Skadden

# The Informed Board

Fall 2022

The proliferation of U.S. sanctions and other regulations affecting cross-border transactions has implications for directors, who may be personally liable for violations in some cases. Meanwhile, the Securities and Exchange Commission has stepped up its enforcement efforts, frequently targeting individuals.

Those are two of the topics we explore in this issue of *The Informed Board*, our quarterly newsletter for directors. We also answer frequently asked questions about China's increasingly important merger clearance process, which differs significantly from its Western counterparts. Finally, we explain why preparing careful board minutes is more than a formality.

# Why Directors and Executives Need To Pay Attention to Sanctions, Money Laundering and Export Rules

- Directors and officers can and have been named personally in both civil and criminal enforcement actions involving sanctions, export restrictions, anti-money laundering and anti-bribery rules.
- Enforcement agencies expect boards and senior managements to ensure their companies' compliance with these rules, which are viewed as key instruments of U.S. foreign policy.
- The same conduct can run afoul of multiple regulatory regimes, and enforcement authorities regularly cooperate and bring joint actions.
- Companies will only receive credit for voluntarily disclosing violations if they do so before enforcement officials discover the problems.

Recent developments, including Russia's invasion of Ukraine, ongoing tensions between the U.S. and China, and turmoil in the digital assets sector, have made it essential for companies — including their directors and senior executives — to pay close attention to compliance with U.S. sanctions, export controls, anti-money laundering (AML) and anti-bribery and corruption (ABC) laws. While most boards have long been alert to the issues raised by the Foreign Corrupt Practices Act, these other regulatory regimes have grown in importance as the U.S. government has increasingly and aggressively turned to them to shine a spotlight on corporate conduct. The U.S. government uses these laws as critical tools to advance its foreign policy, protect the financial system and prevent sensitive U.S. technology and information from falling into the wrong hands.

Boards and senior management need to be especially vigilant because they can become the targets of enforcement actions if there are violations. In recent years, the U.S. government has sought stiff fines and brought criminal charges against dozens of companies, and in some cases their executives and officers, for failing to comply with these laws. In addition to the potential legal penalties, media coverage of possible violations and enforcement actions heightens the reputational risks to companies and individuals. Disclosure of violations, or even of an investigation of potential violations, often is quickly followed by securities class actions litigation and derivative lawsuits claiming that directors failed in their duties to appropriately oversee these risks.

## Key Enforcement Agencies and Laws — and Their Acronyms

- **BIS:** The Department of Commerce's Bureau of Industry Security is the primary federal agency responsible for administering and enforcing U.S. export control laws.
- **DOJ:** The Department of Justice is responsible for investigating and prosecuting violations of U.S. federal law, including the Foreign Corrupt Practices Act (FCPA) and referrals for criminal prosecution from other agencies.
- **FinCEN:** The Department of the Treasury's Financial Crimes Enforcement Network is responsible for implementing, administering and enforcing compliance with the Bank Secrecy Act (BSA) and associated regulations.
- **OFAC:** The Department of the Treasury's Office of Foreign Assets Control is the primary federal agency responsible for administering and enforcing U.S. economic sanctions laws.
- **Other Federal Regulators**, including the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission, conduct compliance examinations and bring enforcement actions for violations of the BSA and associated regulations.

Boards and senior management play a critical role by instilling a culture of compliance, ensuring that compliance functions are adequately resourced and providing continuous and meaningful oversight. Here is a quick guide to the different offices responsible for enforcement, some key compliance risks and the obligations of directors and C-suite officers.

## Focus on Company Officers and Directors

The agencies that implement and enforce these laws are increasingly focused on how senior management oversees and manages compliance risk. Even inadvertent violations of sanctions, AML, ABC or export control laws can expose executives and officers to liability if they fail to take steps to ensure compliance. Willful violations can lead to criminal prosecution.

For example, in April 2021, SAP SE, a software company headquartered in Germany, agreed to pay more than $8 million in penalties as part of a global resolution with the DOJ, BIS and OFAC after the company disclosed thousands of export violations, including illegally releasing U.S.-origin software, upgrades and patches to users in Iran. SAP had also allowed Iranian users to access U.S.-based cloud services. Of note, some SAP senior executives were aware that neither the company nor its U.S.-based provider used geolocation filters to identify and block Iranian downloads, yet they did not remedy the issue. In announcing the resolution and penalties, the DOJ prosecutor stated that the case "should serve as a strong deterrent message to others that the release of software and sale of product and services on the internet are subject to U.S. export laws and regulations."

At the Treasury Department, OFAC and FinCEN have brought several enforcement actions against individuals in recent years for violations of sanctions and export control laws. One case brought by FinCEN resulted in a $450,000 civil fine against the former chief risk officer of a large U.S. bank.

At the Commerce Department, BIS, in cooperation with the DOJ, routinely brings enforcement actions against individuals, including company executives. In 2021 — the last year for which BIS published this data — BIS investigations resulted in criminal convictions of 50 individuals and companies, resulting in a total of 1,118 months of prison time for individual defendants.

A significant policy statement by Deputy Attorney General Lisa Monaco published in September 2022 (the Monaco memorandum) highlighted DOJ's renewed focus on individual misconduct.

## Parallel Enforcement

It is important to understand that incidents of company wrongdoing often implicate multiple enforcement regimes. Shipping a U.S. product to Iran, for instance, can violate U.S. sanctions prohibitions, export control laws and money laundering regulations.

In April 2022, FinCEN issued an Advisory on Kleptocracy and Foreign Public Corruption urging financial institutions to focus efforts on detecting the proceeds of foreign public corruption — activity that can involve violations of several U.S. laws. The advisory included 10 red flag indicators to assist financial institutions in detecting, preventing and reporting suspicious transactions associated with kleptocracy and foreign public corruption. And in June 2022, FinCEN and BIS issued a joint alert urging companies to be on the lookout for Russian and Belarusian attempts to evade U.S. export controls and reminding financial institutions of their obligation to report suspicious activities, including potential sanctions and export control violations.

In such cases, OFAC, FinCEN and BIS may cooperate in their investigations and bring parallel civil enforcement actions alleging violations of multiple laws. Any one of these agencies can refer cases to the DOJ where there is evidence of willful violations.

Examples of joint enforcement cases:

- In October 2022, OFAC and FinCEN announced settlements of approximately $24 million and $29 million, respectively, with a virtual currency exchange for alleged violations of sanctions and AML laws.
- In July 2021, OFAC and BIS brought parallel enforcement actions against two U.S. and United Arab Emirates companies for violations of sanctions and export control laws stemming from the sale of U.S. tank storage cleaning units to Iran.

The DOJ routinely brings criminal enforcement actions in conjunction with civil enforcement actions pursued by OFAC, FinCEN, BIS and other agencies.

## The Importance of Disclosure

OFAC, FinCEN and BIS have emphasized the importance of voluntary disclosure of potential violations of laws and regulations. Depending on the facts, companies that voluntarily disclose may avoid civil fines or see them reduced because of the disclosure.

Similarly, the Monaco memorandum emphasized that, absent aggravating factors, the DOJ will not seek a guilty plea to criminal charges where a company has voluntarily disclosed conduct, fully cooperated and remediated its conduct appropriately and promptly. On the flip side, failing to voluntarily disclose can lead to higher fines and more onerous settlement conditions.

That said, voluntary disclosure is not always the right call in all circumstances, and companies considering a voluntary disclosure should keep in mind a few important considerations.

## What Regulators Expect From Companies and Their Managements

Regulators expect U.S. companies to maintain effective risk-based compliance programs that are reasonably designed to prevent violations of the law. Companies in the financial services industry are typically required to design and implement an effective anti-money laundering compliance program that is risk-based and meets the minimum requirements of the BSA and related regulations. Boards of directors are expected — and in some cases required — to oversee compliance programs to guard against violations, including ensuring that adequate resources are provided for the compliance function and that there is a strong pro-compliance culture at every level of the company.

In the event of a potential violation, U.S. government agencies will consider the nature and quality of a company's compliance program when determining whether an enforcement action is appropriate and, if it is, what form it takes. In weighing a criminal prosecution, the Department of Justice will consider whether a company deters misconduct by, for instance, creating incentives for compliance, enforcing personal accountability and instituting compensation clawback provisions.

**Disclosure after the government learns of the violation will not be considered voluntary.** The Monaco memorandum makes clear that a company will only receive credit for self-disclosure if that is made prior to an imminent threat of disclosure or government investigation. Companies should therefore ensure that their compliance programs incentivize employees to surface problems to management, and that management surfaces problems to the board, before the conduct becomes known to the government, often through a whistleblower and sometimes a disgruntled employee who positions himself as such. Boards should carefully review whether current reporting mechanisms, up to management and the board, are effectively alerting the company's leadership and those responsible for oversight, including the board, to problems.

**Disclosure to one agency is not necessarily disclosure to others.** The U.S. government agencies typically expect that a company will disclose a possible violation to all relevant agencies. An agency may not extend voluntary disclosure credit if it learned of the conduct from another agency. Therefore, if a company identifies an issue that involves a potential violation of multiple legal regimes, it should carefully consider agencies it should contact and coordinate disclosure to help ensure voluntary cooperation credit. Further, in instances where companies have specific filing obligations, such as a suspicious activity report filing in the AML context, they should not consider their obligations satisfied by virtue of, for example, a disclosure to OFAC or BIS.

**U.S. agencies expect companies to name the individuals involved in misconduct.** Following disclosure of a possible violation of law — whether or not voluntary — U.S. government agencies expect companies to identify the individuals involved. The Monaco memorandum, for example, emphasizes the DOJ's expectation that companies disclose all nonprivileged information related to *all* individuals involved in corporate misconduct to receive cooperation credit.

**Authors**

*Brian J. Egan, Alessio Evangelista, Eytan J. Fisch, Michael E. Leiter, Khalil N. Maalouf, James E. Perry*


# Demystifying China's Merger Review Process

Winning Chinese approval for a merger can seem like an opaque and puzzling process to newcomers, in part because Chinese law requires regulators to consider broad economic and policy considerations, not just the impact on competition.

China's merger clearance authority plays a critical role in global M&A, even for deals that have few obvious ties to China. Particularly in the technology area, China is often the last hurdle to clear. Moreover, unlike those in other major jurisdictions, China's competition regulator must consider the impact of a deal not only on competition but also on China's national economic interests.

Hong Kong-based partner **Drew Foster** answers some common questions about the merger clearance process in China, which can seem opaque to many, and how best to navigate it.

## 1 What cases have to be submitted for review?

China's Anti-Monopoly Law requires parties to submit transactions that entail a change of "control." These include mergers and acquisitions, of course, but also joint venture (JV) transactions (sometimes even when the JV has no current or planned operations in China) and certain minority investments where no party is based in China.

China's competition authority, the State Administration for Market Regulation (SAMR), interprets a change of "control" broadly and has significant discretion in directing parties to file. Even the acquisition of a minority stake may be subject to filing if it comes with board representation, important veto rights such as appointment or removal of the CEO, or approval of the annual budget or business plan.

The revenue thresholds (converted to U.S. dollars) currently are:

1. at least two parties to the transaction each has revenue of $55 million or more in mainland China, and

2. the parties' combined annual group revenues globally are at least $1.4 billion, or they have combined revenue of at least $277 million in mainland China.

These thresholds are under review and are likely to be increased by the end of 2022 or early 2023.

The breadth of deals that fall under the filing requirement can surprise some. Revenue is calculated at the parent level (including the entire group), and SAMR does not require any nexus to China, other than group revenues. Thus, if two American parents form a JV in the U.S. to provide services in California, and the JV does not plan to have China activities but the parents otherwise meet the China revenue thresholds, SAMR requires a filing. (The deal may be eligible for expedited review, however, as explained below.)

SAMR also has the power to investigate transactions that do not meet the filing thresholds but might otherwise negatively affect competition in China or worldwide, as SAMR determines.

## 2 What does China consider in its review?

SAMR will conduct conventional competition analyses, examining transactions among competitors, looking at combined market shares and evaluating the risk that the transaction will raise consumer prices or stifle innovation. It will also review vertical and conglomerate mergers where the parties are active in related but nonoverlapping markets. Here, SAMR looks at whether a combined firm could block competitors' access to important inputs, unlawfully tie sales of a "must have" product together with sales of a weaker product or gain access to sensitive information about competitors (*e.g.*, where a competitor of one party is a customer of the other).

Unlike other jurisdictions, Chinese law requires that, in addition to competition concerns, SAMR consider the impact of a transaction on the "national economic development of China," *i.e.*, whether it runs counter to China's industrial policies or domestic interests. This means that, in most ordinary merger reviews, SAMR must solicit input from and take into account the views of a wide range of Chinese stakeholders.

## 3 How long does the review take?

China has a fast-track "simplified procedure," and about 99% of such cases are approved within three months from the initial submission. Deals are eligible where the parties' combined market shares are below 15% and their individual shares in related markets are below 25%. Overseas JVs with no operations in China also qualify. But SAMR has full discretion to determine which deals ostensibly meeting these requirements will in fact be allowed onto this fast track.

> *"If Chinese stakeholders object to a transaction, SAMR will try to achieve a consensus on the terms of a clearance."*

All other cases will be reviewed under the ordinary procedure, which typically takes six to nine months or more, even for cases that pose no serious competition or industrial policy issues. Complex cases usually take nine to 12 months — longer if they pose particular problems for stakeholders in China. Although SAMR's statutory time frames for reviews are shorter, in practice there are no consequences for the agency when it misses its deadlines. Indeed, SAMR was recently granted the ability to stop the review clock altogether, giving it even more power to delay reviews.

SAMR will not accelerate ordinary procedure reviews unless there is extraordinary political will on the China side to do so. Usually, this only occurs where a deal brings significant, incontrovertible benefit to China.

## 4 Why does the review take so long?

Because SAMR must consider China's national economic interests, it cannot unilaterally approve a transaction without factoring in the views of major stakeholders. Those include not only customers but also competitors, trade associations and important government ministries. If Chinese stakeholders object to a transaction, SAMR will try to achieve a consensus on the terms of a clearance. That can take many months, especially when there are commercial or geopolitical incentives to delay or obstruct a deal and/or there are serial negotiations with stakeholders (with sometimes competing interests themselves). SAMR's outreach process to domestic stakeholders is kept confidential from the parties, which makes assessing the situation at any given time extraordinarily challenging.

Fortunately, for deals that qualify, the simplified procedure replaces this stakeholder consultation with a 10-day public comment period. If no negative comments are received in that window, SAMR usually approves the transaction within a week or two.

## 5 Do Chinese regulators coordinate their investigations or remedies with authorities in other jurisdictions?

In complex global transactions, SAMR commonly coordinates with other peer regulators, especially those in the European Union, U.K. and U.S. The regulators will typically coordinate on theories of harm and timing expectations, though SAMR generally does not share large numbers of documents with other regulators. Traditionally, it has preferred to see what other major regulators will do before finalizing its own approach, often by addressing China-specific interests in addition to aligning with those dealt with at the global level.

## 6 What are the chances China will block our deal?

Of the thousands of deals that China has reviewed, only three (less than 0.01%) have been prohibited. The overwhelming majority (99%) are cleared unconditionally. Conditions typically are imposed in only about four to 10 cases each year (less than 1%). There have also been a handful of transactions where China delayed its decision for so long that the parties abandoned the deal.

It is noteworthy that nearly all of the prohibitions, conditional approvals and abandonments over the past 10 years have occurred in the technology sectors that are important to China's national growth, such as semiconductors, automotive/aviation, and industrial equipment and supplies.

*"It cannot be stressed enough that there is no silver bullet, and no single person, consultant or politician can cut short SAMR's review or consultation procedures and deliver a miraculous unconditional approval. In almost all instances, the only way through the process is through it. … ."*

China has not wanted to discourage investment or create geopolitical tensions by blocking deals, but many Chinese stakeholders are adept at using the SAMR process to extract commercial benefits or delay foreign deals. The agency is also very willing to insist on China-specific remedies, even where all other global regulators have approved unconditionally.

## 7 What impact do current geopolitical tensions have on the SAMR review process?

Particular incidents, sanctions or legislation may cause temporary delays or reactions through SAMR, and deals in sensitive sectors are more likely to experience political delays or remedy requests. For example, the China-U.S. trade disputes of the last five years, coupled with China's determination to achieve "chip independence," have led to significant scrutiny of semiconductor and related deals. Fortunately, geopolitical tensions usually do not affect the deals that SAMR permits to be reviewed in the simplified procedure.

## 8 How do we maximize our chances of getting through the review process quickly and unscathed?

Advance planning is the key. Well before signing, parties must assess China's likely level of interest in a deal, identify potential Chinese stakeholders with an incentive to use SAMR's review to their advantage and scope out competitive, geopolitical and industrial policy issues that could affect a decision. There is no substitute for undertaking thorough and detailed stakeholder mapping and using that to develop an action plan for the potential challenges.

It cannot be stressed enough that there is no silver bullet, and no single person, consultant or politician who can cut short SAMR's review or consultation procedures and deliver a miraculous unconditional approval. In almost all instances, the only way through the process is through it. Nonetheless, parties should use their own China government relations teams to navigate stakeholder demands. These contacts can also be supplemented by expert local counsel who can offer insight into the SAMR process.

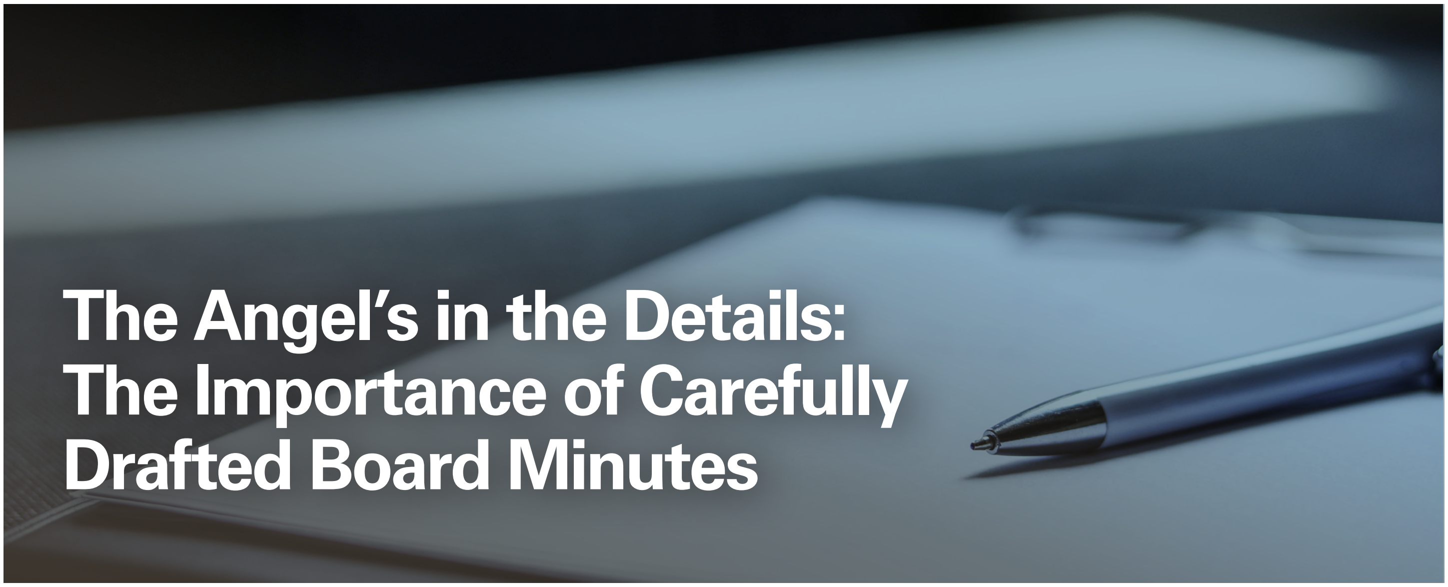
Finally, it is best to keep a low profile politically to minimize the odds of attracting adverse attention.

## 9 What id we just don't file or, if we run into trouble, close without Chinese approval?

If the filing thresholds are met, Chinese law prohibits closing any part of the deal prior to approval. SAMR will not allow the parties to hold separate the China portion of a deal while closing elsewhere or "park" China assets with a financial buyer with no China revenues in order to circumvent the filing obligation.

China recently increased the fines for gun-jumping (closing before approval) tenfold to about $700,000 for cases that do not pose issues. For a high-profile transaction raising real competition or industrial policy concerns, the fine can now be up to 10% of the acquirer's global turnover in the previous year. In addition, SAMR can, in theory, order the parties to unwind the transaction and/or revert to the status quo prior to the transaction, although that power has only been used once in China's merger review history, and that was done in a domestic combination.

**Authors**
*Andrew L. Foster, Julia Zhu*



# The Angel's in the Details: The Importance of Carefully Drafted Board Minutes

- Boards should see minutes as a way to tell how they worked to fulfill their duties to stockholders, capturing a board's deliberations and the reasoning behind its decisions.
- Properly documenting the board's deliberative process takes on heightened significance for "mission-critical matters" such as major deals, oversight of monoline businesses or significant revenue flows, or catastrophic events, where board actions may be the subject of stockholder litigation.
- Well-drafted board minutes can help contain the scope of stockholders' books and records requests and make it easier to win early dismissal of lawsuits.
- To protect against claims that a company's disclosures were misleading, a company's public statements and filings should be consistent with the board minutes.

Board minutes are an essential part of a company's internal record keeping. But they are more than a routine, formal exercise. They also play a pivotal role in stockholder litigation. As a contemporaneous record, plaintiff stockholders will scrutinize minutes when evaluating and pursuing claims against directors and officers, and judges will consider minutes at the pleadings stage. Boards should see minutes as a way to tell how they worked in fulfilling their duties to stockholders.

Minutes of important board meetings, and proxy statements describing them, have become increasingly important in recent years as a result of developments in Delaware law. Courts have sometimes granted stockholders early access to documents beyond formal board materials, such as directors' emails and text messages, where they found that minutes offered too sparse an account of a board's consideration of a particular issue. In addition, if a formal board record is lacking, stockholders may argue that a board breached its duty to oversee and address risk.

By contrast, a sufficiently clear record in the minutes of directors' deliberations and the process by which they reached decisions can position the company to head off intrusive probes of internal records at the outset, help prevent complaints from being filed, and potentially aid in winning early dismissal of suits.

## Logistical Drafting Considerations

There is no one-size-fits-all approach to drafting board minutes, but they typically reflect, among other things, formal matters such as the date that the board meeting was noticed or, alternatively, if notice was waived by all directors; who attended the meeting (including executives, employees and any outside advisers) and how they participated (in person or remotely); as well as when the meeting commenced and adjourned. If the board received presentations, those may also be attached as exhibits.

In some instances, where individual directors make comments or raise questions, good practice is to identify the issues considered, inputs the board received and other details about the discussion generally without a need to detail specific questions or name individual directors.

## Potential Stockholder Challenges

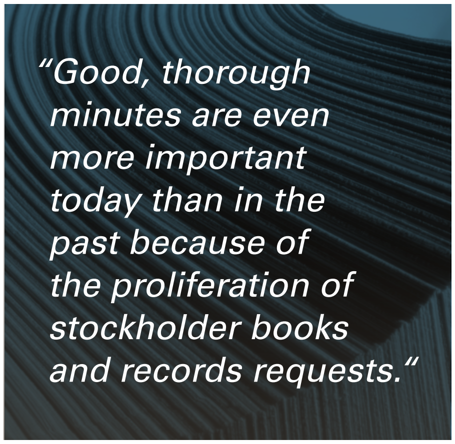
When drafting board minutes, keep in mind that there can be several types of stockholder challenges to board action or inaction of a Delaware public company. The board should expect such challenges, whether in the form of a books and records demand, derivative or direct litigation, or demands that the company pursue litigation. Here are the most common issues raised by stockholders, and how good minutes can be helpful in defending against legal challenges:

**Delegation to a committee.** If a board determines that a committee would be helpful to oversee an investigation or transaction, whether to avoid a potential conflict or allow for more agility and speed with a smaller group, it is best to document the decision with board resolutions. The minutes may (i) explain why the board concluded it was in the company's best interest to enlist a committee and (ii) specify the committee's mandate and scope of authority. For example, it may be helpful to explain whether the committee has full authority (like a special committee weighing a transaction where there is a potential conflict of interest for other board members), or whether the committee will make a recommendation for full board approval.

**Oversight.** When the board is deliberating about significant issues, including those that Delaware courts have deemed "mission-critical," the board's process and actions should be adequately captured to reflect its oversight. This may include documenting how it received and considered the input of management and advisers, as well as a discussion of a board's consideration and decision regarding risks and mitigation of those.

**Director independence and conflicts.** Directors and officers may complete questionnaires on a regular basis as well as in a specific context, like a transaction, to evaluate their independence and to identify potential conflicts of interest. Certain disclosures, particularly ones that might pose a potential conflict, may warrant board-level consideration. The minutes should reflect this deliberation and subsequent determinations.

**Other conflicts.** Where there is a potential conflict regarding any matter, the board should weigh whether that should be disclosed and document that consideration in the minutes. For example, stockholders commonly challenge a board's choice of advisers — particularly financial firms assisting on transactions. A board may require disclosure




of potential adviser conflicts, and consider those before retaining an adviser. It may also insist on updates if any additional material conflicts arise. It is important that the minutes clearly document this process and any conflict considerations. Not all conflicts are fatal, particularly if understood and appropriately considered and addressed (if appropriate), but failing to identify and consider conflicts can be problematic.

**Deal processes.** Just as it is important to document the board's deliberation regarding significant issues, it is critical to make a record of the board's process when selling the company. Boards should receive regular updates about the sale process, including any important communications (or lack thereof) with bidders. For a significant M&A transaction, the record should reflect a thorough, board-centric process, even if — as is generally perfectly appropriate and typical — the CEO is leading negotiations.

It is common to use code names when discussing M&A deal counterparties even in the official record, as other parties may end up seeing the board's minutes.

**Disclosure claims**. The company's public statements and publicly filed documents should reflect what actually happened at the board. Accordingly, when preparing public filings, care should be given to reviewing board materials and minutes. If there are discrepancies, stockholders may allege that the company's disclosures were incomplete or misleading.

Potential disclosure violations take on heightened significance in the deal context. If a stockholder successfully alleges a disclosure deficiency, directors may not benefit from the protections of two important Delaware decisions, *Corwin* and *MFW*. Under *Corwin*, a transaction approved by fully informed, uncoerced stockholders, not involving a controlling stockholder, is protected by the business judgment rule, which shields directors from liability if they acted in good faith and followed proper procedures.

*MFW* and later cases that follow also apply the business judgment rule to controlling-stockholder "squeeze out" mergers if certain conditions are satisfied. One condition is that there was a fully informed vote of minority stockholders. Accordingly, when drafting the disclosure document, the board minutes should be used as a guide so that the documents track each other and accurately reflect the board's deliberations and actions so the board may receive the benefits of Corwin and *MFW* in any litigation down the road.

## Protecting Privilege

It is important to ensure that the fact that legal advice was given to the board is reflected in the minutes at least at a high level, but boards need to guard against waiving the attorney-client privilege. Although privileged information is typically redacted when minutes are produced to plaintiff stockholders, legal advice may at some point become an issue in litigation if the board asserts that it relied on that advice.

To protect privileged information from disclosure, minutes reflecting legal advice should be characterized as an outside attorney or in-house counsel "providing legal advice" about a matter as opposed to "advising the board" to take a certain action, because advice from a lawyer that is not legal in substance — say, advice on business strategy — potentially may not be protected by the privilege. See our April 13, 2021, *Informed Board* article "Just Between You and Us: The 10 Most Common Client Misconceptions About the Attorney-Client Privilege."

## The Increase in Books and Records Demands Makes Board Minutes All the More Important

Good, thorough minutes are even more important today than in the past because of the proliferation of stockholder books and records requests. Several developments in Delaware law have given stockholders and their counsel strong incentives to make those demands before taking other legal steps. As a result, many Delaware companies find themselves deluged with those requests, which can furnish stockholders with ammunition for litigation. See our June 1, 2022, *Informed Board* article, "In the Name of the Company: When Stockholders Interfere in the Boardroom."

By observing careful practices regarding minutes, companies can make it more likely that the courts will not allow access to books and records beyond formal documents such as minutes, thereby limiting the material that can be used in complaints. Moreover, at the pleadings stage, companies may point the court to portions of minutes to rebut the inference given to plaintiffs' allegations, or to demonstrate "cherry picking" or inaccuracies in the plaintiffs' characterizations that create a false picture of the board's process.

In sum, prepared carefully, minutes tell the board's side of the story to stockholders and courts.

**Authors**
*Sonia K. Nijjar, Jenness E. Parker, Lauren N. Rosenello*

# This SEC Press Release Is a Compliance Checklist for Corporations

- The SEC collected a record $4.2 billion in penalties in enforcement actions in 2022, nearly three times the figure in 2021.
- Recent enforcement actions involving ESG issues, 10b5-1 plans and cybersecurity align with the SEC's rulemaking initiatives on those topics.
- Increasingly, as part of settlements, the commission has insisted that companies retain an independent compliance consultant who will report back to the staff of the SEC's Division of Enforcement on compliance-related undertakings.
- Accounting and disclosure issues, including earnings manipulation, sales practices that impact revenue disclosures and non-GAAP metrics, remain a high priority for enforcement.

The Enforcement Division of the U.S. Securities & Exchange Commission (SEC) recently reported a robust enforcement year with record-breaking results. The summary is an indicator of where the division is concentrating efforts, and thus a forward indicator of areas where companies need be sure they do not run afoul of securities laws.

In the fiscal year ended September 30, 2022, the division initiated 462 new enforcement actions, and 760 actions in total (including follow-on actions and cases involving missing and delinquent filings) and imposed $6.4 billion in penalties and disgorgement, according to the November 15, 2022, press release summarizing the results.

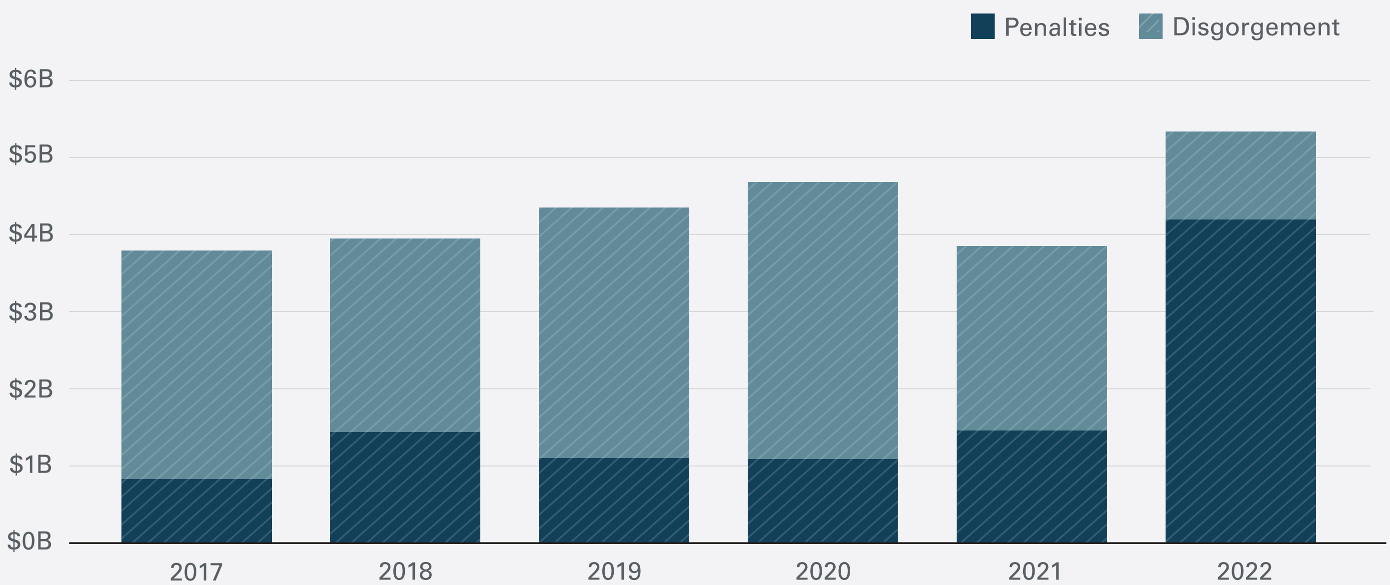
## Notable Trends

**Higher penalties and a higher penalty/disgorgement ratio.** The Enforcement Division views significant penalties as one of its tools to deter future misconduct. Officials have said in recent public remarks that they believe penalties should be calibrated to convey to market participants that complying with the securities laws is less costly than violating them.

**Mixed messages about cooperation.** The division continues to emphasize the benefits of full cooperation. However, while we did see actions where cooperation resulted in no penalties, we also saw others where significant penalties were imposed despite self-reporting and cooperation. The division has emphasized that the amount of cooperation credit will depend on the facts and circumstances of a particular action.

**Imposition of independent compliance consultants (ICCs).** Increasingly, we have seen the division requiring parties to engage an ICC who will report back compliance-related findings to staff of the division as part of a settlement, especially in cases

**SEC Enforcement Results**




Figures for fiscal years ending September 30.

where there has not been enough time for the division to assess the effectiveness of the company's compliance program.

**Increased gatekeeper accountability.** There is a continued focus on gate-keepers, including auditors and compliance and legal personnel. In one case, a former general counsel of a public company settled an action alleging *unintentional* misconduct.

## Financial Fraud and Issuer Disclosure

The SEC views public company disclosures as the bedrock of the securities markets and it continues to view this area as an enforcement priority. In FY 2022, the SEC brought and obtained settlements in several cases that show how broad a view it is taking of necessary disclosures. For example:

- A mining company was alleged to have misled investors about a technology upgrade it claimed would reduce costs but ultimately increased them, and for failing to properly assess whether to disclose financial risks stemming from excessive discharges of mercury in Brazil.
- In a first-of-its-kind action against a multinational technology company,

the defendant was charged with failing to disclose that rising sales of products designed for gaming were driven in part by cryptocurrency mining. Even though the company's stated revenue and accounting were accurate, the SEC alleged that the Risks and Management Discussion and Analysis sections of its disclosures did not adequately disclose that earnings and cash flow fluctuations reflected in part the volatile crypto mining industry.

**Earnings-per-share (EPS) initiative.** The SEC continues to closely monitor earnings management practices, such as accounting adjustments that may be quantitatively immaterial but impact EPS or earnings guidance in way that have a qualitatively material impact — *e.g.*, a penny per share that was the difference between "making or missing" the quarter. This ongoing program, begun in 2020, leverages data analytics to generate leads about companies that are making post-quarter adjustments in discretionary accounts in order to round up reported EPS to meet or beat publicly announced earnings guidance.

In 2022, as part of this initiative, the SEC brought actions against two companies and charged senior executives in both actions. In one case, the SEC alleged that the company made unsupported reductions in a reserve account that allowed it to round up its EPS reporting, while in, the other case, the company allegedly pulled forward revenue and shipped customer orders without approval.

**Sales practices disclosure cases.** The SEC continues to monitor sales practices, including "pull-in" practices and order backlog management where the revenue recognition is correct under the Financial Accounting Standards Board's rules, but disclosures surrounding financial performance — such as ability to meet revenue guidance, maintain year-over-year growth or have customer demand for a product — may be inaccurate or misleading.

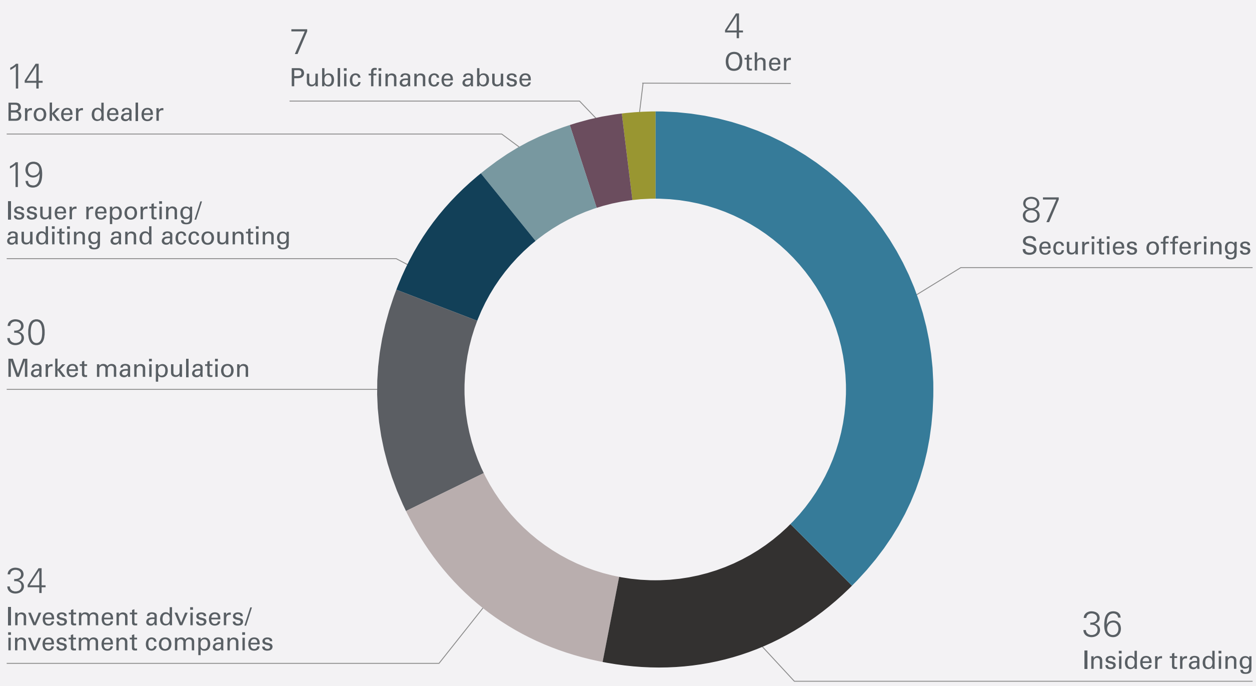
For example, the division brought a case last year, later settled, against a cloud computing and virtualization company that allegedly did not properly disclose (i) its order backlog management practices, which enabled the company to push revenue into future quarters by delaying deliveries to customers and (ii) the company's slowing performance relative to its projections. Again, the financial accounting itself was not challenged, only the misleading overall financial picture these practices were alleged to have created.

## Cybersecurity and Compliance

Most of the key cybersecurity cases brought in FY 2022 concerned broker-dealers and investment advisers. However, the SEC has repeatedly emphasized the importance it places public companies having appropriate systems to assess vulnerabilities and meet disclosure obligations during a cybersecurity incident.

**SEC Enforcement Cases by Type**

By primary action type. Fiscal year ended September 30, 2022.




A proposed SEC rulemaking would require:

- reporting material cybersecurity incidents on Form 8-K within four business days of discovery, disclosing updates on previously reported cyber incidents on Forms 10-K and 10-Q, disclosing the company's policies and procedures concerning cybersecurity risks,
- maintaining internal controls over information systems that are used (not just owned) by the company, and
- disclosing board members with cybersecurity expertise.

Even before rules are finalized, these proposals are likely indicators of the SEC's expectations.

We expect continued SEC enforcement activity in this area in 2023.

## Environmental, Social and Governance (ESG) Issues

The division has focused attention on ESG issues for public companies, as well as investment products and strategies. The SEC has applied principles from existing law and regulations concerning materiality and accuracy of disclosures to challenge what it believes to misleading statements and "greenwashing." In March 2021, the division created a Climate and ESG Task Force that is charged with analyzing ESG voluntary disclosures companies make in filings and proactively identifying ESG-related misconduct.

In one notable ESG enforcement action, the SEC litigated against a publicly traded South American metals and mining company, alleging that it made false and misleading claims to local governments, communities and investors about the safety of its dams prior to the collapse of one in Brazil, which caused environmental and social harm. The SEC's complaint cited several market and financial factors to support its assertion that the disclosures were material, including that the dam failure led to $4 billion decline in the company's market cap; its ADRs traded on the New York Stock Exchange lost more than 25% of their value; and its credit rating was downgraded to junk status.

Proposed ESG rules in the pipeline at the SEC could make enforcement easier for the commission. In addition, in 2023, we expect the Climate and ESG Task Force within the Enforcement Division to continue to analyze voluntary ESG disclosures in filings and proactively identify ESG-related misconduct.

## Market Abuses: 10b5-1 Plans

As we have mentioned above, in 2022, the Enforcement Division brought cases in areas that are the subject of SEC rulemakings to reinforce the need for additional, and likely more prescriptive, regulation. One such area was 10b5-1 predetermined stock sales plans for insiders. The SEC has proposed a rulemaking that would significantly alter the Rule 10b5-1 requirements, aimed at curbing perceived abuses.

In one enforcement action in FY 2022, the SEC charged a public company's executives with insider trading, alleging that they established a 10b5-1 plan after becoming aware of a significant decline in the revenue from the company's largest advertising partner. The settlement included several undertakings that align with aspects of the SEC's proposed rulemaking on 10b5-1 plans, including, for example, an agreement to include a 120-day cooling off period (*i.e.*, when trading is prohibited) after the adoption or modification of a 10b5-1 plan.

## Non-GAAP Financial Reporting

The Enforcement Division and the Division of Corporation Finance continue to scrutinize non-GAAP financial metrics and related disclosures and internal controls. The SEC has made it clear that, if a company presents non-GAAP metrics, they must be appropriately labeled, accurate and consistent, and any assumptions or judgment calls should be disclosed.

For example, the SEC sued a multinational health care company alleging that it entered into intra-company foreign exchange transactions for the sole purpose of generating foreign exchange gains, or avoiding foreign exchange losses, on revenue received in foreign currencies using a non-GAAP conversion process. That had the effect of materially misstating the company's net income, the suit charged. The SEC also found that the company did not have adequate internal controls to monitor and quantify the difference between the non-GAAP and GAAP calculations of the foreign exchange gains and losses.

**Authors**
*Anita B. Bandy, Raquel Fox,*
*Leo Chomiak, Andrew Hansen*

## Contacts

**Anita B. Bandy**
Partner / Washington, D.C.
202.371.7570
anita.bandy@skadden.com

**Brian J. Egan**
Partner / Washington, D.C.
202.371.7270
brian.egan@skadden.com

**Alessio Evangelista**
Partner / Washington, D.C.
202.371.7170
alessio.evangelista@skadden.com

**Eytan J. Fisch**
Partner / Washington, D.C.
202.371.7314
eytan.fisch@skadden.com

**Andrew L. Foster**
Partner / Hong Kong
852.3740.4864
andrew.foster@skadden.com

**Raquel Fox**
Partner / Washington, D.C.
202.371.7050
raquel.fox@skadden.com

**Michael E. Leiter**
Partner / Washington, D.C.
202.371.7540
michael.leiter@skadden.com

**Sonia K. Nijjar**
Partner / Palo Alto
650.470.4592
sonia.nijjar@skadden.com

**Jenness E. Parker**
Partner / Wilmington
302.651.3183
jenness.parker@skadden.com

**Khalil N. Maalouf**
Counsel / Washington, D.C.
202.371.7711
khalil.maalouf@skadden.com

**Leo W. Chomiak**
Associate / Washington, D.C.
202.371.7511
leon.chomiak@skadden.com

**Andrew Hanson**
Associate / Washington, D.C.
202.371.7225
andrew.hanson@skadden.com

**James E. Perry**
Associate / Washington, D.C.
202.371.7652
james.e.perry@skadden.com

**Lauren N. Rosenello**
Associate / Wilmington
302.651.3125
lauren.rosenello@skadden.com

**Julia Zhu**
Associate / Shanghai
86.21.6193.8297
julia.zhu@skadden.com

**View past editions / You can find all *Informed Board* articles here.**



Skadden, Arps, Slate, Meagher & Flom LLP
One Manhattan West
New York, NY 10001
212.735.3000

skadden.com