breach of fiduciary duty. Because the complaint sought only monetary damages, and because the company's charter contained an exculpation provision, the plaintiff was required to plead a breach of the duty of loyalty. The court explained that to meet this burden in the context of a sale, the plaintiff must plead nonconclusory facts that support an inference that the majority of the board was either interested in the sales process or acted in bad faith. The plaintiff asserted five separate arguments as a basis for finding a duty of loyalty violation. Each was analyzed and rejected for lack of sufficient factual allegations to draw an inference of disloyalty.

High-Speed Trading

Second Circuit Revives Claims That Certain Securities Exchanges Participated in Manipulative Scheme With High-Frequency Trading Firms

***City of Providence v. BATS Global Mkts., Inc.*, No. 15-3057-cv (2d Cir. Dec. 19, 2017)**

The Second Circuit reversed and vacated the dismissal of claims that multiple national securities exchanges violated Section 10(b) of the Securities Exchange Act by misleading investors about the products and services sold to high-frequency trading (HFT) firms. The plaintiffs alleged that the defendants favored HFT firms by selling them products (access to proprietary data feeds, co-location services and certain complex-order types) that provided them with market information more quickly and with more detail than what they provided to ordinary investors, which permitted HFT firms to front-run the market. The plaintiffs claimed that the proprietary data feeds allowed market data to reach HFT firms before other investors. The plaintiffs claimed that the co-location services allowed HFT firms to place their computer servers in close proximity to the exchanges' systems, reducing the lag time in communication between the servers. The plaintiffs also claimed that certain complex-order types enabled HFT firms to "place orders that remain hidden from the ordinary bid-and-offer listings on an individual exchange until a stock reaches a particular price, at which point the hidden orders emerge and jump the queue ahead of other investors' orders." The plaintiffs alleged that the defendants failed to fully disclose the services they were providing to HFT firms, harming ordinary investors.

The lower court had dismissed those claims on the grounds that (1) the exchanges are registered with the SEC as self-regulatory organizations (SROs) and are entitled to absolute immunity as quasi-governmental entities, and (2) even if the exchanges were not absolutely immune, the plaintiffs failed to state a claim under the Securities Exchange Act. On appeal, the defendants argued that they were entitled to immunity, as the Second Circuit had previously held that SROs were immune to suits because they were delegated regulatory authority pursuant to the Securities Exchange Act and effectively "st[ood] in the shoes of the SEC." The defendants also argued that the plaintiffs failed to plead that the SROs engaged in a manipulative scheme under Section 10(b) because the "plaintiffs do not allege that the exchanges themselves engaged in any manipulative 'trading activity'" and because Section 10(b) does not provide for liability for aiding and abetting. The plaintiffs argued that the exchanges were not entitled to immunity because they were acting not in their capacity as regulators in providing premium products and services to HFT firms but as ordinary market participants. The plaintiffs argued that the exchanges had engaged in a manipulative scheme by permitting HFT firms to obtain nonpublic information unavailable to normal investors and had failed to disclose the impact of those services, "creat[ing] a false appearance of market liquidity that, unbeknownst to [the] plaintiffs, resulted in their bids and orders not being filled at the best available prices."

The Second Circuit agreed with the plaintiffs. The court declined to extend immunity to the SROs because the SROs' alleged conduct was not regulatory. The court noted that the plaintiffs "do not allege that the exchanges inadequately responded to, monitored, or policed their members' actions," and that "plaintiffs challenge exchange actions that are wholly divorced from the exchanges' role as regulators." Regarding the manipulative scheme claim under Section 10(b), the court found that the plaintiffs need not allege that the exchanges themselves engaged in manipulative trading activity. The court noted that "the exchanges do not cite, and we are not aware of, any authority explicitly stating that such a claim must concern a defendant's trading activity." Although the court agreed with the defendants that Section 10(b) does not provide for aiding-and-abetting liability, the court noted that "the plaintiffs do not assert that the exchanges simply facilitated manipulative conduct by the HFT firms. ... [T]he plaintiffs contend that the exchanges were co-participants ... and profited by that scheme."

Loss Causation

Ninth Circuit Holds That General Proximate Cause Test Governs Loss Causation Inquiry; Market Need Not Learn Defendant Engaged in Fraud to Satisfy Standard

***Mineworkers' Pension Scheme v. First Solar Inc.*, No. 15-17282 (9th Cir. Jan. 31, 2018)**

Shareholders claimed that First Solar Inc. fraudulently inflated stock prices by concealing defects in its solar panels. The plaintiffs argued that First Solar's misrepresentations caused their loss when the stock price fell from $300 in 2008 to less than $50 in 2012. The defendants countered that loss causation requires that the market learn of the alleged fraud and react to it, leading to a stock drop. Both parties pointed to conflicting lines of cases to back their arguments.

The Ninth Circuit answered the following question that the district court certified for interlocutory appeal: "[W]hat is the correct test for loss causation in the Ninth Circuit? Can a plaintiff prove loss causation by showing that the very facts misrepresented or omitted by the defendant were a substantial factor in causing the plaintiff's economic loss, even if the fraud itself was not revealed to the market (*Nuveen*, 730 F.3d at 1120), or must the market actually learn that the defendant engaged in fraud and react to the fraud itself (*Oracle*, 627 F.3d at 392)?"

The panel concluded that "a general proximate cause test ... is the proper test" for loss causation. Under that standard, the "ultimate issue" is simply "whether the defendant's misstatement, as opposed to some other fact, foreseeably caused the plaintiff's loss." The market need not actually learn that the defendant engaged in fraud and react to the fraud itself. The panel stated, "Disclosure of the fraud is not a *sine qua non* of loss causation, which may be shown even where the alleged fraud is not necessarily revealed prior to the economic loss." While acknowledging prior Ninth Circuit precedent that appeared to require a revelation of fraud, the panel stated that "[r]evelation of fraud in the marketplace is simply one of the 'infinite variety' of causation theories a plaintiff might allege to satisfy proximate cause."

Securities Exchange Act

Fourth Circuit Declines to Find a 'Strong Inference' of Scienter Based on Inference That Defendant Knew He Had Made a Material Misrepresentation

***Maguire Fin., LP v. PowerSecure Int'l, Inc.*, No. 16-2163 (4th Cir. Nov. 15, 2017)**

A three-judge panel affirmed the judgment of the Eastern District of North Carolina dismissing plaintiff-appellant Maguire Financial, LP's amended complaint because it failed to adequately allege scienter under Section 10(b) of the Securities Exchange Act and Rule 10b-5. The court held that a statement by the CEO of PowerSecure International, Inc. to analysts regarding a multimillion dollar contract renewal was insufficient to support an allegation of scienter. The court rejected Maguire Financial's theory that an inference that the CEO knew his statement was false was sufficient to demonstrate the CEO acted intentionally or recklessly to deceive, manipulate or defraud.

PowerSecure provides utility and energy technologies to electric utilities and their customers. Its CEO, Sidney Hinton, referring to PowerSecure's three-year contract with Florida Power & Light (FP&L) for the West Palm Beach area that would soon expire, stated during an August 7, 2013, conference call and live webcast that PowerSecure was "blessed to announce securing a $49 million three-year contract renewal, both the renewal and expansion with one of the largest investor [owned] utilities in the country."

On May 7, 2014, PowerSecure reported a first quarter loss due to increased costs and expenses resulting from the changed geographies it was serving pursuant to its new contract with FP&L. Three class action lawsuits were then filed against PowerSecure, Hinton and PowerSecure's chief financial officer.

The district court consolidated the lawsuits and appointed Maguire Financial lead plaintiff. Maguire Financial filed a consolidated complaint, alleging that "PowerSecure's share price was artificially inflated after Hinton's August 7, 2013, statement that PowerSecure had obtained a 'contract renewal,' because PowerSecure knew then that its West Palm Beach contract had not been extended, and it had instead been awarded a less profitable contract in Ft. Myers." The district court held that Maguire Financial had adequately alleged the August 7, 2013, statement was materially misleading but that the complaint failed to plead scienter.

On appeal, Maguire Financial argued that Hinton, as CEO of PowerSecure with decades of experience, must have known that the contract was not a renewal but rather a new contract for a different location, which would require PowerSecure to hire and train new workers at a significant expense. Maguire Financial also argued that Hinton, along with other company executives, had various motives to inflate the stock price and that these motives, combined with Hinton's knowledge that the contract was not a renewal, satisfy the scienter requirement.

The Fourth Circuit held that Maguire Financial failed to adequately plead scienter as required by Section 10(b), Rule 10b-5 and the Private Securities Litigation Reform Act (PSLRA). The court drew a distinction between the material misrepresentation and scienter elements of a Rule 10b-5 claim, explaining that "[t]he material misrepresentation inquiry focuses on the reasonable investor's view of a factual statement, while the scienter inquiry focuses on the defendant's mental state."

The court rejected Maguire Financial's argument that the inference that Hinton knew his statement was false was sufficient to show he acted with scienter. The court explained that Maguire Financial's "argument fuses an inference that Hinton knew enough to realize that his characterization was technically incorrect with an inference that he intended it to deceive." The court instructed that "scienter and knowledge with respect to misrepresentation are distinct components of the requisite analytical framework," and that "[t]o conflate the two, as [Maguire Financial] would have us do, would read the scienter element out of the analysis in contravention of the PSLRA's exacting pleading standard."

The court also analyzed the complaint's allegations in totality and held that the alleged facts did not support the inference that defendants intentionally or recklessly misled investors. In explaining where Maguire Financial's allegations fell short, the court noted that "the amended complaint's failure to identify a single fact that shows that Hinton knew ... the new contract would be less profitable" at the time he made the allegedly material misrepresentation was a "serious deficiency." The court was not swayed by the fact that the new contract eventually did reduce PowerSecure's profitability, partly because the complaint neither alleged that PowerSecure had previously incurred additional costs in serving an existing client in a new location nor that this was common knowledge in the industry. Moreover, Maguire Financial's allegation that PowerSecure sold 2.3 million shares a week after Hinton's statement, absent anything more, was "scarcely sufficient" to suggest impropriety in the court's view.

Securities Fraud Pleading Standards

Ninth Circuit Holds Disclosure of FTC Consumer Complaints Insufficient to Establish Loss Causation

***Curry v. Yelp, Inc.*, No. 16-15104 (9th Cir. Nov. 21, 2017)**

The Ninth Circuit affirmed the dismissal of a putative securities fraud class action against Yelp, Inc. for failure to adequately allege loss causation and scienter.

Yelp, Inc. hosts a website that provides reviews of businesses. In response to a Freedom of Information Act request, the Federal Trade Commission (FTC) disclosed more than 2,000 complaints from businesses claiming that Yelp had manipulated reviews of their services. The plaintiffs alleged that this disclosure revealed that Yelp's prior statements about the independence and authenticity of its reviews were false, and that Yelp's stock dropped as a result.

The district court dismissed the complaint, and the Ninth Circuit affirmed. The court explained that the announcement of an investigation is insufficient to establish loss causation under Ninth Circuit law. Given that standard, the lesser revelation of mere consumer complaints —which were not followed by an investigation—certainly cannot meet the heightened pleading standards of the PSLRA and Federal Rule of Civil Procedure 9(b). In short, the court concluded, the plaintiffs cannot simply assert that "where there is smoke, there must be fire."

As an additional basis for dismissal, the court also held that the plaintiffs failed to adequately plead scienter. In rejecting the plaintiffs' attempt to invoke the core operations theory, the court reasoned that management's general awareness of the daily business did not satisfy the pleading standard. The court noted that 2,000 complaints represented a small fraction of Yelp's business — just one in 26,500 reviews — and, therefore, the FTC complaints were not so central to the company's operations as to support a strong inference of scienter.

The court also held that the plaintiffs' allegations of stock sales were insufficient to plead scienter. In particular, the plaintiffs failed to allege specifics of the individual defendants' prior trading history, despite the district court's directives to do so. Absent such allegations, the plaintiffs could not allege that the sales were dramatically different from prior trading practices.

Review and Analysis of 2017 U.S. Shareholder Activism

By Melissa Sawyer and Marc Trevino

Small Group of “Frequent” Activists Leading High-Profile Campaigns at Large-Cap Companies

Concentration of Equity Ownership Among Three Largest Index Fund Providers Continues to Influence Outcomes in Activism Situations

Activists Continue to Find Success Despite Institutional Investor Criticism of Rapid Settlements

Institutional Investors Increasingly Focused on ESG and “Long-Termism” May Lead Activists to Focus on Governance Topics

Activism Is Increasingly Shaping the M&A Landscape

INTRODUCTION

Shareholder activist hedge funds grew modestly in 2017, not yet restoring global activist fund assets under management (“AUM”) to 2015 highs. Moreover, the rate of formation of new activist funds continued to decline, and the “winners” in this environment – those activists attracting the most new capital – seemed to be the well-established activists with strong brand names and track records of outperforming the market. Mirroring this development in fundraising, 2017 also saw a resurgence of campaign activity by frequent activists. Notably, these frequent activists appeared to focus on the largest companies, with activists targeting large-cap companies in over 21% of all campaigns (up from 19% in 2016).. Large-caps like P&G, GE, General Motors, Nestle and ADP became notable targets. Despite this increased activity by frequent activists, the overall number of proxy contests and the number of board seats sought by activists both declined during 2017, continuing similar declines observed during 2016.

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Meanwhile, the concentration of ownership among the largest passive institutional investors continues to grow. The three largest index fund providers (BlackRock, State Street and Vanguard) now own about 18.5% of the S&P 500 (compared to 14.7% in 2013), and the top ten institutional holders own over 30% of the S&P 500. In contrast, retail holders now hold less than 30% of the S&P 500. Although retail share ownership at smaller market cap companies remains slightly higher than at the largest companies (e.g., 38% at companies with market capitalizations between $300 million to $2 billion), it also continues to decline, consistent with the overall trend.

With the growing size of the index fund providers' stakes, an activist now only needs to convince a handful of holders (as opposed to hundreds) of its attack thesis. For example, if an activist can accumulate a significant stake of an issuer in which Vanguard, State Street and BlackRock each own a large percentage, then the top four holders would control such a large portion of the outstanding shares that the top 10-12 investors alone could determine the outcome of a shareholder vote. This is particularly the case if the matter to be voted on, such as the election of directors, requires approval of only a majority or plurality of the shares voted rather than a majority of the shares outstanding, because the average percentage of shares voted (even in a contested election) is below 85%. Retail holders, who suffer from a collective action problem, historically have been less likely to vote and may become even less inclined if they perceive their votes as irrelevant to the outcome.

Well-known activists often develop relationships with significant institutional holders because they have communicated with these investors in prior activist campaigns and maintain a regular dialogue. In comparison, issuer management teams and directors may have fewer or more limited relationships with institutional investors, especially passive asset managers and voting teams at active managers. While many issuers have engaged in significantly more outreach to the largest institutions as part of an increasingly proactive and routinized shareholder engagement calendar, they are not always successful in reaching their audience. This is especially the case at smaller-cap issuers who, despite at times hiring sophisticated advisors to assist with investor relations, may struggle to secure meetings with the portfolio managers and governance teams at the largest funds who have limited resources to engage in routine update meetings with the thousands of issuers in their portfolios.

This potential asymmetry of access by issuers and activists to institutional investors is supported by observations from the 2017 activism landscape. First, index funds showed an increased willingness to support dissidents in complex and consequential proxy contests, perhaps because with better access to the index funds, the activists were able to convince the funds of the merits of the dissident slate (e.g., BlackRock supported Pershing Square at ADP). Second, the resurgence of the most prolific activist investors in 2017 may not be solely related to their brand names and fund raising efforts. It also may be partly attributable to the fact that they may have deeper relationships with certain institutional investors, thereby increasing the likelihood of success in any particular campaign.

There is a further hidden cost in the growth of passive investing in that index funds by definition do not make judgments about the businesses or operations of the issuers whose shares they hold. Moreover, expense management in the index fund industry, where margins are already very thin, requires that they focus on voting principles that are scalable and more likely to be "one-size-fits-all" or at least easily and objectively comparable across peers. The result has been index funds and other large asset managers using relative share price performance (such as total shareholder return statistics) and relative executive compensation metrics issues as the key parameters for guiding their voting behavior. Additionally, index funds, public pension funds and large activists alike place a strong emphasis on environmental, social and governance ("ESG") parameters.

Indeed, these institutions have given activists and issuers alike clear guidance about their ESG engagement priorities. In 2017, ESG issues played a prominent role in the passive investors' public discourse, with the index funds' CEOs making public statements on investment stewardship principles and the index funds publishing annual reports articulating more aggressive stances on issues like gender diversity on boards and climate risk. At times, the index funds have even openly targeted specific issuers on these issues. For example, BlackRock has urged oil giant ExxonMobil to be more open about the effects of climate change on its business and criticized its directors' lack of engagement with shareholders. When combined with the parallel focus of pension funds and other large activists, the index funds' focus on ESG has influenced the discourse in corporate governance circles to a large extent, even catalyzing explicit updated voting policies from the proxy advisory firms Institutional Shareholder Services ("ISS") and Glass Lewis.

Unsurprisingly, the index funds' focus on ESG has caused some activists to start to tack toward ESG topics. Activists now not only have additional avenues to launch ESG-based attacks on companies but also a potential path to distinguish their fundraising efforts and appeal to pension funds and other asset managers. Jana Partners, for example, announced that it is raising funds for a new sustainability fund – an announcement that gave emphasis to Jana's and CalSTERs' joint campaign at Apple to institute more parental controls on iPhones.

Not to be overlooked was the clear message that BlackRock's Larry Fink delivered in his 2018 annual letter to CEOs (the "BlackRock CEO Letter") in which he admonished issuers to be focused on and prepared to speak to investors about long-term strategy.[1] It still remains to be seen whether institutional investors will reward issuers who comply or hold activists to the same standard of having to articulate a viable long-term strategy for the targets of their campaigns. Recent index fund criticism of "short termism" – i.e. institutional investor criticism of issuers' swift settlements with activists – did not have a significant impact on the outcome of activism contests in 2017. More than a third of activist campaigns in 2017

[1] *See* Larry Fink's Annual Letter to CEOs – A Sense of Purpose (available at: https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter)

resulted in settlements, which is on par with the rate of settlements in 2016, and the speed with which issuers and activists reached settlements in 2017 was, on average, comparable with 2015 and 2016.

In this environment, ISS has continued to maintain its "what's the harm" approach to voting recommendations in activists' short-slate proxy contests, whether or not the activist presents shareholders with a viable long-term alternative to the issuer's strategic plan. The results of ISS's approach are predictable. Activists are now obtaining board seats at a record rate as a percentage of the overall number of proxy contests – activists won an additional 76 board seats in 2017 alone, raising their five-year total to 642. These directors are also staying on the boards for long periods of time. Since 2010, prominent activist fund insiders who became directors following a settlement agreement stayed on the relevant board for an average of approximately two years longer than the minimum provided for in the settlement agreement, and many insiders in this subset were still on the relevant board at the time of review.

Finally, an important and growing consequence of activism is its nexus with M&A. Activists both catalyze deals (in some cases, by creating a welcoming environment for unsolicited acquisitions) and hold up deals by engaging in so-called "bumpitrage."

Activist agitation has been the genesis for numerous strategic and sale processes, with the activists promoting the M&A alternative, whether a divestiture or a whole company sale, as a "fix" for underperforming businesses. In this environment, 2017 saw a dramatic uptick in unsolicited M&A, with 80% of "friendly" M&A being initiated by bidders rather than targets conducting planned sale processes. Acquirers are able to leverage the disruption engendered by activists, a phenomenon observed at Buffalo Wild Wings, BroadSoft, Parexel, SeaWorld and Whole Foods. In some cases, activists also pressure companies to consider unsolicited takeover bids, as was the case with PPG's ultimately unsuccessful bid for AkzoNobel, which was supported by Elliott Management, and Land & Buildings' pressure on Hudson's Bay to consider Signa's bid for its German retail business.

For any announced M&A transaction, there is the threat of having shareholder approval of the transaction held up by an activist seeking a higher price. Activist pressure resulted in the scuttling or sweetening of multiple M&A deals that were poorly received by investors in 2017, including SandRidge/Bonanza, Huntsman/Clariant, Qualcomm/NXP, Bain-Cinven/STADA, Safran/Zodiac, KKR/Hitachi Kokusai and GE/Arcam. For example, in EQT/Rice Energy, Jana Partners sought to terminate the deal outright, arguing that the dealmaking was motivated by a desire to maximize production growth, the key metric that formed the basis of EQT's executive compensation plans, rather than a desire to secure earnings growth.

Trends and developments in shareholder activism in 2017 portend another busy year for activists and issuers alike in 2018.

NOTES ON THE SCOPE AND SOURCES OF DATA USED IN THIS ARTICLE

The information in this article on proxy contests and other activist campaigns is based on the database maintained by FactSet Research Systems, Inc. on SharkRepellent.net, using a data run on January 5, 2018, supplemented as necessary by our own review of public information and other third-party sources. In order to provide an analysis relevant to our U.S. public company clients, we have not included campaigns at companies with a market cap of under $100 million and have not included campaigns at non-U.S. companies. We have followed the SharkRepellent categorization of campaigns as "proxy fights" or "other stockholder campaigns," but have not included those categorized merely as exempt solicitations or Schedule 13D filings with no public activism. We have not included the mere submission of Rule 14a-8 proposals as "campaigns," although the section "Types and Objectives of Activist Campaigns" discusses the use of shareholder proposals that were brought in conjunction with the activist campaigns covered in this article. We have also excluded from the "other stockholder campaigns" category strategic acquisition attempts that involve unsolicited offers by one business entity to acquire another, though we have included takeover attempts involving unsolicited offers by activist hedge funds.

Data in this article regarding hedge fund AUM, performance and formation is based on the most recent Hedge Fund Industry Report issued by Hedge Fund Research (HFR), unless otherwise indicated. Other data sources, including Proxy Pulse (a Broadridge and PricewaterhouseCoopers initiative) and Preqin, are identified as they arise.

Our analysis throughout this article is heavily dependent upon these data, statistics, our anecdotal experience and various assumptions. If our assumptions prove to be incorrect or if the data is incomplete or contains errors, our analysis and conclusions could change. Moreover, every activism situation is unique and none of the statistics and analysis presented in this article should be construed as legal advice with respect to any particular issuer, activist or set of facts and circumstances.

Table of Contents

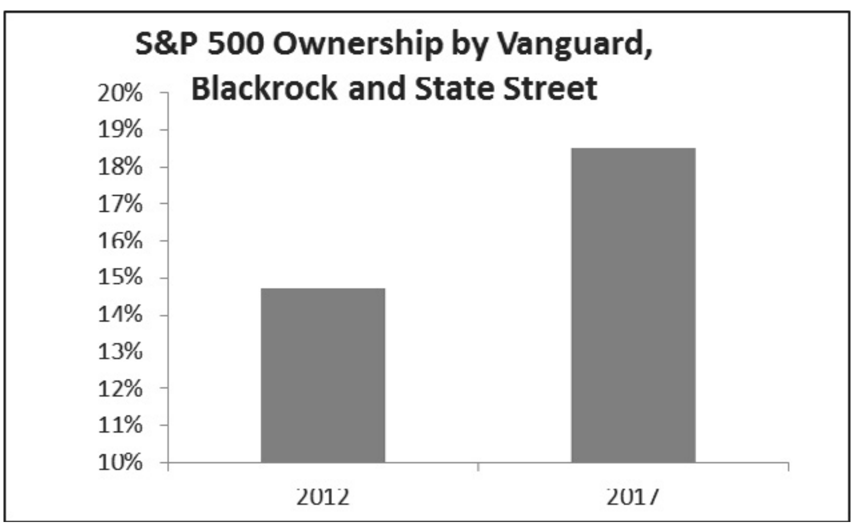
INSTITUTIONAL INVESTORS

The influence of large index and other institutional investors has been central to outcomes of shareholder activism contests. Despite the growth of activist investing in recent years, activists in the aggregate hold a very small percentage of public company stock. Even in companies where they launch campaigns, activists usually do not hold enough stock to play a determinative role in vote outcomes. For campaigns launched in 2017, the median percentage ownership of the dissident group was about 8% and was less than 2% at companies with a market cap of over $20 billion.

To succeed in proxy contests or other campaigns, activists depend on the support of the large institutional investors. These large investors, particularly index fund managers, are well aware of their critical role. Accordingly, before turning to a detailed discussion of activist campaigns, it is worth highlighting trends at the large institutional investors decisive to the activism playing field.

A. CONCENTRATION AMONG LARGEST INSTITUTIONAL INVESTORS

Concentration of equity ownership, particularly among the largest three index providers, continues to be a key component in the activism landscape. As of June 2017, one of BlackRock, Vanguard or State Street was the largest single shareholder in 438 companies out of the S&P 500, or roughly 88 percent of the firms in the index.[2] Fidelity is the fourth largest institutional investor and its ownership also signicantly contributes to the equity concentration of the S&P 500. The following chart shows the growth in ownership stakes held in S&P 500 companies by Vanguard, BlackRock and State Street, which were the three largest U.S. institutional investors in each year:[3]



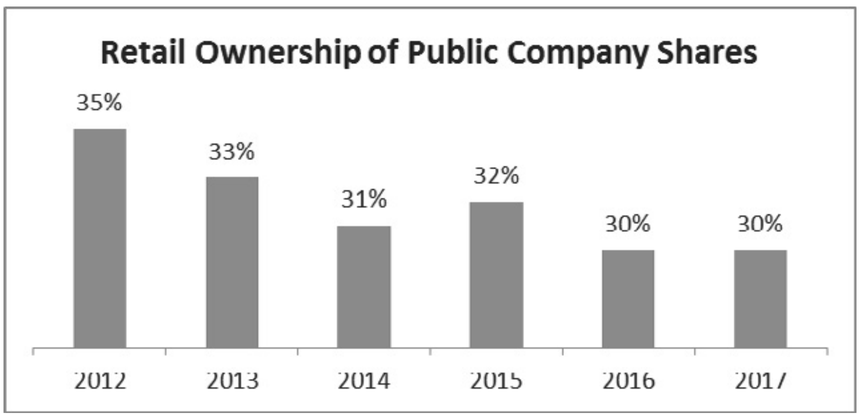
2 Fichtner, Heemskerk, and Bernardo-Garcia, *Hidden power of the Big Three? Passive index funds, re-concentration of corporate ownership, and new financial risk.*

3 *See* Wall Street Journal, *At BlackRock, Vanguard and State Street, 'Engagement' Has Different Meanings* (January 20, 2018).

In last year's Memorandum, we noted that the SEC's proposal to provide dissident shareholders with the ability to list company nominees on the dissident proxy card could make this concentration of share ownership even more impactful. We observed that, if a dissident shareholder could trigger the use of a universal proxy card by reaching out to a small number of large shareholders, it would be much less costly to run a proxy contest. The universal proxy proposal is not on the SEC's near-term agenda but remains active. Moreover, as a counterpoint to our observation, some proxy solicitors suggest that the current system of strictly separating the management and dissident candidates onto separate proxy cards in a plurality-based election system may be backfiring on incumbents in instances in which institutions would prefer to split their vote among management and dissident candidates.

B. SHIFT FROM RETAIL TO INSTITUTIONAL OWNERSHIP

More shares of public companies are in the hands of institutions than in the hands of retail investors. Over the past two years, retail ownership has hovered around 30%, while the top ten institutional holders alone now own more than 30% of the equity ownership of the S&P 500.[4] Retail ownership is even lower at the largest companies – as of December 31, 2016 (the latest data publicly available), companies with market capitalizations in excess of $2 billion were less than 26% owned by retail investors.[5]



The decline in retail ownership understates the actual increase in voting power held by institutional investors. A critical difference between retail and institutional investors is their voting participation level. In 2017, only 29% of retail-held shares were voted, compared to 91% of shares held by institutions.[6] The difference in voting participation is the result of several factors. First, in many cases, institutional investors are required to vote their shares because of fiduciary duties, while there is no requirement for retail investors to vote their shares. Second, the use of notice-and-access for delivery of proxy materials

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4 ProxyPulse, 2017 Proxy Season Review, 2016 Proxy Season Review and 2015 Proxy Season Wrap-up.

5 ProxyPulse, 2017 Proxy Season Preview.

6 ProxyPulse, 2017 Proxy Season Review. This relates to overall votes; not merely contested matters.

to shareholders has contributed to the declining voter participation of retail investors.[7] Third, the diminishing voting participation of retail shareholders has been amplified by the elimination of broker discretionary voting on uninstructed "street name" shares.

Lower levels of retail ownership and voting participation could potentially play a more significant role in the context of future ESG campaigns. A recent analysis of more than 3,000 annual shareholder meetings suggested that retail investors were significantly more likely than institutional investors to support the existing management team on environmental matters, executive compensation practices, and board diversity initiatives.[8] Assuring a high level of retail voting participation will be an important focus for companies that are targets of activist campaigns in these areas. This is particularly true in light of the fact that overall voting participation in contested elections is below 85% and that voting power at many companies is concentrated in the hands of only a few institutional investors. Even a small percentage increase in the voting participation of retail investors could change the outcome of a vote.

The multi-tiered system of beneficial ownership of U.S. equity securities also complicates efforts to verify the legitimacy of retail participation in proxy contests. Trian's campaign at P&G, where it took the inspector of elections 66 days to finalize the vote count after a reportedly intense period of counting proxies in the "snake pit," highlighted the shortcomings of this system. Although a number of proposals to simplify the system or facilitate a different approach to proxy tabulation, such as blockchain initiatives and universal ballots, have been floated, none of them has gained sufficient popularity or, in the case of blockchain, has sufficiently proven technological capability to change the landscape.

C. SHIFT TO INDEX INVESTING AND THE RISE OF SHAREHOLDER ENGAGEMENT

In 2017, investment dollars continued to move away from institutions with active investment philosophies toward index funds and other passive investors. The growth of passive funds has accelerated in recent years, and the percentage of fund assets held in passive strategies has nearly doubled since 2008.[9] According to Morningstar's annual net asset flows report, nearly $692 billion flowed into passive funds during 2017, while $7 billion flowed out of active funds.

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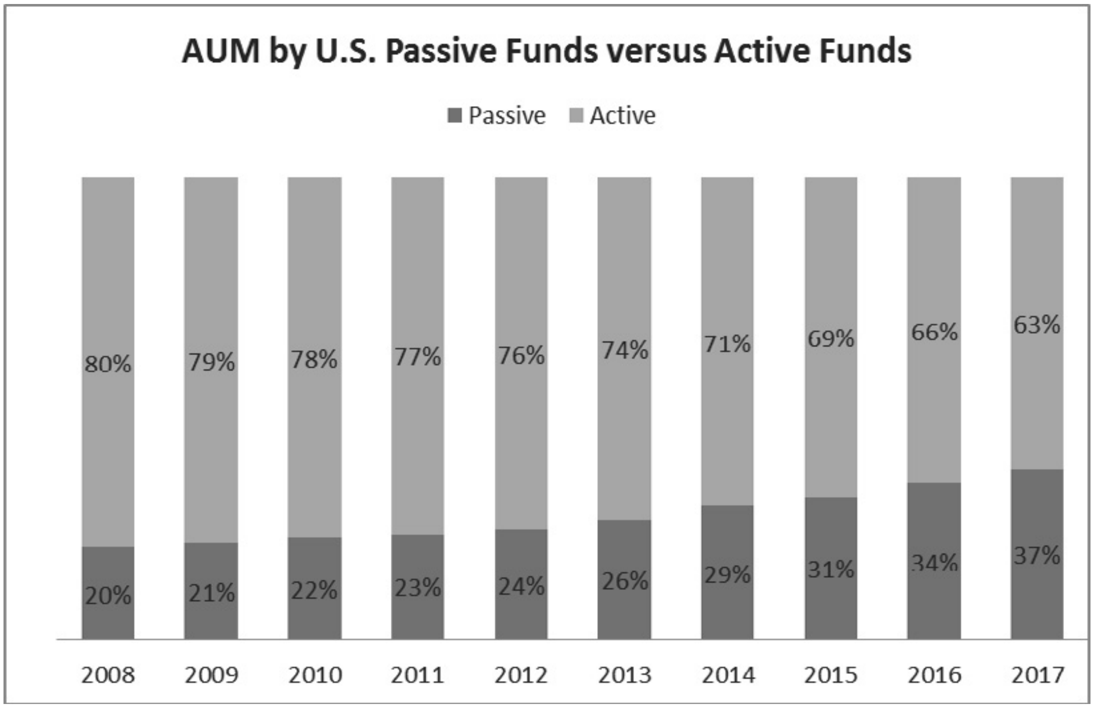
7 The concerns over reduced retail participation when notice-and-access is used are discussed in SEC Release No. 33-9108 (Feb. 22, 2010).

8 *See* Wall Street Journal, *Small Investors Support the Boards. But Few of Them Vote.* (Oct. 6, 2017).

9 Based on Morningstar net assets as of November 30, 2017. Includes U.S. domiciled funds and ETFs, excludes money market funds and funds of funds.



Historically, passive funds have faced stiff price competition, and accordingly, as a means of controlling overhead costs, passive managers have dedicated a limited amount of resources and employees towards engaging with the companies in which they invest. For example, in 2016 the Wall Street Journal noted that State Street had less than 10 employees dedicated to monitoring and deciding positions on issues at over 9,000 companies and that the manager used automated filters to identify companies and issues on which to focus these employees' attention.[10]

This landscape, however, is changing somewhat in the face of the realization by some passive managers that, in addition to competing on price, they can compete on their support for policy initiatives that resonate with their constituents. For example, the BlackRock CEO Letter stated that BlackRock will be doubling the size of its investor stewardship team over the course of the next three years, reflecting increasing focus on a model of shareholder engagement that "deepens communications between shareholders and the companies they own." BlackRock's most recent report on its engagements with issuers states that it engaged with companies on more than 1,200 separate occasions during the 12-month period ended June 30, 2017.

BlackRock is not alone in increasing its engagement with issuers. For example, in its 2017 report, Vanguard indicated that it had engaged with company directors or management more than 800 times during the 12-month period ended June 30, 2017, an increase of 67% over three years. Further, Vanguard indicated that more than 15% of these engagements were discussions regarding activism or

10 Wall Street Journal, *Passive Funds Embrace Their New Power* (Oct. 25, 2016).

contentious transactions. It is expected that these engagement figures will continue to rise as large institutional investors expand their engagement efforts and grow the size of their engagement teams.

Much engagement in 2017 focused on social impact issues, such as board and employee diversity initiatives and environmental matters. In May 2017, a proposal requiring ExxonMobil to share more information about its climate-related plans and strategies passed with supporting votes from BlackRock, Vanguard and State Street. As detailed in the BlackRock CEO Letter, BlackRock intends to send letters to more than 300 companies seeking information about approach to boardroom and employee diversity. Vanguard also has indicated that its engagement efforts have deepened on climate change risks at some of the largest oil and gas companies and that it engaged in discussions with companies on labor and supply practices as well as the importance of gender diversity on boards. In August 2017, State Street announced that it will expand its asset stewardship program and will place increased efforts on its ESG initiatives.

ACTIVIST INVESTORS

A. TOTAL ACTIVIST CAMPAIGNS

2017 saw a slight decrease in the number of activist campaigns, with only 233 campaigns announced. However, as was also a trend in European markets, the year saw an increase in the number of campaigns at the largest companies, which resulted in more capital being deployed by activists year over year. The lower number of campaigns in 2017 reflects that activity is increasingly concentrated among the most frequent activists and that they, in turn, appear to be increasingly focused on campaigns at the largest companies. Based on anecdotal information, a significant number of activist situations also are being resolved without publicity (but confirmatory data on this trend is not available).

Proxy contests made up a smaller percentage of announced activist campaigns in 2017 and 2016 than has been observed in prior years, with 2017 including noticeably fewer contests than even 2016. During these two years, less than 20% of activist campaigns developed into proxy contests.

The trends across 2017 and 2016 in the overall number of campaigns and the proportion that developed into proxy contests marked a notable shift from prior years. In 2014 and 2015, activists recorded substantial increases in campaigns. In 2015, activists publicly announced a total of 300 campaigns, an increase of 10% over the 272 campaigns announced in 2014 and an increase of 36% over the 221 campaigns announced in 2013.[11] Full-scale proxy contests developed, on average, in slightly less than one quarter of all activist campaigns announced from 2013 through 2015. Importantly, this statistic does not take into account campaigns that settled prior to developing into a full proxy contest, but still resulted in board seats for the activists.

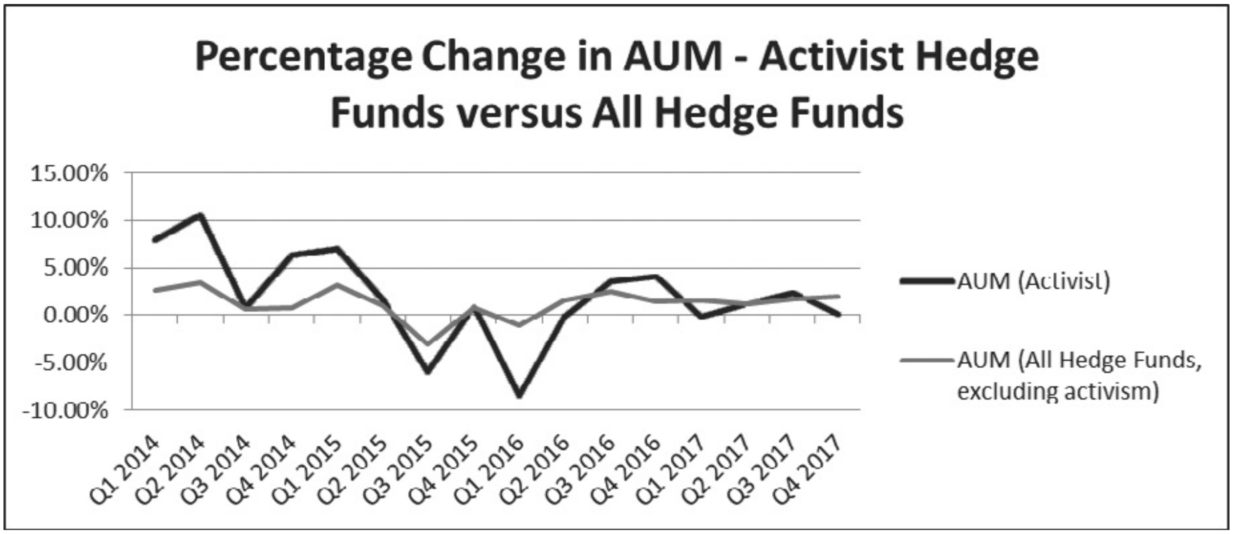
B. ASSETS UNDER MANAGEMENT BY ACTIVIST HEDGE FUNDS

In 2017, activist hedge fund AUM showed very modest increases, growing at a meaningfully lower rate than hedge funds overall. Despite continued growth since the second half of 2016, activist funds AUM remains slightly below the 2015-mid-year peak (while overall hedge fund AUM has more-or-less increased at a steady pace over this two-year period).

AUM (in billions) and Percentage Change Per Half Year										
	H1 2013	*H2 2013*	*H1 2014*	*H2 2014*	*H1 2015*	*H2 2015*	*H1 2016*	*H2 2016*	*H1 2017*	*H2 2017*
Activist Funds:										
AUM	$84	$93	$111	$119	$129	$122	$112	$121	$123	$126
% Change	29%	11%	19%	7%	9%	(5%)	(9%)	8%	1%	2%
Other Hedge Funds:										
AUM	$2,330	$2,535	$2,689	$2,725	$2,839	$2,773	$2,785	$2,897	$2,977	$3,085
% Change	7%	9%	6%	1%	4%	(2%)	0%	4%	3%	4%

11 Based on information from SharkRepellent.net for companies with market cap over $100 million. *See* “Notes on the Scope and Sources of Data Used in this Publication” on page 5.

The decline in AUM that activist hedge funds experienced from mid-2015 to mid-2016 was a reversal of a long-term trend of activist increases in AUM at a higher rate than hedge funds overall and was largely driven by poor activist hedge fund performance during the third quarter of 2015 and the first quarter of 2016. From the early 2000s until the economic downturn in 2008, AUM by activist hedge funds grew each year. After a short period of retrenchment, this growth resumed as the economy recovered. From 2013 to mid-2015, the growth rate of AUM by activist hedge funds was significantly higher than the growth rate experienced by the hedge fund industry as a whole. Activist AUM grew on average 7% per quarter over this time period, whereas all other hedge funds grew at an average rate of less than 3% per quarter.[12]



C. ACTIVIST HEDGE FUND WITHDRAWALS AND REDEMPTIONS

The modest improvement in activist AUM in 2017 (approaching the high point achieved in the first half of 2015) has been driven primarily by enhanced returns. Activist hedge funds experienced a positive net asset flow of only about $875 million in 2017, which was achieved entirely in the second half of the year. The development of positive net asset flow, however, did reverse a trend of negative net asset flows beginning in the fourth quarter of 2015. During this period, withdrawals and redemptions exceeded new investments by over $12 billion at activist hedge funds. Net outflows at activist hedge funds represented approximately 10% of average AUM during this period, whereas outflows at all other hedge funds represented just over 2% of average AUM.

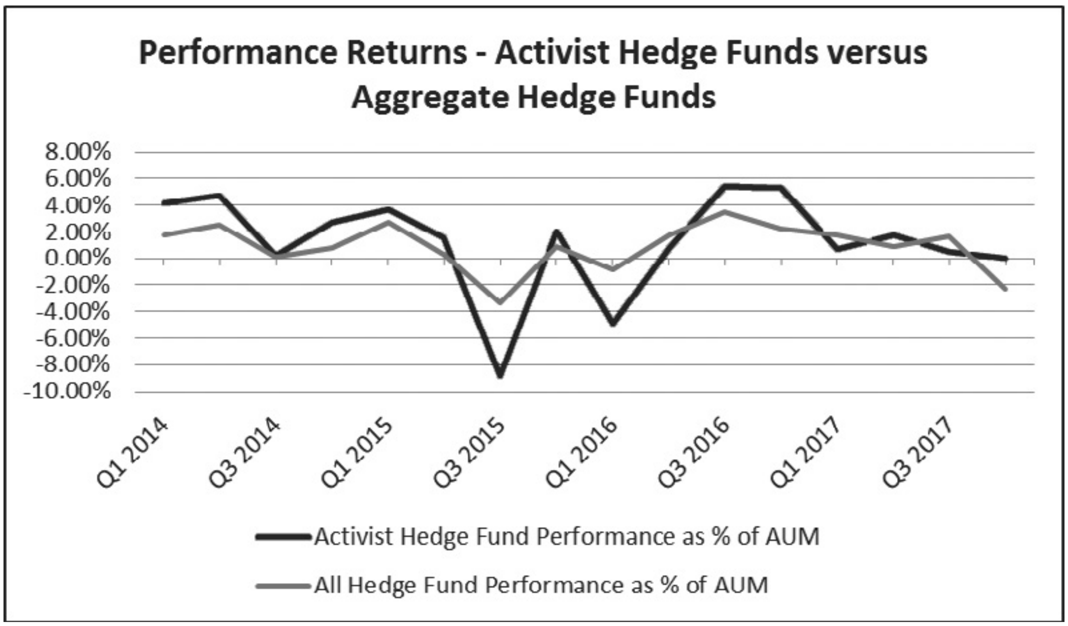
Although the outflows did reverse in the second half of 2017, it remains too early to predict whether investors view activist strategies as capital constrained. The disproportionate amount of outflows over the last two years suggest, at a minimum, that any headwinds encountered by these funds in identifying and

12 Based on information from HFR. See "Notes on the Scope and Sources of Data Used in this Article" on page 46.

capitalizing on activism opportunities can continue to raise significant fundraising and fund-retention challenges.

D. ACTIVIST HEDGE FUND PERFORMANCE

In 2017, the hedge fund industry as a whole earned low returns – an average of 0.48% per quarter – and activists only slightly outpaced the industry by posting average returns of 0.73% per quarter. In contrast, the Dow Jones Industrial Average return during 2017 was more than 24%.[13] If measured from mid-2016, activist hedge funds have earned superior average returns of 2.3% per quarter compared to 1.3% per quarter returns by the hedge fund industry as a whole. On the other hand, from mid-2015 to mid-2016, activist hedge funds on average experienced losses of 2.7% per quarter, whereas hedge funds as a whole experienced average losses of only 0.4% per quarter. In general, activist hedge funds have been more volatile than hedge funds in the aggregate, and this volatility has continued through recent years.



E. FORMATION OF ACTIVIST HEDGE FUNDS

The formation of activist hedge funds has been steadily declining since a peak in 2014. Excluding the effect of the financial crisis, formation numbers generally increased until 2014 and have declined by double digits in each year since.[14] This decrease reflects a shakeout in activist funds on the whole and an enhanced concentration of AUM (and activity) in brand-name activist funds.

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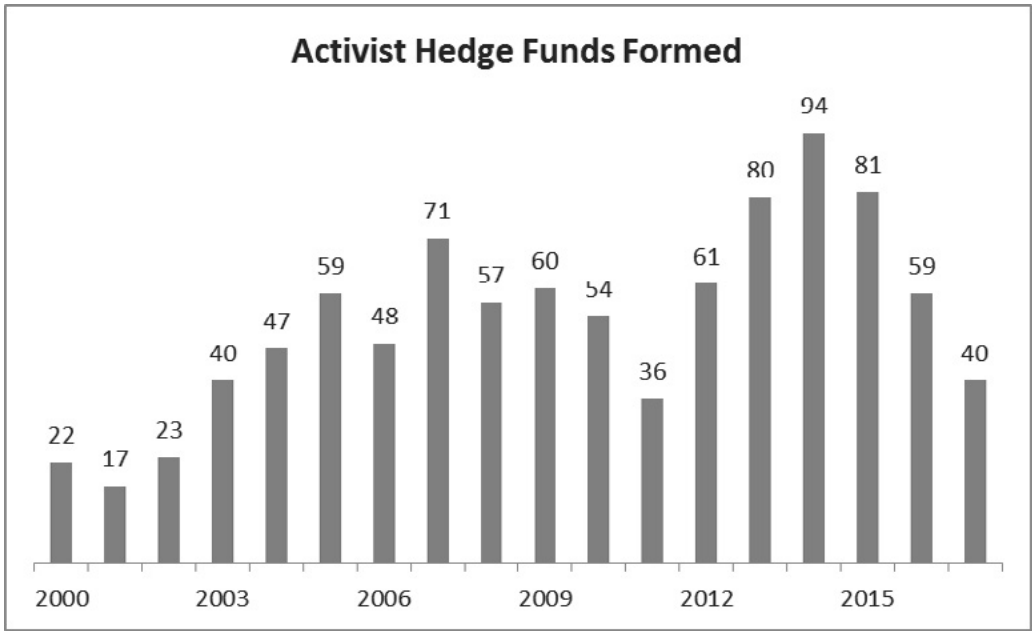
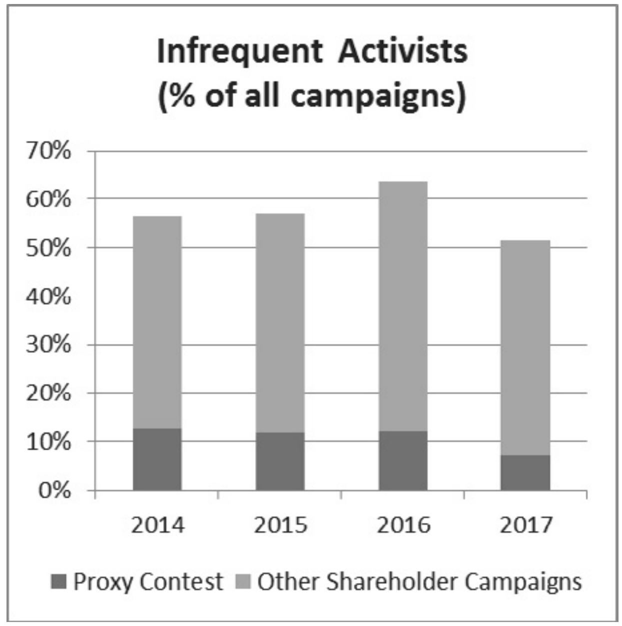
13 Seeking Alpha, *2017 Dow Jones Industrial Average Return* (Jan. 4, 2018).

14 Based on 2018 Preqin Global Hedge Fund Report.



F. INCREASE IN ACTIVIST CAMPAIGNS BROUGHT BY FREQUENT ACTIVISTS

2017 saw a small number of activist investors dominate the activist space, making up a large portion of the total number of public activist campaigns. For purposes of this article, we have defined frequent activists as those that have each brought more than five campaigns since the beginning of 2014. Frequent activists brought 9% of all proxy contests and 49% of all announced campaigns, marking a resurgence from 2016, in which frequent activists brought only 6% of all proxy contests and 37% of all announced campaigns, and representing activity levels more consistent with 2014 and 2015. Given that frequent activists more often target large companies, their activity levels in 2017 are consistent with the increase in large companies targeted by activists.



G. FREQUENT ACTIVIST INVESTORS

The most frequent activists in terms of announced campaigns in 2017 were Elliott Management, Saba Capital and GAMCO Asset Management. In addition to the public campaigns discussed below, these and other activists engage in "behind the scenes" campaigns that often prove successful. GAMCO and Elliott have appeared in the top-three four and three times, respectively, over the past five years, while this is Saba's first time in the top-three. During this time period, GAMCO has engaged in 41 announced campaigns, while Elliott is second with 36 announced campaigns. Starboard Value, which also has been in the top-three three times, announced three campaigns in 2017:

Announced Campaigns by Most Frequent Activists[15]	
2017	
Elliott Management Corporation	8
Saba Capital Management	8
GAMCO Asset Management, Inc.	7
2016	
Elliott Management Corporation	8
Bulldog Investors, LLC	7
Starboard Value LP	3
2015	
GAMCO Asset Management, Inc.	11
Bulldog Investors, LLC	9
Elliott Management Corporation	8
2014	
Starboard Value LP	10
GAMCO Asset Management, Inc.	9
Lone Star Value Management, LLC	8

15 Based on information from SharkRepellent.net for companies with market cap over $100 million. See "Notes on the Scope and Sources of Data Used in This Article" on page 46 of the *Introduction*.

Announced Campaigns by Most Frequent Activists[15]	
2013	
GAMCO Asset Management, Inc.	10
Starboard Value LP	10
Clinton Group, Inc.	8

H. PROMINENT ACTIVIST INVESTORS

As discussed further in the section “Target Companies by Market Capitalization” below, a large percentage of Fortune 100 companies have been the targets of activist campaigns. But, given the capital required to raise a significant stake in large-cap companies, only a small number of prominent activist investors have targeted Fortune 100 companies. Only five investors have announced more than one activist campaign against a Fortune 100 target company since 2014.

Fortune 100 Campaigns 2014–17	
Activist	**Campaigns**
Trian Fund Management, L.P.	4
Value Act Capital Management LP	3
Greenlight Capital, Inc.	3
Third Point LLC	3
Icahn Associates Corp.	2

I. MOST SUCCESSFUL ACTIVISTS BY BOARD SEATS OBTAINED

Activists have obtained board seats as a result of their efforts at a consistent rate in recent years, although the number of board seats sought and achieved has declined markedly since 2015. As summarized in the table below, activists on average have received just over one board seat for every two campaigns announced in a particular year.[16]

Board Seats Obtained by Activists					
	2013	**2014**	**2015**	**2016**	**2017**
Total Board Seats Obtained	128	169	173	96	76
Number of Total Completed Campaigns	221	272	300	243	115
Average Board Seats Per Campaign	0.57	0.62	0.57	0.40	0.66

Not surprisingly, the activists that have been the most successful at obtaining board seats are generally those who are the most prolific in terms of number of campaigns. Icahn Associates is a notable exception, in that it has not been in the top three most frequent activists in any year during the period. Many board seats are also obtained through “quiet” campaigns where an activist engages with the issuer “behind the scenes.”

Number of Board Seats Obtained by Most Successful Activists					
	2013	**2014**	**2015**	**2016**	**2017**
Starboard Value LP	7	24	13	5	7
Icahn Associates Corporation	5	5	9	3	0

16 Based on information from SharkRepellent.net for U.S. companies with market cap over $100 million. *See* “Notes on the Scope and Sources of Data Used in This Article” on page 46. For purposes of this section, board seats are recorded as obtained during the year in which the activist campaign was initiated.

Number of Board Seats Obtained by Most Successful Activists					
	2013	*2014*	*2015*	*2016*	*2017*
Elliott Management Corporation	5	7	6	9	2

TARGET COMPANIES

A. TARGET COMPANIES BY MARKET CAPITALIZATION

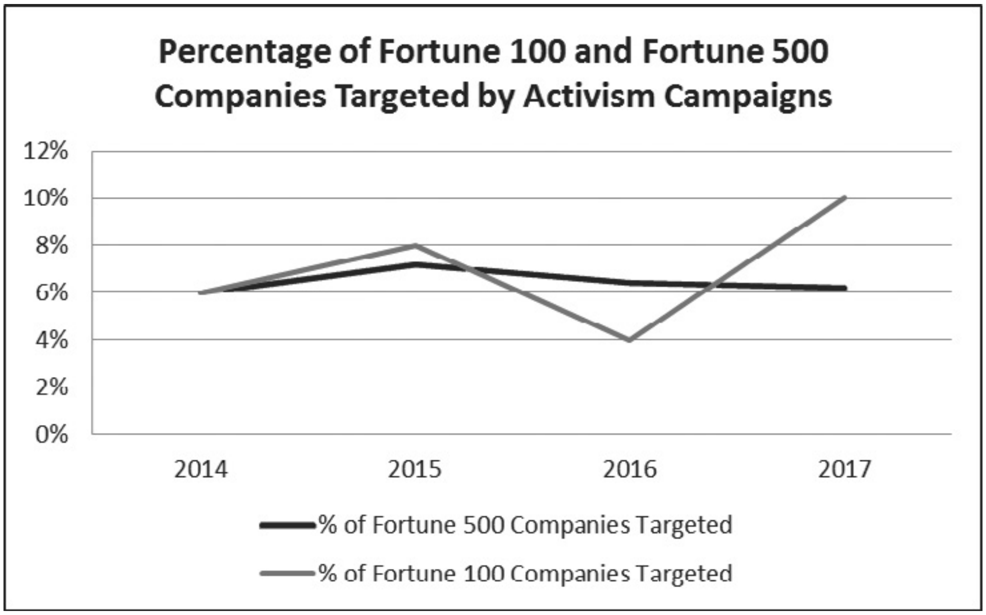
2017 saw a sharp increase in the percentage of campaigns at the largest companies, including highly public campaigns at household-name companies. It remains to be seen, however, whether 2017 signals a trend. The following sets forth the market cap of companies targeted by activist campaigns announced since the beginning of 2013, with the first row indicating the allocation of *all* U.S. public companies in each range.[17]

Target Company Market Capitalization					
	\$100m–\$500m	*\$500m–\$1b*	*\$1b–\$10b*	*\$10b–\$50b*	*>\$50b*
Percentage of total companies	*26%*	*15%*	*44%*	*11%*	*3%*
2017 campaigns	42%	15%	28%	8%	6%
2016 campaigns	44%	19%	29%	6%	2%
2015 campaigns	45%	15%	29%	8%	3%
2014 campaigns	42%	14%	33%	6%	5%
2013 campaigns	38%	14%	35%	7%	3%
Five-year average	42%	15%	30%	7%	4%

Smaller companies tend to be targeted somewhat more frequently, with companies whose market cap is between $100 million and $500 million representing an average of 42% of campaigns, while representing only 26% of public companies. In contrast, companies with market caps between $1 billion and $10 billion are somewhat less likely to be targeted, as these companies represent an average of 30% of campaigns, while making up 44% of public companies.

On average, about 11% of the campaigns in each year targeted companies with market caps of greater than $10 billion, with companies of greater than $50 billion making up around 4% of total campaigns. In 2017, however, companies with market caps greater than $50 billion made up 6% of total campaigns, while representing only 3% of companies. It is not clear whether the increased targeting of larger cap companies is a trend, but at a minimum, 2017 has confirmed that the largest companies are in no way immune from activist campaigns. For the companies that are currently in the Fortune 100, 33% have been targeted by a public activism campaign since 2013 and untold others have dealt with activism situations privately. The following chart shows the percentage of Fortune 100 and Fortune 500 companies that have been targets of activist campaigns in each of the past five years.

17 As discussed further in “Notes on the Scope and Sources of Data Used in This Article” on page 46, we have based this analysis on information from SharkRepellent.net, and limited our analysis to U.S. companies with a market capitalization of over $100 million.



B. INDUSTRIES OF TARGET COMPANIES

Activists have targeted a wide variety of industries since 2014. The most targeted industries, which have generally been consistent in each year, include investment vehicles (including investment trusts and mutual funds), pharmaceutical companies, software companies, other commercial service providers and regional/mid-sized banks.[18]

Most Targeted Industries 2014 to 2017	
Industry	*Total Campaigns*
Investment Trusts / Mutual Funds	77
Packaged Software	58
Miscellaneous Commercial Services	42
Major Pharmaceuticals	38
Regional/Mid-sized Banks	34

Particular industries that have been targeted in 2017 more than in prior years include real estate development, financial conglomerates, semiconductors, medical specialties and movies/entertainment.

TYPES AND OBJECTIVES OF ACTIVIST CAMPAIGNS

Initiating or threatening to initiate a proxy contest for representation on a company's board of directors is a common strategy used by activists to achieve their campaign objectives. A proxy contest occurs when an activist nominates one or more directors for election in opposition to a public company's slate of director nominees. Activists also conduct campaigns through other avenues and tactics, all of which we have included in the general category of "other shareholder campaigns"; this can include publicly

18 Industry classifications based on data from SharkRepellent.net. *See* "Notes on the Scope and Sources of Data Used in This Article" on page 46.

disclosing letters to target companies, issuing press releases, proposing precatory or binding shareholder proposals, running "vote no" campaigns against incumbent directors, calling special meetings or taking actions by written consent.[19]

A. FREQUENCY OF DIFFERENT CAMPAIGN TYPES

2017 saw a moderate decrease in the number of activist campaigns, including both proxy contests and other shareholder campaigns, following a similar reduction in 2016 which was emphasized by a sharp decline in the number of proxy contests. For the prior three years, activist campaigns had been continuously growing.

Number of Campaigns Announced Per Year			
	Proxy Contests[20]	*Other Shareholder Campaigns*	*Total*
2017	39	194	233
2016	49	218	267
2015	73	227	300
2014	62	210	272
2013	65	156	221
Five-year average	58	201	259

On average, 22% of activist campaigns have taken the form of actual proxy contests. The actual percentages are lower for campaigns announced in 2016 and 2017, at 18% and 16%, respectively, which is due in part to the fact that the above numbers include only completed contests, not pending ones, and that some of the campaigns currently categorized as "Other" may yet evolve into actual proxy contests in 2018.

B. UNDERLYING OBJECTIVES OF ACTIVIST CAMPAIGNS

Although board representation remains the most common objective in activist campaigns, it is almost always sought to promote other underlying objectives. In past years, the most common underlying objectives of proxy contests related to business strategies, balance sheet actions (such as returning cash to shareholders through dividends or share repurchase, which are often related to capital allocation strategies) and divestitures or other M&A actions (such as encouraging a sale of the target company or opposing a merger). In 2017, proxy contests focused more on balance sheet issues (such as concerns about the capital structure of the company) and board-related governance issues, with business strategy issues and M&A actions less of a focus. However, much of the increase in focus on balance sheet issues in the 2017 campaigns related to a more-or-less generic concern for shareholder value rather than

19 These categories align with "Proxy Fights" and "Other Stockholder Campaigns" used by SharkRepellent.net. We have not included SharkRepellent.net's other categories of "Exempt Solicitations" and "13D Filings Without Public Activism" as activist campaigns in this article, as they more often reflect ordinary course shareholder interaction rather than true activist situations. See "Notes on the Scope and Sources of Data Used in This Article" on page 46 for a further discussion.

20 Throughout this section, to aid comparison of outcomes across years, we have included only proxy contests that have been completed, not those that remain pending. This results in a lower number of contests for 2017 in particular than would appear if the outcome of all pending contests was known.

specific proposals (which is perhaps a symptom of the fact that companies have become more proactive in taking concrete actions to improve shareholder value or have already made changes in response to a prior activist approach). In addition, over the past three years, an increasing number of proxy contests have included a focus on compensation-related issues.

Objectives of Proxy Contests[21]						
Issue	***2013***	***2014***	***2015***	***2016***	***2017***	***Five-year average***
Business Strategies	40%	44%	34%	21%	14%	31%
Balance Sheet	31%	35%	53%	21%	71%	44%
M&A	31%	27%	40%	21%	14%	27%
Board-Related Governance	18%	26%	26%	23%	57%	30%
Compensation	3%	5%	11%	10%	13%	8%
Other Governance	6%	19%	8%	2%	13%	10%

Over the last five years, the top three objectives of other shareholder campaigns relate to business strategies, balance sheet actions and M&A actions, with a push for divestitures and other M&A actions being the dominant objective in the past few years. 2017 as a whole was consistent with these trends, with noteworthy increases in campaigns relating to business strategies and board-related governance.

Objectives of Other Shareholder Campaigns[21]						
Issue	***2013***	***2014***	***2015***	***2016***	***2017***	***Five-year average***
Business Strategies	29%	23%	24%	24%	47%	29%
Balance Sheet	29%	26%	21%	17%	17%	22%
M&A	24%	31%	37%	34%	32%	32%
Board-Related Governance	6%	7%	11%	13%	24%	12%
Compensation	1%	4%	7%	5%	5%	4%
Other Governance	3%	0%	2%	1%	4%	2%

C. TACTICS USED BY ACTIVISTS

The most common tactics in the activists' playbook (aside from nominating a director slate) are publicity campaigns (including publicly disclosing letters to the company and issuing press releases) and, less commonly, putting forth shareholder proposals. The following sets forth how frequently each of these tactics was used in activist campaigns announced in each year.

Tactics Used in Activist Campaigns		
	Public Disclosure by Activist	***Shareholder Proposals***
2017	31%	10%
2016	41%	6%
2015	46%	6%
2014	42%	5%

21 The percentages in these tables often add up to over 100% because single campaigns often have multiple objectives.

Tactics Used in Activist Campaigns		
	Public Disclosure by Activist	*Shareholder Proposals*
2013	53%	9%
Five-year average	43%	7%

The decline during 2017 of the public airing of concerns may be due to an increased focus by companies on engagement with an activist, and often even settlement with an activist, before the demands are made public. Other tactics that are used from time to time, including initiation of litigation and the calling of a special meeting, happen relatively rarely—in less than 5% of campaigns over this period.

D. STRUCTURAL AND BEHAVIORAL ACTIONS USED BY COMPANIES IN RESPONSE TO ACTIVISM

Target companies respond to activist campaigns with a variety of structural and behavioral actions, some designed to create obstacles for activists and some designed to address shareholder concerns at least nominally. Actions taken by target companies in response to campaigns include substantive business steps (such as hiring advisors to evaluate strategic alternatives, and returning cash to investors through dividends or buybacks), governance changes (including those viewed as governance enhancements by shareholders) and tactical actions (such as adoption or revision of poison pills, calling of a special meeting, adjourning or postponing meetings, initiation of litigation or changing board size).[22] The most frequently taken action during a campaign is to return cash to shareholders, though this was less common in 2017 than in recent years. More aggressive tactical steps, such as adoption of poison pills and initiation of litigation, remain relatively uncommon during a campaign.

Actions Taken by Target Companies in Response to Activism						
	2013	*2014*	*2015*	*2016*	*2017*	*Five-year average*
Substantive Actions						
Act to Increase Shareholder Value (e.g., buybacks or dividends)	17%	8%	21%	12%	10%	14%
Hire Advisors to Evaluate Strategic Alternatives	6%	3%	8%	7%	5%	6%
Governance Changes						
Amend Advance Notice Requirements	8%	2%	4%	3%	1%	4%
Other Charter/Bylaw Changes	9%	5%	10%	3%	7%	7%
Corporate Governance Enhancement	8%	1%	3%	4%	1%	3%
Tactical Actions						
Increase Size of Board	8%	5%	17%	10%	5%	9%
Adopt Poison Pill	6%	7%	1%	2%	2%	4%
Adjourn Meeting	4%	0%	1%	2%	1%	2%
Postpone Meeting Date	2%	1%	3%	2%	1%	2%
Amend Poison Pill	1%	0%	1%	1%	0%	1%
Decrease Size of Board	1%	2%	3%	2%	3%	2%
Call Special Meeting	1%	1%	1%	1%	0%	1%

22 The categorizations of defensive actions taken are derived from those used by SharkRepellent.net.

Actions Taken by Target Companies in Response to Activism						
	2013	2014	2015	2016	2017	Five-year average
Initiate Litigation	<.5%	<.5%	1%	0%	1%	1%

PROXY CONTESTS

As noted, initiating a proxy contest for representation on a company's board of directors is one of the primary strategies used by activists to achieve their campaign objectives. Defending against a proxy contest requires a public company to expend considerable time and resources as it undertakes to demonstrate to its shareholders that its director candidates are better positioned to lead the company. As a result, a company may choose to settle with an activist for minority board representation, and accept the risk of prolonged controversy or even disruption in the boardroom, rather than taking the risk of engaging in a public proxy contest. This section analyzes key statistics and trends regarding proxy contests, which may help inform strategies for approaching a potential proxy contest.

However, these overall statistics tell only part of the story, as the decision whether or not to settle in individual cases will depend on the particular facts and circumstances. Moreover, as other statistics provided below demonstrate, the consequences of accepting dissident directors can be profound.

A. HOW OFTEN ARE PROXY CONTESTS SETTLED?

Proxy Contests: Frequency of Votes, Settlements and Withdrawals							
	Total Number	Went to Vote	Percentage	Settled/Concessions Made	Percentage	Withdrawn	Percentage
2017	39[23]	11	28%	15	38%	7	18%
2016	49	14	26%	22	41%	12	22%
2015	73	26	36%	35	48%	12	16%
2014	62	14	23%	32	52%	16	26%
2013	65	26	40%	26	40%	13	20%

Following an 18% rise in the total number of proxy contests in 2015 as compared to 2014, both 2016 and 2017 saw a significant drop-off in the number of reported proxy contests. This decline is almost certainly not due to lower activist interest in obtaining board representation but rather reflects a trend toward engaging in private discussions with activist investors to resolve the shareholder's concerns before a potential proxy contest is made public.

Proxy Contests Settled After the Date of the Definitive Proxy Statement				
	Proxy Contests That Went Definitive	As a Percentage of Total Proxy Contests	Proxy Contests Settled After Definitive Date	As a Percentage of Proxy Contests That Went Definitive
2017	21	54%	8	38%
2016	25	51%	7	28%
2015	36	49%	5	14%

23 The total number of proxy contests in 2017 includes campaigns which are still pending.

Proxy Contests Settled After the Date of the Definitive Proxy Statement				
	Proxy Contests That Went Definitive	*As a Percentage of Total Proxy Contests*	*Proxy Contests Settled After Definitive Date*	*As a Percentage of Proxy Contests That Went Definitive*
2014	23	37%	5	22%
2013	38	59%	9	24%

Each year since 2013, around half of the proxy contests extended beyond the date that the proxy statements for both sides go "definitive" – in other words, closer in time to the date of the shareholders' meeting at which directors are elected. Of these, issuers and activists generally settled, on average, one in four, although the settlement rate in 2017 jumped to more than one in three.

B. RESULTS OF RECENT PROXY CONTESTS

Proxy Contests – Short vs. Control Slate							
	Number of Proxy Contests With Short Slate	*Percentage of Proxy Contests With Short Slate*	*Activist Wins at Least One Board Seat (Short Slate)*	*Number of Proxy Contests With Control Slate*	*Percentage of Proxy Contests With Control Slate*	*Activist Wins at Least One Board Seat (Control Slate)*	*Activist Wins Majority of Board Seats (Control Slate)*
2017	16	41%	50%	23	59%	25%	4%
2016	13	27%	39%	36	74%	36%	8%
2015	24	33%	42%	49	67%	39%	8%
2014	18	29%	67%	44	71%	52%	14%
2013	24	37%	58%	41	63%	46%	15%

Activist investors historically have been aggressive with the level of control they seek through their proxy contests, with the percentage of proxy contests involving a control slate, or a slate for more than a majority of the board seats, ranging from 59% to 74%. This suggests that, once activists invest in formally commencing a proxy contest, many are not content to merely gain a seat at the table to influence the direction of the company but rather are seeking the ability to control the direction of the company, or at a minimum are willing to threaten a control attempt in order to gain negotiating leverage.[24] It remains to be seen, however, whether the sharp decline in the last year of these contests (as a percentage of total contests) represents a trend or an anomaly.

Over the last five years, about 45% of all proxy contests, control slates or short slates (a slate for a minority of the board seats), resulted in the activist investor obtaining one or more seats on the board. However, for each year in our study, short slate contests are more successful than control slate contests by this measure and control slate contests have become steadily less successful over this period. It is notable that 2017 represents the lowest proportion of control slate contests and control slate successes in our study.

[24] In addition, the ability of an activist to launch a campaign for a control slate may be limited by regulatory restrictions in certain industries, such as the financial services industry.

Short Slate Contests – Percentage of the Board Sought				
	Number of Short Slate Contests	Dissident nominees for < 15% of Board	Dissident nominees for 15% ≤ x < 30% of Board	Dissident nominees for 30% ≤ x ≤ 50% of Board
2017	16	19%	38%	44%
2016	13	31%	38%	31%
2015	24	8%	50%	42%
2014	18	0%	44%	56%
2013	24	21%	29%	50%

When an activist investor puts forward a short slate of directors, it is often for more than 15% of the available board seats. After the 15% threshold, which typically equates to one or two nominees, the data shows a fairly even split between the percentage of times that activist investors seek up to 30% of the board seats, which typically equates to three or four nominees, and the percentage of times they seek up to 50% of the board seats.

Proxy Contest Settlement Frequency – Short vs. Control Slate				
	Number of Short Slate Contests	Percentage of Short Slate Contests Settled/Concessions Made	Number of Control Slate Contests	Percentage of Control Slate Contests Settled/Concessions Made
2017	16	50%	23	30%
2016	13	31%	36	58%
2015	24	25%	49	60%
2014	18	44%	44	54%
2013	24	29%	41	46%

For the four years before 2017, when an activist investor put forward a short slate of directors, the issuer and activist investor ended up agreeing to settle the contest before a vote about 32% of the time on average. In 2017, the percentage that ended up settled jumped to 50%, the highest percentage in our study. In the context of control slates, for the four years before 2017, the issuer and activist investor agreed to settle the contest before a vote about 55% of the time on average. In 2017, however, that percentage dropped to 30%.

The reversal in the frequency of the pre-vote resolution of proxy contests in the short versus control slate contexts may have a number of explanations. One explanation revolves around the factors described in the introduction that combine to tip the balance in favor of activists in a short slate contest. A second is that management may be predisposed to settling in the context of a short slate contest because it is more difficult to justify the monetary and reputational cost of publicly fighting an activist that is seeking only one or two board seats. In contrast, in the control slate context, an issuer may be less likely to be able to settle with the activist on acceptable terms and may be increasingly willing to defend the company's incumbent directors and strategic direction in a public forum. Issuers' decisions in these cases have been bolstered by data showing that an issuer is more likely to prevail in a control slate contest than the activist.

Outcome of Proxy Contests That Went to a Vote			
	Won by Issuer	Won by Activist	Vote Split
2017	55%	36%	9%

Outcome of Proxy Contests That Went to a Vote			
	Won by Issuer	Won by Activist	Vote Split
2016	79%	21%	0%
2015	65%	27%	8%
2014	43%	57%	0%
2013	39%	42%	19%

Of the proxy contests that go all the way to a vote, incumbent board candidates had been increasingly successful in defeating activist investors' slates of directors up until 2017. The margin declined in 2017, but still favored incumbents. The reasons for companies' success against the activists vary from campaign to campaign.

Outcome of Proxy Contests That Went to a Vote – Short vs. Control Slate						
	Short Slate Contests			Control Slate Contests		
	Won by Issuer	Won by Activist	Vote Split	Won by Issuer	Won by Activist	Vote Split
2017	60%	20%	20%	50%	50%	0%
2016	60%	40%	0%	89%	11%	0%
2015	67%	27%	7%	64%	27%	9%
2014	33%	67%	0%	50%	50%	0%
2013	53%	33%	13%	18%	55%	27%

In the last three years, issuers' success in winning short slate contests that go to a vote has been fairly consistent at rates between 60% to 67%. In contrast, from 2013 to 2016, incumbent slates of directors had seen a fairly rapid year-over-year increase in their success rate with respect to winning control slate votes. In 2017, issuer success in control slate contests returned to the 2014 rate of 50%. One possible explanation for the 2017 rate is that activist investors have become more selective when pursuing control slate contests. Given the limited success of control slate campaigns in the past few years, activists may be less willing to expend resources for control slate campaigns, and to see those campaigns through to the finish line, unless they are confident in their chances of success.

C. HOW DO PROXY ADVISORY FIRM RECOMMENDATIONS IMPACT A PROXY CONTEST?

Although their impact may have waned somewhat in recent years, ISS and Glass Lewis continue to have a notable, if not always determinative, effect on the outcome of a proxy contest.

ISS has been inclined to recommend in favor of at least one activist director candidate in a proxy contest for minority representation on the board of directors if the activist presents a credible case that change is warranted at the company. In 2017, ISS recommended in support of issuers only 33% of the time, recommended in favor of the activist 45% of the time and spit its recommendation 9% of the time. From 2013 to 2016, in the proxy contests in which ISS issued a recommendation, ISS recommended for activist investors in about 45% of contests and for issuers in about 38% of contests. In the remaining 17% of the contests, ISS either split its support or recommended "withhold" votes. Over time, the trend has favored activists, as discussed in the introduction.

From 2013 to 2016, ISS's influence appeared to have decreased in proxy contests. In 2013, ISS recommendations matched the outcome of the vote in 77% of proxy contests. That figure dropped to 73%, 62% and 50% in the years 2014, 2015 and 2016, respectively. This decline was likely due at least in part to the internal proxy advisory functions that many of the larger investment funds have developed, as noted above, and may also be due in part to ISS's increased support for activists. Nevertheless, ISS's recommendations have remained consistent with the ultimate outcome of a proxy contest a majority of the time, and in 2017, ISS recommendations matched the outcome of the vote in 73% of the proxy contests. The reversal is likely due to ISS's continued efforts to improve its proxy voting guidelines in accordance with shareholders' needs and views, which may have narrowed the gaps between the voting practices of ISS and influential institutional shareholders.

D. WHAT OCCURS IN THE AFTERMATH OF A PROXY CONTEST?

Company Changes in the Aftermath of a Proxy Contest				
	CEO Change	***Merger or Spin-off***	***Additional Proxy Contests***	***Board of Directors Change***
2017	9%	9%	9%	55%
2016	7%	14%	7%	57%
2015	11%	14%	11%	45%
2014	44%	31%	0%	31%
2013	23%	19%	31%	29%

The conclusion of a proxy contest, regardless of the outcome, is often a precursor to a number of different types of changes for the company. In the year or so after a proxy contest, it is not uncommon to see changes to senior management or the board of directors, strategic initiatives such as mergers or spin-offs, or the continuation of activist efforts through additional future proxy contests (whether waged by the same or another activist). The table above presents how often certain changes or events occur in the aftermath of all proxy contests that go to a vote. Note that because these changes can take time, the 2016 and 2017 data should be considered in light of the fact that there may not have elapsed enough time since each proxy contest concluded for some of these changes to take place.

There have been fewer CEO changes and mergers or spin-offs from 2015 to 2017, and the likelihood of additional proxy contests remained low after 2013. However, changes to the board have increased notably since 2013 and have impacted a majority of the target companies after a proxy contest that went to a vote in 2016 and 2017. Activist funds are now holding investments longer, regularly up to five years, and focusing initially on operational turnarounds. It is possible that activists have had no choice but to adapt to a longer time frame as companies susceptible to quick fixes have largely disappeared due to preemptive actions by boards. We expect that if operational and share price targets are not achieved, the push for another solution will become more urgent and be reflected in CEO change or merger/spin-off activity at the same rates as appeared in our data for 2013 to 2015.

Interestingly, the frequency of these types of changes does not seem to depend heavily on the outcome of the contest—that is, whether management or the activist won or the vote was split. This may indicate that the issues raised during the course of the contest, including those raised by the activist and those arising in shareholder outreach discussions, can in some cases lead the board and management to conclude that responsive steps should be taken, even if the management slate wins. Moreover, activists do not simply withdraw following a contest. They often continue campaigns after a lost vote, many times successfully.

SETTLEMENT AGREEMENTS

This section analyzes the publicly filed settlement agreements that have been reached for activist campaigns announced in 2017 as compared to 2015 and 2016, including the frequency of settlements, the timing of reaching a settlement and the key provisions of settlement agreements.

A. FREQUENCY AND SPEED OF SETTLEMENT AGREEMENTS

The percentage of settlement agreements that have been filed with the SEC for 2017 campaigns to date as compared to the total number of completed activist campaigns has decreased significantly from 2016 and returned closer to 2015 levels. This decline may be because companies are more carefully considering activist demands before settling in light of prior institutional investor concerns regarding the "short-termism" of activist objectives.

	Settlement Agreements Filed with the SEC		*Filed Settlement Agreements for Proxy Contests*		*Filed Settlement Agreements for Other Shareholder Campaigns*	
	Number	*Percentage of Total Completed Campaigns*	*Number*	*Percentage of Total Proxy Contests*	*Number*	*Percentage of Total Other Shareholder Campaigns*
2017	38	15%	11	27%	27	12%
2016	66	41%	15	43%	33	40%
2015	81	25%	22	28%	59	24%

The speed with which settlement agreements have been reached in 2017 is generally in line with each of the prior two years. While there is more variation in individual categories, 65% of settlement agreements were reached within three months in 2017, as compared to 63% in 2016 and 57% in 2014. For the purposes of these calculations, the time when an activist initiates a campaign is deemed as the time when it makes the first public step towards achieving its goal, either by publicizing a letter sent to the company, sending a letter to the other shareholders, filing a Schedule 13D or otherwise publicly announcing its intent to initiate a campaign. Of course, in many cases the company and the activist will have had extensive discussions prior to there being any public knowledge of the campaign, and the first public announcement may come in the form of a finalized settlement agreement between the parties.

Time between the Initiation of Campaigns and the Date of the Settlement Agreements	*Less than 1 month*	*1–2 months*	*2–3 months*	*3–6 months*	*6 months or more*
2017	18%	35%	12%	35%	0%[25]
2016	23%	19%	21%	25%	12%
2015	15%	23%	19%	21%	21%

For the purpose of comparison and review, we have chosen not to examine settlement agreements that are either simple appointment letters without any standstill provisions or confidentiality agreements that do not have customary settlement agreement provisions. In addition, this year, where multiple settlement agreements were filed for the same campaign, either because there were multiple activists or because one activist launched campaigns against several affiliates, we limited our review to one settlement agreement. Therefore, for the 185 publicly filed settlement agreements for completed campaigns that were announced in 2015, 2016 and 2017, this section examines 152 of those settlement agreements.

B. NOMINATION PROVISIONS AND MINIMUM SHAREHOLDING PROVISIONS

The majority of settlement agreements relating to 2017 activist campaigns provided for the appointment of a director to the board. The remaining agreements either provided for the mere nomination of a director candidate or some other arrangement, such as the appointment of an activist as a board observer. Where settlement agreements provided for the appointment or nomination of a director candidate, the vast majority covered one or two candidates. 73% of settlement agreements covered one or two director candidates.

Directors in Settlement Agreement	*Percentage*
4+ directors	16%
3 directors	10%
2 directors	33%
1 director	40%

The appointment of one or more new directors pursuant to a settlement agreement led to a board size change in 49% of 2017 settlement agreements reviewed. The change in board size was generally an increase to make room for new nominees, but in some cases there were removals from the board in conjunction with the agreements that led to a decrease in board size.

Board Size Change	*Percentage*
Yes, by 3 members	10%
Yes, by 2 members	10%
Yes, by 1 member	29%
None	52%

25 2017 data for longer-term periods is likely artificially low, because the data includes only completed campaigns, and long-running campaigns announced in mid-2017 will not yet have been completed. This played out in our November 2016 analysis of settlement agreements where we reported that only 4% of 2016 settlement agreements had been reached in six months or more year-to-date. Now that more agreements have been reported, this number is up to 12%. We would expect a similar increase in the 2017 numbers.

52% of 2017 settlement agreements have provisions requiring minimum shareholding of the activists in order to keep the directors nominated by such activists on the board or to nominate replacements if such directors resign or are otherwise unable to serve. This represents a slight decrease from the 59% of settlement agreements in 2015 and 2016 with the same provision. The minimum shareholding threshold is generally set based on the percentage owned by the activist at the execution of the settlement agreement (and can be quite low).

C. BOARD SEATS PURSUANT TO SETTLEMENT AGREEMENTS

We further analyzed data from select campaigns by certain prominent activist funds from 2010 to January 2018 that resulted in settlements granting the fund the right to appoint at least one director to the board of the target company to assess the frequency with which these activists chose to have a fund insider appointed to the board, as well as the length of time that insider remained on the board. As shown in the chart below, 58% of the appointed directors in our data set were insiders of the activist fund. Corvex, Icahn, Pershing Square, Third Point, Trian and ValueAct appointed an activist insider in 75-100% of the settlements reviewed, whereas Elliott, Jana and Land & Buildings chose an insider in 25% or less of the settlements; Starboard was almost evenly split between insiders and independents, with a slant toward independents. Of the insiders, 62% stayed on the board longer than the length of time that the target company was required to appoint and nominate the director pursuant to the settlement agreement. Those who remained on the board for longer than the duration provided for by the settlement agreement served an average of approximately 20 months longer than the period provided for in the agreement. However, that average likely understates the total amount of time activist insiders stay on a target board following the expiration of the settlement period, as about half of the insider appointees in our data set were still serving on their respective boards and three were still serving within the period provided for by their settlement agreements as of January 2018.

Fund	*Settlements Reviewed*	*% Insider*	*% Independent*	*% of Insider Appointees Who Remained on Board Beyond Duration of Settlement Agreement*	*Average Months Insider Appointees Are on Board Beyond Settlement*
Corvex	4	100%	0%	N/A	N/A
Elliott	14	7%	93%	7%	9
Icahn	14	86%	14%	64%	19
Jana	13	23%	77%	8%	7
Land & Buildings	4	25%	75%	25%	2
Pershing Square	6	83%	17%	17%	36
Starboard Value	13	46%	54%	N/A	N/A
Third Point	4	75%	25%	50%	21
Trian Partners	5	80%	20%	N/A	N/A
ValueAct Capital	13	100%	0%	46%	27
TOTAL	**90**	**58%**	**42%**	**62%**	**20**

D. COMMITTEE MEMBERSHIP OF NOMINEES

68% of the settlement agreements reviewed include provisions providing for committee membership of the directors appointed or nominated under the agreement. Of these agreements that provide for committee membership, most of them place the director onto a key committee. A smaller percentage of agreements place the director on the executive committee as well, if the board in question has such a committee. Where the settlement agreements we reviewed do not provide for committee membership, the agreement either notes that the company must consider the nominee/appointee for committee membership along with other members of the board or is silent on committee membership.

Committee Membership	*Percentage*
Prohibit information sharing with activist	55%
Key committees & executive committee	13%
No committee	32%

In 2017, there was a slight increase in the number of settlement agreements that provided for the formation of a new committee. 19% of agreements reviewed for 2017 provide for the formation of a new committee. The committees to be formed differed in name and purpose, but were generally strategic committees with titles such as “Strategic Alternatives Committee” and “Cost Savings Committee.”

E. STANDSTILL PROVISIONS

Almost every settlement agreement includes a standstill provision, which prohibits activists from engaging in certain activities within a prescribed period of time. The main purpose of the standstill provision is to restrict the activist from initiating or participating in any further campaigns. The standstill period generally runs from the date of the settlement agreement until a date tied to the time when the director nominated by the activist is no longer required to be nominated to serve on the board (or earlier upon a material breach by the company of provisions in the settlement agreement).

The following table lists the types of activities typically restricted by the standstill provisions and the frequency of their inclusion in 2017.

% of 2017 Agreements	*Activities Prohibited*
94%	***Publicly disparaging the company or its directors or officers.*** Prohibits activists from disparaging or negatively commenting on the company or its affiliates or any of their respective officers or directors, including the company’s corporate strategy, business, corporate activities, board or management. Of the settlement agreements we reviewed, 90% include a mutual non-disparagement clause that also prohibits the company from publicly disparaging the activists.
94%	***Soliciting proxies or consents.*** Prohibits activists from making, engaging in or in any way participating in, directly or indirectly, any “solicitation” of proxies or consents to vote, or advising, encouraging or influencing any person with respect to the voting of any securities of the company.

% of 2017 Agreements	*Activities Prohibited*
94%	***Seeking board additions or removals.*** Prohibits activists from seeking to elect or remove any directors or otherwise seeking representation on the board.
94%	***Presenting a shareholder proposal.*** Prohibits activists from making any proposal at any annual or special meeting of the shareholders.
94%	***Seeking amendments or waivers from the standstill or challenging validity of the standstill.*** Prohibits activists from requesting any waiver of or amendment to the standstill provision or contesting the validity thereof. A majority of the settlement agreements include an exception that such actions could be pursued through non-public communications with the company that would not be reasonably determined to trigger public disclosure obligations.
90%	***Forming a group or a voting trust or entering into a voting agreement.*** Prohibits activists from forming or participating in any Section 13(d) "group" with any persons who are not their affiliates with respect to any securities of the company or seeking to deposit any securities of the company in any voting trust, or subjecting any such securities to any voting agreements (other than any such voting trust, arrangement or agreement solely among the activists and their affiliates).
84%	***Seeking extraordinary transactions not recommended by the board.*** Prohibits activists from seeking, facilitating or participating in "extraordinary transactions" not recommended by the board. The term "extraordinary transactions" is generally defined to include any tender or exchange offer, merger, consolidation, acquisition, scheme, arrangement, business combination, recapitalization, reorganization, sale or acquisition of assets, liquidation, dissolution or other extraordinary transaction involving the company. Some settlement agreements include an exception that the activists could still tender their shares into any tender or exchange offer or vote their shares with respect to any extraordinary transactions. The prohibition sometimes extends to making public communications in opposition to the extraordinary transactions approved by the board.
81%	***Calling shareholder meetings or referendums.*** Prohibits activists from calling or seeking the company or any other person to call any meeting of shareholders, as well as action by written consent, or conducting a referendum of shareholders.
71%	***Requesting a shareholder list or books and records.***
68%	***Publicly announcing intent to go against the settlement agreement.*** Prohibits activists from making any public disclosure, announcement or statement regarding any intent, purpose, plan or proposal that is inconsistent with the standstill provisions.
58%	***Acquiring more shares.*** Prohibits activists from acquiring, offering to acquire or causing to be acquired beneficial ownership of any securities of the company such that immediately following such transaction the activists would have beneficial ownership of securities exceeding a certain prescribed limit. Settlement agreements sometimes clarify that exceeding the limit as a result of share repurchases or other company actions that reduce the number of outstanding shares should not be counted as a breach of this clause.

% of 2017 Agreements	*Activities Prohibited*
55%	***Entering into third-party agreements that go against the settlement agreement.*** Prohibits activists from entering into any discussions, negotiations, agreements or understandings with any third party with respect to any activities restricted by the standstill provision.
55%	***Bringing litigation or other proceedings (other than to enforce the settlement agreement).*** Prohibits activists from instituting or joining any litigation, arbitration or other proceeding (including any derivative action) against the company or its directors or officers other than to enforce the provisions of the settlement agreement. Many settlement agreements also include exceptions for counterclaims with respect to any proceeding initiated by the company against the activists, exercise of statutory appraisal rights or responding to or complying with a validly issued legal process.
55%	***Seeking to control or influence the company or the management.*** While many settlement agreements simply provide for a flat prohibition on any actions designed to control or influence the company or management, some settlement agreements specify the types of activities that are prohibited, including any proposal to change the composition of the board, any material change in the capitalization, stock repurchase programs or dividend policy, any other material change in the company's management, business or corporate structure, amendments to the certificate of incorporation or bylaws, causing a class of securities of the company to be delisted from any securities exchange or become eligible for termination of registration pursuant to Section 12(g)(4) of the Exchange Act.
32%	***Short selling.*** Prohibits activists from engaging in short selling of the company's securities.
29%	***Transferring shares to a third party.*** Prohibits transfers of the company's securities to a third party that would result in such third party having aggregate beneficial ownership of more than a certain percentage. Many settlement agreements carve out certain parties from this restriction, such as parties to the settlement agreement, directors and officers of the company and/or affiliates of the company. A small number of settlement agreements also prohibit any purchase, sale or grant of any option, warrant, convertible security, stock appreciation right or other similar right.

The frequency of activities prohibited in standstill prohibitions remained relatively stable in 2017 as compared to data collected for the previous two years, with certain exceptions. Notably, there was a 15% increase in prohibitions on short selling, from 17% to 32%. This coincided with a 15% drop in prohibitions on acquisitions of more company shares and transfer of shares to third parties. This is in line with the growing trend in activist short selling as an investment strategy, whereby an activist investor sells company stock short, often while publicly criticizing the company and its current stock price.

Additionally, in 2017 there was a 25% increase in provisions prohibiting the activist from publicly announcing an intent to breach the settlement agreement and a 17% increase in prohibiting the activist from seeking amendments or waivers from the standstill.

Settlement agreements generally include exceptions that the standstill provisions will not prohibit the activists from communicating privately with the company's directors or officers so long as such communications are not intended to, and would not reasonably be expected to, trigger any public disclosure obligations or restrict any director nominated by the activists in the exercise of his or her fiduciary duties to the company and all of its shareholders.

F. VOTING AGREEMENTS

94% of the 2017 settlement agreements reviewed include a provision requiring the activists to vote their shares in a prescribed manner within the standstill period compared to 88% of settlement agreements in the prior two years. 16% of the settlement agreements simply require the activist to vote for all the director candidates nominated by the board, and 10% of the settlement agreements require the activists to vote in accordance with all board recommendations. The remaining 68% of settlement agreements either specify proposals that the activists must vote for in addition to voting for the board slate (such as ratification of the appointment of an auditor, "say-on-pay" proposals, proposals regarding equity incentive plans, etc.) or include exceptions permitting activists to vote in their own discretion on certain proposals. One of the most common exceptions to the voting agreement provision is when a board recommendation differs from that of ISS and/or Glass Lewis. This exception appeared in 26% of settlement agreements reviewed for 2017 compared to 22% of agreements reviewed in the prior two years. Other customary exceptions include extraordinary transactions that would influence the control of the company and amendments to the company's articles of incorporation.

Voting Provisions	*2017 Percentage*	*2015/2016 Percentage*
All board recommendations	10%	14%
Specific board recommendations or exceptions	68%	56%
The board slate only	16%	16%
No voting provision	6%	6%

G. EXPENSE REIMBURSEMENT

71% of the settlement agreements reviewed for 2017 set forth how expenses should be split between the company and the activists. In 2017, the most common practice remained for each party to pay its own expenses. Some companies agree to reimburse reasonable, documented out-of-pocket fees and expenses (including legal expenses) incurred in connection with the negotiation and execution of the settlement agreements, the nomination of directors and/or the annual meeting, capped at a certain amount. In 2017, the amounts of the caps appear to increase as 10% more settlement agreements included caps for reasonable expenses of $500,000 or more (while there was a marked decline in caps ranging between $100,000 to $500,000). Companies did not agree to reimburse expenses incurred by activists without a cap in any of the agreements we reviewed.

Expense Reimbursement	*2017 Percentage*	*2015/2016 Percentage*
Each party pays for its own expenses	45%	40%
Cap of less than $100,000	26%	24%
Cap of $100,000 to $500,000	13%	22%
Cap of $500,000 or more	16%	6%
Others (including no cap)	0%	3%

OTHER ACTIVISM DEVELOPMENTS

A. 13D / HSR ENFORCEMENT ACTIVITY

SEC rules require an acquiror of more than 5% of a public company's shares to file a Schedule 13D, disclosing the identity of the acquiror and its intent with respect to the investment, within 10 days of accumulating a 5% or greater stake. When two or more persons act as a group, their shares are aggregated for purposes of the 5% threshold. A Schedule 13G, which requires less comprehensive disclosure, may be filed instead of a Schedule 13D if the filer acquires the securities in the ordinary course and not with the purpose of exerting influence over the issuer. However, a Schedule 13D must be filed within 10 days if a Schedule 13G filer subsequently holds the securities for the purpose of exerting influence.

It is unclear whether the SEC will scrutinize the increasing frequency of institutional investor engagement with issuers and activists alike to assess whether the institutional investors continue to satisfy the "passive intent" requirement to qualify for Schedule 13G (as opposed to Schedule 13D). Certainly the SEC has shown some appetite to police Schedule 13D filings by activists in the past.

On February 14, 2017, two activist investors, Jeffrey E. Eberwein and Charles M. Gillman, were charged with failing to properly disclose material information under Schedule 13D in a series of campaigns to influence or take control of microcap companies. In its administrative action, the SEC said that Eberwein and Gillman began collaborating on activism efforts in early 2012, collaborating on three of the campaigns with mutual fund adviser Heartland Advisor. Eberwein, Gillman and Heartland consented to the issuance of an administrative cease-and-desist order, in final settlement of the SEC's investigation into their alleged disclosure violations. Without admitting or denying the SEC's findings, Eberwein and Gillman agreed to pay civil penalties of $90,000 and $30,000, respectively, and Heartland agreed to pay $180,000. This recent enforcement activity suggests that the SEC may in the future be more actively engaged in monitoring the filings of investors or groups of investors with control or activist intent who fail to properly file a Schedule 13D, particularly where control or activist intent is very apparent, as in this enforcement example.

Relatedly, the DOJ has also shown an appetite for enforcing the Hart-Scott-Rodino Antitrust Improvements Act (HSR Act) against activist investors. Subject to certain exemptions which are usually not applicable to activists, the HSR Act also requires investors to make certain filings and subjects investors to a waiting period if their investment in a company exceeds $84.4 million, unless they are passive investors in which case they can accumulate a stake as high as 10% prior to having to make an HSR filing. The FTC and the DOJ have previously brought charges against activists, specifically Third Point and ValueAct Capital, who were not passive investors and did not comply with the HSR Act requirements, and these charges have resulted in significant settlements. Unlike the Schedule 13D rules, however, under the HSR Act, investors who initially take the position that their investment is passive do not have to file an HSR filing upon changing to an active intent unless they accumulate additional shares.

B. POISON PILLS – "ACTING IN CONCERT"

Although not commonly deployed in response to activists, the adoption of a poison pill is one of the strongest defenses to a share accumulation. Poison pills provide that if a shareholder exceeds a stated ownership (or "trigger") threshold (often 10% or 25%), then all the company's other shareholders (but not the 10%/25% acquirer) may have the right to buy more shares at a steep discount. Poison pills deter unsolicited share accumulations because no shareholder is likely to risk triggering the poison pill and being significantly diluted. ISS and Glass Lewis have adopted policies recommending withhold vote campaigns against companies that adopt long-term, non-shareholder-approved poison pills, so most companies now keep a poison pill "on the shelf" and ready to implement on short notice if a hostile acquiror or activist is quickly accumulating a position in a company's stock. In certain circumstances, ISS and Glass Lewis have shown hostility towards short-term, non-shareholder-approved poison pills as well, even though their policies do not nominally suggest such hostility. Additionally, obtaining shareholder approval of poison pills is often difficult.

Traditionally, poison pills have aggregated the stock of all shareholders that have an "agreement, arrangement or understanding" for the purpose of holding, voting, acquiring or disposing of stock in determining whether the trigger threshold had been met. Some more recent poison pills have gone a step further than the traditional approach and regulated shareholders "acting in concert." These "acting in concert" provisions seek to prevent shareholders (particularly activist hedge funds) from cooperating with or acting in parallel to each other in ways that do not rise to the level of an "agreement, arrangement or understanding," but still allow the shareholders to act in a large block to force a course of action on a company.

In November 2017, "acting in concert" provisions were put into the spotlight by Carl Icahn, who sharply criticized SandRidge Energy after the company adopted a poison pill with an "acting in concert" provision amid strong opposition to SandRidge's bid to acquire Bonanza Creek Energy from Icahn and another major shareholder. In a public letter to the SandRidge board on November 30, 2017, Icahn called the poison pill "a complete travesty and … a new low in corporate governance." Icahn argued that the "acting in concert" provision is "patently absurd and we believe unenforceable because it is a transparent attempt to preclude large shareholders from communicating with one another and exercising their rights as shareholders." On December 8, 2017, SandRidge issued a response letter to Icahn defending its poison pill as "straightforward and unremarkable" and confirming that Icahn would not trigger the pill merely by discussing his opposition to the proposed transaction with other shareholders, among other actions.

C. ENFORCEMENT OF ORAL SETTLEMENT AGREEMENTS

The Court of Chancery of Delaware recently issued a decision that specifically enforced an oral settlement agreement between a public company and an insurgent activist investor. In February 2017, Sarissa Capital Domestic Fund LP launched a proxy contest to elect three director nominees to the board of Innoviva, Inc. at its annual shareholder meeting in April 2017. After ISS, Glass Lewis and Egan-Jones each recommended a vote in favor of Sarissa's slate, Innoviva's board attempted to negotiate a settlement with Sarissa. At first, the parties discussed increasing the board size from seven to nine and appointing two Sarissa nominees to the board, but they could not reach a deal because Sarissa refused to sign a standstill. Later, when Innoviva's board learned that one of its major institutional shareholders had decided to vote in favor of Sarissa, the board agreed to settle with Sarissa without receiving a standstill. Sarissa promptly accepted the board's offer over the phone, and both parties confirmed that they "had a deal." While a written definitive settlement agreement was being prepared, the Innoviva board learned that another major institutional shareholder had voted in favor of the board's slate of nominees, which secured the board nominees' election, and determined not to proceed with the settlement agreement. Sarissa filed suit in Delaware to specifically enforce the terms of the oral agreement, including expanding the board, appointing two Sarissa nominees to the board and not requiring a standstill from Sarissa, and the court found that the parties had reached an agreement and it enforced the oral settlement.

This case suggests that companies should be cautious about inadvertently entering into a binding agreement in settlement negotiations. To avoid this predicament, a company should make it very clear from the outset that no agreement will be deemed to have been made unless both parties have executed a definitive written agreement and should reiterate this point at key stages of the negotiation to dispel any ambiguity.

D. PROXY ACCESS AND SPECIAL MEETING / WRITTEN CONSENT PROPOSALS

In last year's Memorandum, we noted that proxy access bylaws have become mainstream at the largest U.S. companies and that they are generally favored by shareholders at any company where they are the subject of a proposal. Despite widespread adoption of proxy access bylaws and significant convergence as to key terms, the use of proxy access nominations has been limited to only one failed attempt. GAMCO Asset Management's 2016 proxy access nomination at National Fuel Gas Co, which was ultimately rejected by the company on the basis that the nomination was inappropriate due to GAMCO's control intent, remains the only attempt to use proxy access to date. Despite this almost non-existent use, there continues to be a larger number of proxy access proposals, including recent proposals arising in the context of small market cap companies. It is unclear whether activists will use proxy access bylaw provisions as a strategic tool to accomplish their objectives in future proxy seasons.

Additionally, there has been some increase in the number of shareholder proposals relating to special meetings and increased success of proposals for a shareholder right to act by written consent, although the data set is too small to suggest a trend. Nineteen proposals were called to reduce the ownership threshold necessary to call a special meeting. Although an increase of four over the related number of proposals introduced during the 2016 proxy season, only one of these proposals passed. In both 2017 and 2016, there were four proposals which requested a new right to call special meetings, three and two of which passed in 2017 and 2016, respectively. There was also a small uptick in the success of shareholder proposals requesting companies grant shareholders the right to act by written consent. Three out of fourteen (21%) of these proposals passed in 2017, representing a marginally higher pass rate than in previous proxy seasons.

E. EUROPEAN ACTIVISM

We discuss several trends that are also consistent with the activism environment in Europe. Shareholder activism levels in Europe remained high during 2017, with over 130 campaigns launched targeting European companies. While campaigns were observed throughout the European Union, they were largely concentrated in the United Kingdom and Germany.[26] This level of activist activity represents a significant increase over the activity of the past several years combined, with Europe accounting for a much larger percent of activity worldwide. Large companies were consistently the targets of European activism, consistent with the activism trends observed in the U.S—nearly 20% of such activist campaigns occurred at target companies with market capitalizations of $10 billion or more.

Much of this activity is the product of activist funds with a large presence in the United States increasing their activity in Europe. Corvex, for example, revealed a $400 million position in Danone and Third Point disclosed a record $3.5 billion position in Nestlé. This trend is the result of several factors, including increased competition among the most prominent U.S. activist funds for domestic targets.

Although the influx of U.S. activist funds in the European market has increased the tolerance for the more aggressive tactics typically utilized by U.S. activists, shareholder activism in Europe still tends to be less adversarial and more cooperative than in the U.S. Activists may approach boards and management directly and engage in private negotiations rather than launching a public campaign. For example, the Swiss firm Teleios Capital Partners has participated in discussions for change with dozens of companies since its founding in 2014 but has only made its demands public in three instances.[27]

[26] Activist Insight – The Activist Investing Annual Review – 2018.

[27] The Economist, *Investor activism is surging in continental Europe* (August 24, 2017).

European activism trends may also be impacted in the future by the European Parliament's recent adoption of a revised Shareholder Rights Directive. This revised Directive is intended to promote long-term shareholder engagement in the European Union and may lead to a more favorable regulatory environment for activism. Among other items, the directive will increase European companies' ability to obtain details about their shareholders from intermediaries and will require institutional and asset managers to develop and articulate their policies on shareholder engagement more clearly. Member states must implement the directive by mid-2019.

STEPS COMPANIES SHOULD TAKE BEFORE AN ACTIVIST EMERGES

Developing practices in shareholder engagement, in particular the greater communication between issuers and institutional investors, has led to an environment that has helped issuers anticipate and, in some cases head off, activist challenges. However, well-known activists have developed relationships with the most significant institutional investors that are likely to be at least as deep as those of any issuer. If shareholder engagement outside of activist challenge lapses into a routine exercise, it will provide a significant opportunity for activists to capitalize on their relationships. It is our experience that issuers routinely overestimate the strength of their relationships with the most significant institutional investors in advance of an activist challenge.

There is no "one size fits all" approach to activism. Every company's situation is different, and every activist is different. Small differences in circumstances can lead to substantial differences in available options and possible outcomes. Considerations may include, among others, the identity of shareholders, the timing, content and tone of recent engagements with shareholders, total shareholder return (both in absolute terms and relative to peers), the identity and track record of the activist, the nature of the activist platform, size of equity capitalization, the media profile of the company and activist, the overall governance profile of the company, and of most importance, the unity (or lack thereof) of the board. The governance profile includes not only structural defenses but also director tenure and diversity (which are becoming more significant institutional investor considerations), director expertise and compensation structures (even though these items, individually or in the aggregate, do not necessarily translate into support for the activist).

Study possible arguments and be prepared to respond. It is essential that issuer management, boards and advisors thoughtfully consider possible areas of vulnerability before being approached by an activist. These potential vulnerabilities and arguments in favor of change should be a component of ongoing discussion with institutional investors. Issuers should evaluate whether any actions that might be advocated should be implemented and, if not, develop a clear explanation for why doing so is not advisable. This process should be rigorous and fact-based and should seek to anticipate activist and investor counterarguments to the company's position. The company should also consider proactively informing investors about its analysis of options to create value, including previewing for investors why some superficially appealing actions are not advisable.

Materials (talking points, communications to shareholders, other investor or analyst presentations, etc.) should be prepared in advance of any approach and explain in clear language why pre-identified activist ideas are not advisable. Although the amount of effort devoted to preparation of materials may vary from issuer to issuer, once an activist gains traction with shareholders, it can be difficult to turn things around. Accordingly, preemption, and, if preemption is not possible, speed of response, is essential. Nonetheless, materials prepared in advance should be used as a starting point only – prepared responses, if not tailed to the particular situation, may be seen as “canned” and unresponsive.

Prepare the board of directors. Management and advisors should keep the board apprised on possible activist approaches, intended company responses, views of significant investors, issues that could be created by aggressive tactics by activist investors to gain seats on the board, and current trends in activism generally and tactics in particular. A high level of board cohesion will be essential if an activist emerges, and the response mechanics should be established in advance. Companies should also consider reviewing board policies to confirm that they suitably emphasize to directors their obligation to keep board discussions and other nonpublic information confidential, which will be important not only during an activist campaign, but also if one or more activist designees join the board.

Understand the consequences of the governance emphasis by institutional investors. Index funds have coalesced around a focus on the quality of governance as described by a prescribed set of arrangements and procedures as one way to create an environment that maximizes the overall value of public equities. The good news is that adherence may give public companies some advantage in obtaining the support of these investors. The bad news is that procuring this support can require significant adherence to a sort of “check the box” litany of governance initiatives, not all of which are appropriate or advisable for every company.

The asymmetry of access by issuers and activists to institutional investors will be difficult for issuers to overcome in any case. This hurdle will be heightened if an issuer is viewed as evidencing a disregard for investor governance initiatives. It remains to be seen, however, how much, in an activist challenge context, institutional investors will actually reward issuers that adopt these initiatives.

Regularly review corporate bylaws. Corporate bylaws can establish equitable rules for the sorts of corporate actions sometimes initiated by activists, including calling special meetings of shareholders, acting by written consent and nominating candidates for director. Market practices are continuously developing, including, for example, the addition of new director qualifications, exclusive forum bylaws, and details of advance notice and proxy access provisions. Companies should regularly review their bylaw provisions to ensure that they are consistent with current developments, but being mindful that bylaws should not be excessive in a manner that will draw criticism from activists or institutional investors.

This is particularly the case with respect to advance notice bylaw provisions. Following the rejection of activist director nominees by companies such as Xerox and HomeStreet (whom we are advising in a regulatory capacity) based on technicalities in their advance notice provisions, activists may start challenging companies' onerous advance notice provisions. On occasion, particular proxy contests highlight practical issues with bylaw provisions that can lead to drafting improvements.

FUTURE AREAS OF STUDY

As noted above, there are several steps that a company may take to prepare for an activist campaign. For many issuers, preparing for an activist campaign has become a routine corporate crisis preparedness exercise and often includes retaining an outside party to engage in mock "table top" exercises to analyze operational vulnerabilities and capital allocation strategies, board review of associated output in conjunction with annual strategic planning retreats, engaging experts to improve shareholder engagement processes, reviewing ESG characteristics, and working with financial advisors, law firms, proxy solicitors and public relations firms to prepare response playbooks.

However, even well-prepared issuers with a well-performing stock, a well-defined long-term strategy, good governance and strong shareholder engagement practices may find themselves confronting an activist and then seating the activist director designees, whether due to a loss at the polls or a settlement agreement. As described in the *Introduction*, there are multiple factors combining to tip the balance in favor of activists once they take a position, including the concentration of ownership among passive funds, the application of increasingly uniform governance metrics and ISS's approach to voting recommendations in activism situations. Moreover, for most issuers, once an activist emerges, there are very few structural defenses that are effective to fend off the attack.

In our experience, even issuers with well-formulated preparedness plans may not be fully prepared to have an activist join their board. Below, we discuss considerations for a company if an activist nominee is seated on the board. As noted above, this year's study confirmed our anecdotal experience that activists remain on boards for extended periods, emphasizing the importance of issuers being prepared to manage their interactions with the activist over a period of years. Going forward, we will continue to incorporate to the extent possible data about what happens after the initial activity stimulated by an activist campaign. We expect that our anecdotal experience regarding increased management turn-over following seating an activist director also will be confirmed.

ISSUES COMPANIES SHOULD CONSIDER IF AN ACTIVIST DESIGNEE JOINS THEIR BOARD

Given that adding an activist nominee to the board is a common means of settling a campaign, and is a necessary step following a loss in a proxy contest, boards should give thought to developing guidelines for working as effectively as possible with an activist director. Below is a checklist of considerations companies should anticipate to ensure integration of an activist designee onto the board, including:

- Understanding what rights and restrictions will apply to the activist designee's and the activist fund's ability to access and use financial and other information of the issuer, such as developing a policy that any information provided to the activist designee also must be made available to all other directors
- Understanding how to apply existing compliance policies (e.g., insider trading) and corporate governance policies (e.g., code of conduct and related-party transactions) to an activist insider
- Considering whether to permit an activist insider to transfer director compensation to the activist fund
- Understanding the activist fund's and activist designee's SEC filing obligations (e.g., Section 16 filings)
- Considering the effect of the presence of an activist designee on shareholder engagement activities
- Understanding the applicability of Rule 144 sell-down restrictions to the activist fund's investment
- Evaluating to what extent retention arrangements or alternative compensation arrangements may be necessary for key members of the executive management team
- Continuing pre-emergence preparedness exercises in view of the risk that an additional activist may emerge or that the existing activist investor will engage in additional activist activities despite having been designated a director
- Ensuring that interactions between the activist designee, the incumbent directors and the senior management team remain cordial and constructive

The 2017 activism landscape, which has been highlighted by several high-profile campaigns, increased engagement by the most prominent institutional investors, and the continued success of activist nominees gaining seats on company boards suggests that activism will continue to be an important consideration for companies in 2018. Many additional topics of activist and institutional investor focus, such as ESG and governance-related shareholder proposals, will be revisited in our 2018 Proxy Season Review.

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Mom (as Always) Was Right: Don't Talk to Strangers

By C. Evan Stewart

For most Rick Springfield aficionados, his best song is undoubtedly "Jessie's Girl"—after all, it is/was his only number one hit.[1] Always the contrarian, I guess, I much prefer his "Don't Talk to Strangers" —which is/was not too shabby, reaching and staying at No. 2 on the U.S. Billboard Hot 100 chart for four weeks.[2] And Rick's advice has turned out to be pretty good,[3] especially when it comes to understanding the attorney work product doctrine.

General Cable Corporation

In January of 2012, two senior executives of a Brazilian subsidiary of General Cable Corporation (GCC) allegedly became aware of material problems with the subsidiary's inventory, as well as an inventory theft scheme by several employees.[4] Nonetheless, neither informed GCC's executive management of these serious matters; as a result, the financial reports issued by GCC were materially in error and a restatement of the company's financial disclosure documents had to be issued. Ultimately, on December 29, 2016, GCC agreed to pay the SEC $6.5 million to resolve the accounting-related violations that resulted from the problems at its Brazilian subsidiary.[5]

In the latter half of 2012, GCC had retained Morgan Lewis & Bockius to investigate what was going on at its Brazilian subsidiary. Morgan Lewis, while interviewing company employees, also informed the SEC of its investigation. The SEC then commenced its own investigation and requested the fruits of Morgan Lewis's labors. In October of 2013, Morgan Lewis lawyers met with SEC staff and presented, among other things, "oral downloads" of 12 witness interviews. These cooperative efforts by GCC and its counsel were cited by the SEC in its December 29, 2016 order, in which the $6.5 million penalty was publicly disclosed.[6] And these cooperative efforts also played a key role in the SEC bringing securities fraud charges against the two subsidiary executives on January 25, 2017 in Miami federal court.[7]

Miami Vice

Defense counsel in the Miami litigation served Morgan Lewis with a Rule 45 subpoena, seeking, *inter alia*, the law firm's witness interview notes and memos which were used in the "oral downloads" on the 12 individuals. Morgan Lewis resisted on work product grounds, and motion practice led to a December 5, 2017 ruling by Magistrate Judge Jonathan Goodman.[8]

The judge initially (and correctly) noted that disclosure of attorney work product to an adversarial government agency like the SEC waives work product protection.[9] Of course, that did not and could not resolve the issue because Rule 26(b)(3) of the Federal Rules of Civil Procedure—the basis for the work product doctrine—only deals with "documents and tangible things that are prepared in anticipation of litigation or for trial," and the interview notes and memos were never given to the SEC. Morgan Lewis thus argued that those *written* materials were not waived because all they did was read from them to the SEC staff. Defendants' position was that they needed those written materials to "level the playing field" — i.e., they had no ability to interview or depose any of the 12 non-citizen interviewees, and the information they provided the SEC (via Morgan Lewis) obviously served as the basis for the SEC's fraud case against the two defendants. Magistrate Judge Goodman sided with defendants on that point, finding that the verbatim-like "oral downloads" were the "functional equivalent" of the Morgan Lewis interview notes and memos. In support of that ruling, the Magistrate Judge cited three district court decisions in which oral presentations of work product to government agencies were so detailed that they "matched [the lawyer's] notes almost verbatim."[10]

Defense counsel did not stop there—they also wanted *all* the work product that Morgan Lewis had shared with GCC's outside auditor, Deloitte; those materials covered, among other things, interviews with 38 witnesses. Magistrate Judge Goodman, however, rejected compelling that disclosure, citing a plethora of decisions which hold that auditors are not in an adversarial relationship with the companies they audit—indeed, they share a "common interest" with their client.[11] Defense counsel tried to argue their way around such unhelpful precedent by arguing that Deloitte did not share a common interest with GCC because Deloitte also might have faced an SEC enforcement action due to its auditing work. The judge did not buy that creative argument on numerous grounds, the most important being that the SEC never in fact brought such a case.

Defense counsel pressed even further, arguing that they were entitled to *all* of Morgan Lewis's work product on the ground that defendants had demonstrated a "substantial need" for it (*see* Fed. R. Civ. P. 26(b)(3)(A)(ii)). The principal basis for this position appears to have been that the key witnesses were in Brazil and could only be questioned (prior to trial) via letters rogatory. Magistrate Judge Goodman was unpersuaded by this, finding that—beyond

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the materials he was compelling production of (which clearly did provide detailed, material information on the 12 key witnesses)—other internal Morgan Lewis materials (not shared in any form with the SEC) should be considered "classic attorney work product" —i.e., opinion work product—and would not be discoverable under a "substantial need" standard.[12]

Flurry from the Peanut Gallery

Magistrate Judge Goodman's decision caused a predictable outcry from the chattering class about "break[ing] new ground," a "troubling trend," and predictions of the "end" of attorney work product, etc.[13] But what is the real scoop?

Starting in reverse order, the judge's ruling with respect to opinion work product was clearly correct. While ends-oriented courts have sometimes invented ways to get around the basic protections of the attorney work product doctrine,[14] it is nonetheless well-settled law that "opinion work product enjoys a nearly absolute immunity and can be discovered only in very rare and extraordinary circumstances."[15] Clearly, such circumstances were not present in *Herrara*; as the Supreme Court has made clear, the "need" exists only in the following situation:

> Where relevant and *non-privileged facts* remain hidden in an attorney's file and where production of those *facts* is *essential* to the preparation of one's case, discovery may properly be had. Such written statements and documents might, under certain circumstances, be admissible in *evidence* or give clues as to the existence or location of relevant *facts*.[16]

Next up, what was new or troubling about the judge's ruling vis-à-vis disclosure of work product to Deloitte? In a word, nothing. Although defense counsel in *Herrara* argued that there is a "split" in authority—with only a "majority" of cases "hold[ing] that auditing and accounting firms typically do share a common interest," in point of fact that is really not so. And the judge correctly pushed back on that assertion, not only citing leading authority to the contrary,[17] but also noting that "Defendants have not cited *any* legal authority, binding or *otherwise*, to support the notion that a common interest disappears under factually analogous scenarios."[18]

As the D.C. Circuit opined in *United States v. Deloitte LLP*,[19] to reach a different result would not only be contrary to the whole purpose of the work product doctrine (to prevent a litigant from gaining an advantage "on wits borrowed from the adversary"), it would be bad public policy as well: "discourag[ing] companies from seeking legal advice and candidly disclosing that information to independent auditors."[20]

Last up is the judge's ruling on the "oral downloads." Morgan Lewis obviously thought it was on safe ground because of the explicit language of Rule 26(b)(3).[21] But given that it was disclosing this information to a governmental agency that was indisputably adverse to its client,[22] the firm should have done a bit of legal research before sending lawyers down to the SEC, where they robotically read to the SEC staff from interview memos—such research would have revealed that that practice was *already* quite dangerous.[23]

Going forward, the judge's decision already points to one way to avoid this problem from recurring. Indeed, Magistrate Judge Goodman suggested that making "vague references" to attorney-generated documents, or providing "detail-free conclusions or general impressions" from the same would have led to a different outcome.[24]

Of course, such "vague references," etc. may not satisfy the SEC in its quest for knowledge (and its desire to have others do the heavy lifting for the Commission's staff). That leaves corporate counsel with a choice, if they want to be deemed "cooperative" by the government. Either they can take their chances with Magistrate Judge Goodman's "vague references" approach, or they can go the full monty route and "download" their work product (and expect disclosure in civil litigation thereafter). If the latter route is chosen, it is clearly preferable to ensure that such work product is in the nature of transcript-like documents, with no trace of attorney opinion work product. That way, whatever is subject to disclosure is merely the functional equivalent of what the opposing side in civil litigation would get in a deposition at some later point; in other words, you might have made life a little easier for your opposite number(s), but at least you have not unnecessarily sacrificed any strategic or tactical advantage(s) to them.

That being said, perhaps the SEC (and other governmental agencies) might want to re-think embracing the "downloads" approach. In *Herrara*, the SEC undoubtedly loved thinking they were having their cake (getting straight "downloads" from Morgan Lewis on 12 key offshore witnesses) and eating it too (using those "downloads" to force a settlement against GCC and then filing a civil fraud case against the two executives, with the expectation that those defendants would not have access to the same information prior to trial and thus would not be in a position to mount a strong defense). It is this same "heads I win, tails you lose" approach that motivated the SEC's consistent—but unsuccessful—advocacy of selective waiver throughout the federal circuit courts.[25]

But now that there is a body of well-reasoned case law rejecting a one-way discovery street in civil litigation that follows an investigation, the SEC will be forced—in cases it brings—onto a level playing field, where the fight will be fair. And if history is any guide, the Commission may find that the 800-pound gorilla could well have its bananas taken away on a regular basis.[26]

Conclusion

Notwithstanding all the hub-bub, the *Herrara* decision by Magistrate Judge Goodman actually plows no new legal ground and its components are consistent with well-established precedent. As set forth above, the real impact of this decision may be that it alters how eager the SEC (and other government agencies) are to be recipients of wholesale dumps of attorney fact work product. But we shall see.

Endnotes

1 Released February 1981 (RCA) (written by Springfield) (two weeks at No. 1 on the U.S. Billboard Hot 100 chart) (appeared on the album "Working Class Dog").

2 Released March 1982 (RCA) (written by Springfield) (appeared on the album "Success Hasn't Spoiled Me Yet"). In 1983, Springfield was nominated for Best Male Pop Vocal Performance for this song. Other songs by this same title have been performed by The Beau Brummels (Autumn Records 1965; No. 52 on the Billboard Hot 100 chart) and Don Hedley (Universal Music 2009; No. 11 on the Canadian Hot 100 chart).

3 Given the title of this article, it is proper and appropriate to review at least some of the songs that pay tribute to Mom (and her advice). So let me highlight just three. First is the Beatle's "Your Mother Should Know" (Lennon and McCartney, but really written by McCartney) (on the "Magical Mystery Tour" album (Parlophone, Capital, EMI 1967)); this song contributed to the widely spread story "Paul is dead"). Next is "Mama Told Me Not to Come" (Randy Newman 1967); this song was originally written for the first solo album of Eric Burdon (most famous for fronting The Animals). Newman covered the song himself on his 1970 album "12 Songs" (Reprise). Also in 1970, Three Dog Night covered the song ("Mama Told Me (Not to Come)") (Downhill); in July 1970, it became (for two weeks) the number one single on the Billboard Hot 100 (and was certified gold that same month). Last but not least is the 1925 Ivor Novello classic "And Her Mother Came Too." Covered innumerable times over the years, the best version (in my view) was performed by Bobby Short ("Mabel Mercer/Bobby Short/Live at Town Hall") (Atlantic 1969). In Robert Altman's last film "Gosford Park" (Entertainment Film Distributors 2001), Jeremy Northam (portraying Ivor Novello) treats his fellow weekend guests to a rendition of this song.

4 *See* SEC Litigation Release No. 23726 (January 25, 2017). On this same day, the SEC filed fraud and other charges in Miami federal court against the two executives. A third executive simultaneously consented to the entry of a final judgement.

5 SEC Release No. 79702 (December 29, 2016). At the same time, GCC also agreed to pay the federal government more than $75 million to resolve parallel SEC and DOJ investigations into Foreign Corrupt Practices Act violations throughout the world (e.g., Angola, Bangladesh, China, Egypt, Indonesia, and Thailand). In addition, GCC's former CEO and CFO returned millions of dollars of compensation they had received during the relevant period of GCC's legal difficulties.

6 How much this "cooperation" did to mitigate the penalty paid by GCC is, of course, unknowable.

7 *See supra* note 4.

8 *SEC v. Herrara*, 2017 WL 60417 (S.D. Fla. Dec. 5, 2017).

9 *See In re Initial Public Offering Sec. Litig.*, 249 F.R.D. 457, 465-67 (S.D.N.Y. 2008). As observed by the author of this decision (Judge Scheindlin), *every* circuit court that has looked at this issue has so ruled—even the 8th Circuit, which anomalously once ruled that there could be selective waiver of attorney-client privileged materials to the government. *See Diversified Industries v. Meredith*, 572 F.2d 596 (8th Cir. 1977). This 1977 decision is an outlier among *all* other circuits. *See* C.E. Stewart, *The False Promise of "Reform,"* New York Law Journal (Feb. 21, 2008); C.E. Stewart, *Can the U.S. Capital Markets Be Saved By Tinkering with the Legal Profession?* The Metropolitan Corporate Counsel (June 2007); C. E. Stewart, *Corporate Investigations: The Good, The Bad, and The Ugly,* New York Law Journal (March 27, 2006); C.E. Stewart, *Attorney-Client Privilege: Killing Limited Waiver,* New York Law Journal (Dec. 17, 1992). All that being said, there are always judicial outliers that can be found. *See, e.g., In re Symbol Techs, Inc. Sec. Litig.*, 2016 BL 334855 (E.D.N.Y. September 30, 2016) (disclosing investigation documents to the SEC did not waive work product protection).

10 *See SEC v. Vitesse Semiconductor Corp.*, 771 F. Supp. 3d. 310 (S.D.N.Y. 2011); *SEC v. Berry*, 2011 WL 825742, at *5 (N.D. Cal. March 7, 2011); *SEC v. Roberts*, 254 F.R.D. 371, 377 (N.D. Cal. 2008). Defense counsel also contended that Morgan Lewis made other oral disclosures of work product at meeting(s) with the SEC staff; to test that claim the judge ordered the law firm to produce *in camera* attorney notes of the meeting(s). And to the extent Morgan Lewis actually supplied the SEC with written work product, the judge ordered that it also be submitted for an *in camera* review.

11 *See*, *e.g.*, *United States v. Deloitte LLP*, 610 F.3d 129, 142 (D.C. Cir. 2010); *In re Weatherford Int'l Sec. Litig.*, 2013 WL 12185082, at *5 (S.D.N.Y. Nov. 19, 2013); *Gutter v. E.I. Dupont de Nemours & Co.*, 1998 WL 2017926, at *5 (S.D. Fla. May 18, 1998).

12 *See Hickman v. Taylor*, 329 U.S. 495 (1947); *In re Murphy*. 560 F.2d 326 (8th Cir. 1977); *Beaubrun v. GEICO Gen. Ins. Co.*, 2017 WL 1738117, at *5 (S.D. Fla. May 4, 2017).

13 *See*, *e.g.*, B. Johnson, B. McGuire, A. DaCunha, *Preserving Privilege in Government Investigations in Light of "SEC v. Herrera,"* New York Law Journal (Jan. 28, 2018).

14 *See* C.E. Stewart, *Caveat Corporate Litigator: The First Circuit Sets Back the Attorney Work Product Doctrine*, NY Business Law Journal (Summer 2010) (discussing *U.S. Textron*, 577 F.3d 21 (1st Cir. 2009) (*en banc*)); C.E. Stewart, *Policing the Corporate Beat: "One Small Step for Man….,"* New York Law Journal (May 7, 1998). *See also FTC v. Boehringer Ingelheim Pharm. Inc.*, 2015 BL 4384 (D.C. Cir. February 20, 2015) (D.C. Circuit rejects "smoking gun" standard in discovery dispute over fact work product).

15 *In re Murphy*, 560 F.2d 326, 336 (8th Cir. 1977). For a full explication of this seminal decision, see C.E. Stewart, *Jumping on a Hand Grenade for a Client*, Federal Bar Council Quarterly (November 2009). *See also United States v. Deloitte LLP*, 610 F.3d 129, 135 (D.C. Cir. 2010) ("virtually undiscoverable"). Of course, if an attorney puts her opinion work product directly at issue in litigation, then all bets are off. *See* C.E. Stewart, *"Positively 4th Street": Lawyers and the "Scripting" of Witnesses,* NY Business Law Journal (Summer 2014); C.E. Stewart, *Corporate Counsel & Privileges: Going, Going…*, New York Law Journal (July 11, 1996); C.E. Stewart, *Corporate Counsel and Attorney Work Product*, New York Law Journal (Nov. 8, 1993).

16 *Hickman v. Taylor*, 329 U.S. 495, 511 (1947) (emphasis added). To review some lower court decisions where the "substantial need" threshold was not attained or exceeded, *see, e.g., Delco Wire & Cable, Inc. v. Weinberger*, 109 F.R.D. 680, 689-90 (E.D. Pa. 1986); *In re Grand Jury Investigation (Sun Co.)*, 599 F.2d 1224 (3d Cir. 1979).

17 *See supra* note 10. A lot of the cannon fodder against this well-settled law comes from a misuse (well-meaning or not) of *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984), in which the Court declined to recognize an accountant work product privilege.

18 *See supra* note 8 (emphasis added). For more context on how the privilege of "common interest" works (and does not work), see C.E. Stewart, *The New York Court of Appeals Takes the Wrong Fork in the Road on the Common Interest Privilege,* NY Business Law Journal (Winter 2016).

19 *See supra* note 11.

20 *Id.*

21 And Morgan Lewis's California lawyers may have weighed in on California's idiosyncratic view of attorney work product. *See Fireman's Fund Ins. Co. v. Superior Ct.*, 196 Cal. App. 4th 1263 (Ct. Appls. 2nd Dept. 2011) (*unwritten* work product is entitled to absolute protection). *See also Coito v. Superior Court*, 54 Cal. 4th 480 (2012).

22 Notwithstanding the Second Circuit's hard to understand decision in *United States v. Stein*, 541 F. 3d 130 (2d Cir. 2008) (state action found because KPMG—under threat of criminal prosecution—was ruled to be a "willing participant in joint activity" with the government) [*see* C.E. Stewart, *A Tale of Two Judges*, NY Business Law Journal (Summer 2012)], the case law on the work product doctrine is clear that disclosure of work product to an agency like the SEC is a waiver. *See supra* note 9.

23 *See supra* note 10. That the 12 key witnesses were offshore and not subject to normal discovery made this asymmetric discovery to the government even more problematic. *See SEC v. Vitesse Semiconductor Corp.*, 771 F. Supp. 2d 310, 313-14 (S.D.N.Y. 2011); *Xerox Corp. v. Int'l R Mach. Corp.*, 64 F.R.D. 367, 381-82 (S.D.N.Y. 2974). This asymmetric discovery directly led to the SEC's civil fraud litigation and that undoubtedly factored into the judge's decision to order disclosure of the written work product relating to the 12 witnesses.

24 *See SEC v. Vitesse Semiconductor Corp.*, 771 F. Supp. 2d 310 (S.D.N.Y. 2011); *United States v. Treacy*, 2009 WL 812033 (S.D.N.Y. March 24, 2009). This type of approach has been used by imaginative counsel before. *See*, *e.g.*, *In re Willkie Farr & Gallagher*, 1997 WL 118369 (S.D.N.Y. March 14, 1977) (counsel gave hypothetical results of its internal investigation to outside auditors). Unfortunately, the court ruled that the information was not work product because the investigation was not done "primarily" with litigation in mind—this decision was rendered pre-*United States v. Adlman*, 134 F.2d 1194 (2d Cir. 1998). *See* C.E. Stewart, *Policing the Corporate Beat: "One Great Step for Man…,"* New York Law Journal (May 7, 1998).

25 *See supra* note 9. *See also* C.E. Stewart, *The Wrong Track to Reforming Corporate Governance*, New York Law Journal (October 10, 2006).

26 *See e.g.*, *SEC v. Prince*, 942 F. Supp. 2d 108 (D.D.C. 2013); *SEC Loses Civil Case Against Securities Felon*, The Blog of Legal Times (May 9, 2013). *See also* C.E. Stewart, *The SEC's Setbacks in Litigation*, New York Law Journal (May 17, 2007); C.E. Stewart, *Courts Undercut SEC's Litigation Advantage*, New York Law Journal (October 8, 1998).

EMPLOYMENT LAW UPDATE

Strategies for Preventing Sexual Harassment

By Jeffrey S. Klein, Nicholas J. Pappas, and Larsa K. Ramsini

For many years, employers have sought to prevent sexual harassment in the workplace by implementing anti-harassment policies, training, grievance procedures, and monitoring systems. However, the effectiveness of these measures has been called into question in recent months by the litany of news reports of sexual harassment and assault by public figures at a number of large and sophisticated employers,[1] suggesting that, notwithstanding these practices, sexual harassment continues to occur at higher rates than previously had been acknowledged. Employers rightfully have turned to the employment bar seeking advice on what more they can do, beyond what the law may require, to further the goal of preventing sexual harassment in the workplace.

A starting point for any employer would be a loud and clear statement from senior leadership that establishes or bolsters the employer's dedication to the core value of respect for the individual. By establishing or bolstering that core value, employers can then choose from a toolkit of options appropriate to the employer's particular circumstances that promote a workplace culture focused on merit and individual performance, rather than on prohibited criteria such as sex. By promoting a respectful and performance-based culture, we believe employers are best able to identify and quickly address behaviors that constitute or may lead to sexual harassment (or bullying, or any other inappropriate conduct for that matter), and ideally before such behaviors become severe or pervasive.

In this article, we provide some suggestions regarding how employers might want to assess their workplace cultures, and then we offer thoughts regarding common issues leaders should consider in seeking to improve their cultures.

Fact Gathering

There is no "one-size-fits-all" solution to the problem of sexual harassment in the workplace. But experience shows that every employer has strengths and weaknesses in how it addresses the issue, and employers should seek to build upon their strengths and aggressively address their weaknesses. Towards that end, employers should gather as much data as reasonably possible and seek advice from counsel and consultants to further expand the base of knowledge and understand the particular problems they face and possible solutions. For example, employers may wish to conduct interviews of select employees, focus groups, upward reviews, or an employee survey to gain diverse perspectives on how the organization could improve. If available, employers should review the results of exit interviews of departing employees and, if not already included, add to the list of questions posed whether the employee had any concerns with how the company addressed misconduct in the workplace. Employers who offer severance benefits may wish to include in their separation agreements a clause stating that the departing employee has disclosed all improper conduct of which the employee is aware. Such a clause may prompt departing employees to disclose potentially valuable information not previously reported.

Another important source of information is the corporation's human resource records. Employers should review existing records of employee complaints to assess whether they expose any weaknesses in specific offices or of specific individuals who may be causing disproportionate levels of grievances. To the extent an employer has not formulated a regular practice of monitoring and acting upon such weaknesses, it should consider having a senior HR manager periodically conduct such an internal self-assessment. Employers also should review existing complaint channels—for example, complaints received by supervisors, by HR, and through a hotline—to confirm that the organization documents and investigates all complaints consistently and timely.

After obtaining the relevant data from one or more of the above sources, employers should focus carefully on anecdotes of inappropriate behavior and seek to identify weaknesses, perceived or actual, in the employer's practices for responding to such behaviors. However, employers should be mindful of the possibility of creating potentially discoverable documents and, prior to implementing any proposal outlined above, be committed and prepared to act on the information learned to make this process worthwhile.

Implementing Change

Following whatever fact-gathering process is appropriate for a particular employer, the employer should carefully assess, ideally with counsel, what steps it should take to improve existing practices and/or to remedy any actual or perceived weaknesses. What follows are a few issues that arise with some frequency, and which we believe employers should carefully consider as they determine what changes they believe will prove most effective.

A significant challenge in preventing workplace harassment is the misperception that different standards

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apply to different individuals depending on the perceived value someone brings to the organization. Some employees, including managers, may come to believe that the employer will excuse inappropriate behavior by a "friend of the CEO" or a "rainmaker" who produces a significant amount of business for the company. The touchstone here is the company culture, because the type of culture fostered by senior management will dictate how employees interact in the workplace. Leaders need to reflect thoughtfully with their senior HR colleagues on questions such as: Are any senior executives perceived to be untouchable? How has the organization responded in the past to the "superstar harasser"? These are the types of culture issues that create risks, even if not rising to the level of a violation of law. Candid self-assessment and honest answers to these questions are an important predicate to corrective action.

Of course, if senior leaders tolerate misconduct by a top performer, that single act can significantly hamper an employer's efforts to build a culture of meritocracy and respect, regardless of other measures the employer has taken to prevent workplace harassment. If employees, correctly or incorrectly, perceive that management tolerates inappropriate workplace behavior from certain individuals, they may become reluctant to report misconduct, thus causing inappropriate behavior to persist or become more pervasive. Leaders committed to making his or her workplace one in which everyone thrives based on their own merits must make clear that everyone is governed by the same rules, regardless of any individual's position, tenure, or economic contributions to the organization.

Sometimes speaking up about misconduct in the workplace is easier said than done, particularly when an employee is concerned about the potential negative consequences that reporting could have on his or her career. For example, if a senior leader hears someone engaging in so-called "locker-room banter" or telling inappropriate jokes, instead of acknowledging or addressing the issue on the spot, or soon thereafter in a confidential setting, she or he may be inclined to simply let the moment pass to avoid the potential for conflict. Employers should encourage leaders to take action in response to inappropriate behavior in the moment to dispel any fear of negative repercussions. However, this type of behavior may not come easily to all managers. Companies should therefore consider including in their training programs a specific focus on bystander intervention. If, after a manager has received sufficient training, she or he repeatedly declines to address workplace misconduct, the employer should consider whether counseling is appropriate, or, if the behavior persists, taking disciplinary action. The behavior of senior leaders as cultural beacons to promptly identify and report on incidents of inappropriate behavior is one of the most critical lines of defense and protection against legal claims. In a truly healthy workplace culture, all employees, and especially leaders, must believe that they have an obligation to stand up and do the right thing, and that senior management will support them for doing so.

There may be times when an employer's goal of establishing a culture of respect appears to conflict with other important goals, such as maintaining valuable client relationships. For example, a customer may not appreciate being asked to refrain from making inappropriate comments to female employees, so bringing this to his attention may result in a deterioration of that relationship. In such cases, an employer may seek the advice of outside counsel and/or consultants for recommendations on addressing the potentially many competing interests at play to ensure its leaders take actions consistent with the organization's obligations as well as its guiding principles. But regardless of the many factors at play in determining how best to address inappropriate workplace behavior, for the employer to reach that point, senior leaders must be role models for the organization by raising the misconduct as an issue to be addressed.

Employers also should be attentive to any backsliding by leaders in mentoring, sponsorship, or mere interaction in the workplace between men and women. The Chief Judge of the U.S. District Court for the Southern District of New York cautioned an audience in December about what is sometimes known as the "Graham Rule"—"that a man should make sure he is never alone in a room with any woman other than his wife for any reason—including perfectly legitimate business reasons."[2] Judge McMahon said such a rule denies opportunities to women "for mentoring, for networking, [and] for assignment to the best deals."[3] Given the profound ramifications a lack of mentoring, networking, and sponsorship can have on women's careers, avoiding interactions with women undercuts the goal of establishing a culture of respect and equal opportunity.

This behavior also may inhibit an employer's goal of preventing sexual harassment. Women today continue to have disproportionately fewer leadership roles in business.[4] Commentators have suggested that having more women in power would reduce the instances of sexual harassment.[5] Of course, many employers have recognized and sought to rectify the imbalance in senior leadership, and it has proven to be a difficult challenge. Companies should continue working to find ways to promote more women into leadership roles, including by encouraging those currently in leadership to be equally open to working with and sponsoring both men and women.

One strategy could be seeking to promote gender parity at all networking, business development, and other business-related social events. Senior leaders could take the same approach when creating teams, committees, or any other group tasked with a particular project or assignment. Actions like this taken by an organization's senior leadership demonstrate to the workforce at large that the goal of establishing a culture of respect is one of leadership's top priorities. And if it is a priority for leadership, it will hopefully become a priority for all employees.

Endnotes

1 *See e.g.*, Samantha Cooney, *Here Are All the Public Figures Who've Been Accused of Sexual Misconduct After Harvey Weinstein*, TIME (Jan. 26, 2018, 4:21 PM), http://time.com/5015204/harvey-weinstein-scandal/.

2 Colleen McMahon, SDNY Chief Judge Colleen McMahon Takes on Sexual Harassment, N.Y.L.J. (Dec. 12, 2017, 8:39 PM), https://www.law.com/newyorklawjournal/sites/newyorklawjournal/2017/12/12/sdny-chief-judge-colleen-mcmahon-takes-on-sexual-harassment/.

3 *Id*.

4 *See, e.g.*, Madeline Farber, *Board Diversity at Fortune 500 Companies Has Reached an All-Time High*, FORTUNE (Feb. 6, 2017), http://fortune.com/2017/02/06/board-diversity-fortune-500/ (noting that, despite an increase in diversity, men held almost 80% of the board seats of Fortune 500 companies in 2016).

5 *See, e.g.*, Claire Cain Miller, *Sexual Harassment Training Doesn't Work. But Some Things Do.*, N.Y. TIMES (Dec. 11, 2017), https://www.nytimes.com/2017/12/11/upshot/sexual-harassment-workplace-prevention-effective.html ("Research has continually shown that companies with more women in management have less sexual harassment."); Frank Dobbin & Alexandra Kalev, *Training Programs and Reporting Systems Won't End Sexual Harassment. Promoting More Women Will*, HARVARD BUS. REV. (Nov. 15, 2017), https://hbr.org/2017/11/training-programs-and-reporting-systems-wont-end-sexual-harassment-promoting-more-women-will ("We already know how to reduce sexual harassment at work, and the answer is actually pretty simple: Hire and promote more women.").

Committee Reports

The Business Law Section conducts most of its activities through individual Committees that specialize in various areas of business law. Membership in any Committee is open to any member of the Section. While active participation is encouraged, there is no required time commitment. To join a committee, email businesslaw@nysba.org. For more information, visit www.nysba.org/BLSCommittees.

Report from the Section Chair

My year as Business Law Section Chair has gone by so fast! It has been an honor to serve as Chair over the past year and I now turn the reins over to Peter LaVigne, well known to our members, who organized our great Section programs last fall and this January. He will be a great Chair! I also want to salute Stuart Newman, who spearheaded the effort for the Section to sponsor the New York Bar Foundation's Small Business Support Fund. And I would recommend and request that Section members who are interested in contributing to the Bar Foundation consider directing their contributions to the Section's Small Business Support Fund. Elsewhere in this issue you will see an article on the first two recipients of monies from the Fund.

This year also marked the addition of a new Mergers and Acquisitions Law Committee chaired by James Rieger, and the transformation of the Corporations Law Committee into the Business Organizations Law Committee chaired by Matthew Moisan. Please consider joining a committee—committee membership comes free with your Section dues. We are always looking for people who would like to get more involved in the Section and the best place to start is with a committee.

Thank you again for having given me the honor of serving as your Chair!

Kathleen A. Scott, Section Chair

Banking Law Committee

The members of the Banking Law Committee include banking, regulatory, and corporate attorneys. We meet in connection with the Spring, Fall and Annual Meetings of the Business Law Section. At the Spring Meeting on May 24, held at the Harvard Club in Manhattan, we had presentations on Blockchain Technology and Banking and covered:

- Blockchain and ICO basics—what you need to know
- Regulatory paradigm
- Implications of blockchain and tokens on the banking industry

The presenters, Blank Rome partners Michelle Gitlitz and Scott Wortman, enthralled the members with an interactive and riveting discussion with ample time for questions. Our next meeting is planned for October in conjunction with the Business Law Section's Fall meeting, where we will discuss cybersecurity and other relevant banking issues.

Tanweer Ansari, Chair

Bankruptcy Law Committee

The Bankruptcy Committee met during the Business Law Section's Spring Meeting. Pat Rafanelli, CPA/ABV, ASA, CVA, CBA, CFE, MAFF, CDFA, Valuation Manager of Grassi & Co., presented an informative seminar to the Committee entitled "Business Valuations in the Context of Insolvency." The Committee engaged in a spirited discussion of the topic at the meeting.

Matthew Spero, Chair

Business Organizations Law Committee

I am very excited to be halfway into the first year of the Business Organizations Law Committee. As a new committee, we are eager to establish and grow our membership. We will be addressing a range of issues affecting business organizations. We intend to grow the committee membership in the coming months, and strive to provide meaningful content and connections.

At the Business Law Section Spring Meeting we addressed tax issues for partnerships and S-Corps, in addition to a discussion surrounding implications of the new tax code. It was a great panel discussion, bringing together attorneys, CPAs, and academics to discuss the many avenues through which tax and business not just overlap, but in some cases drive strategic decisions. I intend to continue to produce programs and content that diversify the typical corporate topics. Business organizations is about so much more than corporations and I am excited to engage with members on these topics.

It is an honor to have been appointed the Chair of this committee, and I am energized to see it grow!

Matthew Moisan, Chair

Insurance Law Committee

The Insurance Law Committee welcomes a new Chair, Giancarlo Stanton. Mr. Stanton is General Counsel and VP Claims with Swyfft, LLC, a data-driven insurance company. The new Chair looks forward to the Insurance Law Committee shining a spotlight on foundational knowledge and skills in insurance law for newly admitted attorneys, with a special focus on the emerging trends in insurance important to both new and seasoned attorneys. If you have particular interest in this area and would like to be involved, please contact the Chair at giancarlo@swyfft.com.

Giancarlo Stanton, Chair

Mergers and Acquisitions Committee

The Mergers and Acquisitions Committee of the Business Law Section of the New York State Bar Association met at the Harvard Club on May 24, in conjunction with the Business Law Section's Spring Meeting. The Committee Chair, James Rieger of Tannenbaum Helpern Syracuse & Hirschtritt LLP, along with Anchin Tax Principal Jeffrey Bowden and Anchin Tax Partner E. George Teixeira, gave a presentation on the "Impacts of the New Tax Bill on Mergers & Acquisitions." A lively question and answer session was interspersed throughout the presentation. The Committee was gratified by the turnout and the continuing positive trend in attendance at this recently established committee.

James Rieger, Chair

Not-For-Profit Corporations Law Committee

Our committee has been actively engaged in responding to multiple proposed amendments to the Not-for-Profit Corporation Law being considered by the legislature and legislative committees, with the indispensable assistance of Kevin Kerwin, the Association's Deputy General Counsel. Among the proposed amendments are amendments relating to the regulation of "key persons"; voting requirements of the boards of certain corporations; and university faculty practice corporations. In addition, the committee has been interfacing with other organizations in the nonprofit legal sector in connection with these proposed amendments.

The committee met on January 24, 2018 as part of the Association's Annual Meeting. Planning for future initiatives was discussed. The two Co-Section Chiefs of the Charities Bureau Enforcement Section presented a very well-received CLE program entitled "A View From the Attorney General's Charities Bureau Enforcement Section."

David Goldstein, Chair

Securities Regulation Committee

The Securities Regulation Committee maintains an active schedule of regular meetings.

- February: A panel consisting of John Narducci and Stephen Lessard from Orrick, Herrington & Sutcliffe LLP, David Simcha of EisnerAmper and Jill Grossman and Spiro Dorizas, each of Grant Thornton, discussed certain consequences of the Tax Cut and Jobs Act for corporations and pass-through entities, including investment funds and hedge funds. Additionally, at a meeting of the Private Investment Funds Subcommittee, Jennifer Duggins, Co-Chair of the Private Funds Unit of the SEC's Office of Compliance and Examinations, discussed SEC priorities, and Gail Bernstein, General Counsel of the Investment Adviser Association, discussed anticipated legislative, legal, regulatory and compliance developments and what investment advisers may expect in 2018.
- April: Paul Dudek of Latham and Watkins and Walter Van Dorn of Dentons discussed Regulation S offerings. Richard Farley of Kramer Levin addressed recent changes to NYSE rules that facilitate the ability of companies to list without an IPO. In addition, Richmond Glasgow of Skadden, Arps presented a securities law basics lecture at the Business Law Bridge the Gap program.
- May: The Committee and the Private Investment Funds Subcommittee held a joint program led by Laura Grossman and Sanjay Lamba from the Investment Adviser Association, which addressed regulatory activities affecting investment advisors. In addition, the Committee submitted a comment letter to FINRA on proposed FINRA Rule 3290.
- June: Daniel Silver of Clifford Chance discussed the EU's recently implemented General Data Protection Regulation, including its extraterritorial application to U.S. entities and its impact on fund managers. Doug Yatter, Steve Wink and Ashley Weeks of Latham & Watkins addressed ICOs and cryptocurrency regulation and enforcement.

We are also currently scheduling additional programs for the remainder of the year, and always welcome suggestions and requests from the members.

Anastasia Rockas, Chair

Publication Policy and Manuscript Guidelines for Authors

All proposed articles should be submitted to the *Journal*'s Editor-in-Chief. Submissions should be e-mailed or sent on a disk or CD in electronic format, preferably Microsoft Word (pdfs are not acceptable). A short author's biography should also be included.

The editors reserve the right to edit the manuscript to have it conform to the *Journal*'s standard in style, usage and analysis. All citations will be confirmed. Authors should consult standard authorities in preparing both text and footnotes, and should consult and follow the style presented in *Bluebook: A Uniform System of Citation*. An *Author's Guide* can be obtained by contacting the Editor-in-Chief. The revised manuscript will be submitted to the author for approval prior to publication.

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Manuscripts are submitted at the sender's risk. The *Journal* assumes no responsibility for the return of the material. Material accepted for publication becomes the property of the Business Law Section of the New York State Bar Association. No compensation is paid for any manuscript.

The Section's Committees are also encouraged to submit for publication in the *Journal* notices of committee events, Annual Meeting notices, information regarding programs and seminars and other news items of topical interest to the members of the Business Law Section.

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NEW YORK STATE BAR ASSOCIATION

Student Writing Competition

The Business Law Section sponsors an annual Student Writing Competition, open to all students who are candidates for the J.D. or LL.M. degree at an accredited law school during the year in which the article is submitted.

Articles submitted in a given year that are judged first, second and third best, provided they are of publishable quality and otherwise meet the criteria of the Competition, will receive cash prizes of $2,000, $1,500 and $1,000, respectively.

At the discretion of the editors, they also will be published in the *NY Business Law Journal*, which is sponsored by the Section in cooperation with Albany Law School.

Additional cash prizes may be awarded in the discretion of the Section. Entries that do not qualify for cash prizes may also be considered for publication in the *Journal*.

Articles submitted will be judged on the following criteria: relevance to the *Journal*'s audience (New York business lawyers); timeliness of the topic; originality; quality of research and writing; and clarity and conciseness.

The Editors congratulate the winners of the 2017 Competition:

First Prize: Niyati Sangani, New York Law School, *Cybersecurity and Its Impact on the Financial Services Industry* (Summer 2017 issue)

Second Przize: Davide Szep, Fordham University School of Law, *Anti-Money Laundering and Privacy: Are They Interrelated or In Conflict?* (Winter 2017 issue)

Third Prize: Grace Nealon, Albany Law School, *The Supreme Court's Dodd-Frank Dilemma: Should Internal Whistleblowers Be Protected?* (Winter 2017 issue)

The manuscript should follow *Bluebook* cite format (using endnotes rather than footnotes) and be a minimum of 3,000 words (there is no maximum). All submissions become the property of the NYSBA and the *NY Business Law Journal*. By submitting an article, the student is deemed to consent to its publication, whether or not a cash prize is awarded. To enter, the student should submit an original, unpublished manuscript in Word format to David L. Glass, Editor-in-Chief, NYSBA *NY Business Law Journal* (david.glass@macquarie.com). The student should include a brief biography, including law school attended, degree for which the student is a candidate, and expected year of graduation.

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