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MERGERS AND ACQUISITIONS

Defining a Pandemic in Commercial Contracts: An Analysis after *AB Stable VIII v. MAPS Hotels & Resorts One*

The Delaware Court of Chancery has issue an important decision that provides guidance on the meaning and applicability of ordinary course and material adverse effect provisions in merger and acquisition agreement.

By Rollo Baker and Jonathan Feder

In a first-of-its-kind decision in the pandemic, Vice Chancellor Laster of the Delaware Court of Chancery provided indispensable guidance on the meaning and applicability of some of the most ubiquitous clauses in merger and acquisition agreements: ordinary course and material adverse effect provisions. Diligent practitioners will scrutinize carefully the important lessons contained in the court's *AB Stable VIII v. MAPS Hotels & Resorts One* post-trial opinion[1] in negotiating future mergers and acquisitions.

Material Adverse Effect

Many transaction agreements, including the sale agreement in *AB Stable*, allow the buyer to terminate its purchase if the acquisition target suffers a "material adverse change" (MAC) or "material adverse effect" (MAE) on its business between the time of signing and closing. Historically, the Delaware Court of Chancery—the oft-preferred court for M&A business disputes—has set an extraordinarily high bar for a buyer to terminate on the basis of an MAE or MAC. In a typical case, the court will ask some set of:

- Whether the triggering event was unforeseeable:
- Whether the effect was severe (approaching a 30 or 40 plus percent decrease in earnings);
- Whether the adverse effect will be sustained (potentially lasting several quarters or over two years); and
- Whether the acquisition target was affected greater than its peers.[2]

Though not each of these elements is necessary in every case, they have only worked in favor of a buyer once in the history of Delaware litigation (in the seminal 2018 *Akorn v. Fresenius* decision[3]); every other time a buyer has claimed that the acquisition target company suffered a material adverse effect, the Delaware Court of Chancery has disagreed.

Material Adverse Effects of the Pandemic

In early March, many practitioners considered whether the COVID-19 crisis would buck that trend and qualify as a material adverse effect in cases where the effects of the pandemic devastated an acquisition target. On March 11, 2020, we wrote this:

> Ultimately, it may be premature to tell how long-lasting the effects of the COVID-19 epidemic will be. But if corporate earnings are depressed and analysts predict potential longer-term effects for certain companies and industries (*e.g.*, cruise lines), MAC clauses may become relevant.[4]

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Fast forward and the landscape seems somewhat changed. Vice Chancellor Laster, on November 30, 2020, "assumes for purposes of analysis that [the acquisition target company] suffered an effect to the COVID-19 pandemic that was sufficiently material and adverse to satisfy the requirements of Delaware case law."[5] Two days later, a court in Ontario, Canada—considering Delaware court precedent—noted: "At first blush, I am prepared to agree that a material adverse effect did occur as a result of the pandemic."[6]

Still, no US court (to our knowledge) actually has decided whether effects of the pandemic are sufficiently severe and durationally significant to be considered a material adverse effect, as that contract term is commonly construed in commercial courts.

Carve-Outs to MAE

When transaction agreements allow termination due to a material adverse effect, the parties also typically specify "a list of exceptions" so that "if an effect occurs that is both material and adverse and yet results from a cause falling within one of the exceptions, then that effect—despite being material and adverse—is not [a sufficient independent basis to terminate the agreement]."[7] In a typical agreement, these exceptions may be structured so as to address two broad categories of risks: "The typical MAE clause allocates general market or industry risk to the buyer and company-specific risk to the seller … using exceptions [*i.e.*, carve-outs] to reallocate specific categories of [market or industry] risk to the buyer."[8]

The MAE clause at issue in *AB Stable*, for instance, read as follows:

> "Material Adverse Effect" means any … effect that would have a material adverse effect on the business … **other than** …
>
> (i) general changes or developments in any of the industries in which the Company or its Subsidiaries operate, …
> (iii) natural disasters or calamities, …
>
> (v) changes in any applicable Laws or applicable accounting regulations or principles or interpretations thereof, …

The court read this as a "typical" MAE clause, allocating company-specific risks to the seller and using exceptions to allocate general systematic risks to the buyer.[9] On that basis, the court concluded that, "The risk from a global pandemic is a systematic risk, so it makes sense to read the term 'calamity' [in exception iii] as shifting that risk to Buyer."[10] In reaching this decision, the court took a holistic approach to MAE contract drafting.

Defining the Pandemic

Taking a step back, the court explained that contracts may seek to address three broad types of risks: (1) known knowns, (2) known unknowns, and (3) unknown unknowns.[11] To address "unknown unknowns," drafters sometimes employ "broad terms" meant to encompass situations both foreseeable and unforeseeable.[12]

Calamity. The court in *AB Stable* reasoned that the term "calamities" in exception 3 to the definition of "Material Adverse Effect" was meant to encompass unknown unknowns: "to allocate systematic risk for as-yet-unknown and as-yet-unimaginable calamities."[13] Defining the pandemic as a calamity, the court found:

> Millions have endured economic disruptions, become sick, or died from the pandemic. COVID-19 has caused human suffering and loss on a global scale, in the hospitality industry, and for [the acquisition target company's] business. The COVID-19 outbreak has caused lasting suffering and loss throughout the world.[14]

On the basis of these observations, Vice Chancellor Laster held: "The COVID-19 pandemic fits within the plain meaning of the term 'calamity'"—a defined category of risk that could not be a basis for termination of the transaction based on an MAE.

Natural Disaster. Exception 3 to the material adverse effect definition also included "natural disasters" as a risk that would not be considered a material adverse effect for purposes of termination. According to Vice Chancellor Laster:

> The COVID-19 pandemic arguably fits this definition as well. It is a terrible event that emerged naturally in December 2019, grew exponentially, and resulted in serious economic damage and many deaths.[15]

In another context but a similar vein, Southern District of New York Judge Denise Cote ruled: "It cannot be seriously disputed that the COVID-19 pandemic is a natural disaster" whose effects were sufficiently "beyond the parties' control" so that a *force majeure* termination provision was "properly invoked."[16] While *force majeure* provisions historically carry a far lower materiality burden than material adverse effect provisions, the SDNY Court's observations are potentially poignant: "It is a worldwide public health crisis that has taken untold lives and upended the world economy."[17]

These decisions create important first brush strokes for courts and litigants that will continue to classify, define, and redefine the novel virus and its wide-ranging effects in a variety of contexts and for years to come.

Ordinary Course

Another common termination right in merger and acquisition agreements is the ordinary course covenant: If a seller fails to operate the target company in the ordinary course of business between signing and closing, the buyer is entitled to walk away from the transaction. The sale agreement in *AB Stable* contained this unique form of the common provision: "the business of the [acquisition target company] *shall be* conducted only in the ordinary course of business *consistent with past practice* in all material respects."[18]

Delaware court precedent on ordinary course provides this dictionary-style definition: Ordinary course of business means "the normal and ordinary routine of conducting a business."[19] Delaware courts also previously elaborated that the ordinary course provision ensures that the company the buyer receives at closing "is essentially the same as the one it decided to buy at signing."[20] The *AB Stable* decision follows this line of reasoning and explains: "The ordinary course covenant recognizes that the buyer has contracted to buy a specific business with particular attributes that operates in an established way. The buyer has not contracted to purchase a basket of fungible goods."[21]

Extraordinary Course

Contrary to every possible understanding of "ordinary course," the Court found that the seller in *AB Stable* made "major material," "monumental," "extensive," "extreme," "dramatic," and "unprecedented" changes to the operation of the acquisition target company during the months of March and April 2020.[22]

The ordinary course provision at issue in *AB Stable* contained, among other things, the following aspects providing important protections to the buyer.

1. *Use of the passive voice.* The covenant ran directly to the operation of the business—"the business … shall be conducted," taking no account of who or what might or might not operate the business in the ordinary course. It therefore did not matter who made the decision to depart from the ordinary course, or whether that decision was within any person or entity's control—the passive promise was unconditional.[23]
2. *Lack of any efforts modifier.* Whereas many contract provisions, including certain provisions in the sale agreement in *AB Stable*, require a party to use "best efforts," "reasonable best efforts," "reasonable efforts," "commercially reasonable efforts," or "good faith efforts," the ordinary course provision was not so qualified.[24] Here again, the sale agreement

in *AB Stable* made clear that the seller's obligation to operate in the ordinary course was unconditional.

3. *A limiting frame of reference for measuring compliance.* The covenant to operate in the ordinary course was qualified by a limiting reference: "consistent with past practice." This limit created additional buyer protection, restricting the seller's acceptable range of conduct "exclusively to how the business has operated in the past."[25] Thus, evidence of concurrent industry practice in response to the pandemic was not relevant; the critical question was "how the company has operated in the past, both generally and under similar circumstances."[26]

Analyzing this particular ordinary course provision, the court held: "The Ordinary Course Covenant imposes an overarching obligation that is *flat, absolute, and unqualified* by any efforts language."[27] Applying the provision to the particular facts of the case, the Delaware Court of Chancery easily concluded that "Seller breached the ordinary course covenant when [the target acquisition company] made extraordinary changes to its business in response to the COVID-19 pandemic."[28] This holding was unaffected by whether those changes were "warranted" and "reasonable" in light of the circumstances.[29] Because the changes were "radical" and "significantly altered the operation of the business,"[30] the court concluded:

> the relevant question is whether "the business of the Company and its Subsidiaries" was conducted consistent with past practice. Quite obviously, it was not.[31]

Not a Straitjacket

Although an ordinary course covenant such as the one in *AB Stable* may "constrain[] the seller's flexibility to the business's normal range of operations," it "is not a straitjacket."[32] In the *AB Stable* sale agreement, the seller was allowed to depart from the ordinary course if it obtained the buyer's "prior written consent (which consent shall not be unreasonably withheld, conditioned or delayed)."[33] Yet, seller "admitted that it never sought Buyer's consent."[34] As the Court explained: "Compliance with a notice requirement is not an empty formality" because notice provides the buyer the opportunity to "engage in discussions with the seller and if warranted, seek information about the situation under its access and information rights[,] … propose reasonable conditions to its consent, and it can anticipate and account for the implications of the non-ordinary course actions when planning for post-closing operations." This lesson in contractual compliance and enforcement is a reminder, if nothing else, to contractual parties that where a "contractual consequence [] follows as a result" of the contractual bargain, that result will not likely be modified by courts based on *post hac* rationalizations.[35]

Conclusion

In *AB Stable*, the Delaware Court of Chancery re-affirmed its consistent approach to commercial contracts, prioritizing the words contained within "the four corners of the agreement … according to their plain, ordinary meaning."[36] In a few places, the court even suggests particular language parties can use in their contracts to clearly manifest certain intended outcomes.[37] Although most deals do not end in litigation, when they do, the court is the ultimate audience. Adopting the type of contractual language suggested by Vice Chancellor Laster in *AB Stable VIII v. MAPS Hotels* would aid both the court and the contracting parties by providing additional clarity as to the parties' intentions.

Notes

1. AB Stable VIII v. MAPS Hotels & Resorts One, 2020 WL 7024929 (Del. Ch. Nov. 30, 2020) (hereinafter, Op.).
2. *See generally* Quinn Emanuel, "US Outlook: Novel Legal Challenges from the New Coronavirus," at 6-7, *JDSupra*

(March 12, 2020) available at *https://www.jdsupra.com/legalnews/us-outlook-novel-legal-challenges-from-67656* (US Outlook).
3. Akorn v. Fresenius, 2018 WL 4719347 (Del Ch. Oct. 1, 2018).
4. US Outlook, *supra* n.2 at 8 (footnote omitted).
5. Op. at 123; *see also* Op. at 109 ("Assuming for purposes of analysis that the business ... suffered an effect that was material and adverse...").
6. Fairstone v. Duo, 2020 ONSC 7397, at ¶ 5 (Ontario Super. Ct. Dec. 2, 2020) (Koehnen, J.).
7. *See* Op. at 122-124.
8. Op. at 134-135; *see also* Op. at 136-137 ("For purposes of finer-grained analysis, the risks that parties address through exceptions can be divided into four categories: systematic risks, indicator risks, agreement risks, and business risks. ... Generally speaking, the seller retains the business risk. The buyer assumes the other risks.")
9. Op. at 137.
10. Op. at 137-138.
11. Op. at 147-148.
12. Op. at 148.
13. Op. at 148.
14. Op. at 131.
15. Op. at 132.
16. JN Contemporary v. Phillips Auctioneers, No. 20-cv-04370, ECF no. 76 at *17-23 (S.D.N.Y. Dec. 16, 2020) (Cote, J.).
17. *Id.* at *23. That December 16, 2020 decision was also issued in a case where Quinn Emanuel represented the prevailing party.
18. Op. at 109-110 (emphases added).
19. *See* Op. at 155.
20. Op. at 156; *see also* Op. at 155 ("an ordinary course provision is 'included to reassure a buyer that the target company has not materially changed its business or business practices during the pendency of the transaction'").
21. Op. at 169.
22. Op. at 173-174.
23. Op. at 175-176. The Court did find, however, that the seller and the acquisition target company directed the material changes to the operation of the hotels to be sold in the transaction. Op. at 176-177.
24. Op. at 162-165; *see also* Op. at 207-208 (explaining the differences, and lack thereof, among efforts qualifiers).
25. Op. at 161.
26. Op. at 160; *see also* Op. at 61 ("Because of the standard that the parties chose, the court cannot look to how other companies responded to the pandemic or operated under similar circumstances.").
27. Op. at 163 (emphasis added).
28. Op. at 171.
29. Op. at 171.
30. Op. at 173.
31. Op. at 177.
32. Op. at 158-159.
33. Op. at 149.
34. Op. at 187.
35. *See* Op. at 183.
36. Op. at 106-107.
37. *See, e.g.*, Op. at 114-115 n.195; Op. at 148.

INVESTMENT MANAGEMENT

SEC Modernizes and Combines Investment Adviser Advertising and Cash Solicitation Rules

For the first time since the 1960s, the SEC has substantively revised the rules governing advertising and cash solicitation by investment advisers. The new marketing rule reflects changes in the investment advisory market and means of communication.

By Lindsey L. Wiersma, Udi Grofman, Philip A. Heimowitz, and Karen J. Hughes

On December 22, 2020, the Securities and Exchange Commission (SEC) adopted amendments to the advertising and cash solicitation rules under the Investment Advisers Act of 1940 (Advisers Act), along with corresponding amendments to the books and records rules and Form ADV.[1]

The amendments create a merged rule (Marketing Rule) that replaces both the investment adviser advertising rule in Rule 206(4)-1 (Old Advertising Rule) and the cash solicitation rule in Rule 206(4)-3 (Old Solicitation Rule) under the Advisers Act, neither of which had been substantively revised since their initial adoption in the 1960s. The Marketing Rule is intended to modernize the regulatory regime to reflect changes in the investment advisory market and means of communication by creating rules that are evergreen and can evolve with changing technologies.

The Marketing Rule moves to a more principles-based approach focused on advertisements not being "fair and balanced" and not materially misleading based on facts and circumstances. Many of the new requirements of the Marketing Rule and practices discussed in the adopting release already are best practices in the private funds industry; so while some changes will be necessary and some additional flexibility has been granted, the Marketing Rule is not expected to mark a sea change in the industry.

The following are certain highlights of the Marketing Rule and its application to private fund advisers. A more detailed summary of the Marketing Rule, including a comparison against the Old Advertising Rule and the Old Solicitation Rule is set forth in the charts accompanying this article.

Lindsey L. Wiersma, **Udi Grofman**, **Philip A. Heimowitz**, *and* **Karen J. Hughes** *are attorneys at Paul, Weiss, Rifkind, Wharton & Garrison LLP.* **Gili Farhadian-Sagiv** *also contributed to this article.*

Definition of "Advertisement"

The Marketing Rule defines advertisement as:

(1) Any direct or indirect communication an investment adviser makes to more than one person (or to just one person if the communication involves hypothetical performance), that (x) offers the adviser's investment advisory services with regard to securities to prospective clients or prospective private fund investors, or (y) offers *new* investment advisory services with regard to securities to current clients or current private fund investors; in each case, *excluding*:
   (a) Extemporaneous, live, oral communications (but not any scripts or prepared materials for such a communication);
   (b) Information contained in a statutory or regulatory notice, filing or other required communication that is reasonably designed to satisfy the requirements thereof; and
   (c) Communications that include hypothetical performance provided either (x) in response to an unsolicited request for such information from a prospective or current client or private fund investor; or (y) to a

prospective or current private fund investor in a one-on-one communication; and

(2) Any endorsement or testimonial (to one or more persons) for which an adviser provides cash or non-cash compensation, directly or indirectly, *excluding* information contained in a statutory or regulatory notice, filing or other required communication that is reasonably designed to satisfy the requirements thereof.

The first prong of the definition relates to traditional advertisement activities previously captured by the Old Advertisement Rule. The second prong is intended to pick up traditional testimonial and endorsement activities previously addressed under the Old Advertisement Rule as well as solicitation activities previously addressed under the Old Solicitation Rule. It does this by defining "endorsement" to include solicitation or referrals of current or prospective clients or private fund investors.

General Prohibitions

The Marketing Rule prohibits the following in any advertisement:

- Any untrue statement of a material fact, or omission of a material fact necessary to make the statement, in light of the circumstances in which it was made, not misleading (*i.e.*, a 10b-5" standard);
- A material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC;
- Information that is reasonably likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the investment adviser;
- Discussion of potential benefits to clients or investors in connection with the investment adviser's services or methods without a fair and balanced discussion of any material risks or limitations associated with the potential benefits;
- Reference to specific investment advice provided by the investment adviser where such advice is not presented in a fair and balanced manner;
- Performance results that include or exclude certain results or time periods in a manner that is not fair and balanced; and
- Otherwise being materially misleading.

These prohibitions apply to all advertisements; advertisements subject to additional specific requirements discussed below will still need to be held to these overarching standards.

Performance

The Marketing Rule incorporates many of the principles that applied to performance advertising in the line of no-action letter guidance under the Old Advertising Rule, but gives investment advisers incrementally more flexibility by taking a more principles-based approach and not limiting advisers to the specific requirements of the no-action letter guidance.

Under the Marketing Rule:

- Gross performance must be accompanied by net performance presented with equal prominence in a format designed to facilitate comparison with gross performance;
- Performance results, *other than performance results of a private fund*, must be presented over one-, five-, and ten-year time periods with equal prominence;
- Any express or implied statement that the calculation or presentation of performance results has been approved or reviewed by the SEC is prohibited;
- If performance results from any related portfolio (*i.e.*, a portfolio with substantially similar investment policies, objectives, and strategies as that being offered in the advertisement) is included, the performance of all related portfolios must be included, subject to certain exceptions;
- Extracted performance (*i.e.*, performance of a subset of a single portfolio) is permitted so long as the advertisement provides, or offers to

provide promptly, performance results of the total portfolio;

- Hypothetical performance (*i.e.*, performance results that were not actually achieved by any portfolio of the adviser[2]) may be presented only if the adviser (x) adopts and implements policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience of the advertisement, and (y) provides sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating the hypothetical performance; and
- Predecessor performance (*i.e.*, performance of a portfolio that was not advised at all times during the relevant period by the advertising adviser) is permitted only if (x) there is sufficient similarity with regard to the personnel and accounts at the predecessor adviser and the personnel and accounts at the advertising adviser that the prior performance would provide relevant information to clients or investors; (y) all relevant prior accounts are included, subject to certain exceptions; and (z) certain required disclosures are included clearly and prominently.

Testimonials, Endorsements, and Third-Party Ratings

The Marketing Rule gives additional flexibility in using testimonials (from clients) and endorsements (from non-clients) and provides additional structure around the use of third-party ratings, in each case, subject to certain requirements intended to ensure that their use is not misleading.

Withdrawal of Prior No-Action Letters

Certain previously issued no-action letters regarding the Old Advertising Rule and the Old Solicitation Rule will be withdrawn as the guidance provided in those letters either is incorporated into the Marketing Rule or will no longer apply. A list of withdrawn no-action letters will be (but has not yet been) published on the SEC's Website.

The SEC does note in the adopting release that the guidance in certain prior no-action letters may continue to be useful as examples of practices that the Staff would consider "fair and balanced" or "not misleading," but emphasizes that those no-action letters are no longer considered prescriptive.

Books and Records Rule; Form ADV; Policies and Procedures

Rule 204-2 under the Advisers Act is being amended to reflect new requirements under the Marketing Rule, including expanding record keeping requirements to all advertisements. Form ADV is also being amended to include questions regarding an adviser's advertising practices.

Investment advisers will need to update their compliance policies and procedures to reflect the Marketing Rule in general as well as its particular requirements. Importantly, the adopting release indicates that for related compliance policies and procedures to be effective, they should include "objective and testable means reasonably designed" to prevent violation of the Marketing Rule.

Effective Date

The Marketing Rule will be effective 60 days after publication in the Federal Register. Advisers will have an 18-month transition period after the effective date to bring their marketing materials into compliance with the Marketing Rule.

Notes

1. Release No. IA-5653 (December 22, 2020).
2. Hypothetical performance includes, without limitation, performance of model portfolios, backtested performance, and targeted or projected performance, but does not include interactive analysis tools that produce simulations and statistical analyses or predecessor performance (which is subject to its own requirements).

Overview of Differences between the Old Advertising Rule and the New Marketing Rule

	Old Advertising Rule	New Marketing Rule
Definition of “Advertisement” *General Definition*	• Defined as: Communications by the adviser, addressed to more than one person, which offer investment advisory services to clients.	• Defined as: (1) Any direct or indirect communication an investment adviser makes to more than one person (or to just one person if the communication involves hypothetical performance), that (x) offers the adviser’s investment advisory services with regard to securities to prospective clients or prospective private fund investors, or (y) offers *new* investment advisory services with regard to securities to current clients or current private fund investors; in each case, *excluding:* (a) extemporaneous, live, oral communications (but not any scripts or prepared materials for such a communication); (b) information contained in a statutory or regulatory notice, filing or other required communication that is reasonably designed to satisfy the requirements thereof; and (c) communications that include hypothetical performance provided either (x) in response to an unsolicited request for such information from a prospective or current client or private fund investor; or (y) to a prospective or current private fund investor in a one-on-one communication; and (1) any endorsement or testimonial for which an adviser provides cash or non-cash compensation directly or indirectly, *excluding* information contained in a statutory or regulatory notice, filing or other required communication that is reasonably designed to satisfy the requirements thereof. • Note that “advertisement” in the Marketing Rule includes communications to *current* clients or private fund investors only to the extent that relates to new advisory services. Communications about *existing* advisory services or private fund investments (*e.g.*, account statements, transaction reports, presentations at annual investor meetings and similar materials), are not “advertisements,” even if they are intended to retain the client or private fund investor (although they do remain subject to the general anti-fraud rule). • Note that because any solicitation or referral of a prospective or current investor is included in the definition of “endorsement,” clause (2) makes communications by a placement agent, that solicits or refers clients or private fund investors, advertisements of the adviser which are subject to all of the advertising rules and the adviser’s compliance and oversight functions.

	Old Advertising Rule	New Marketing Rule
		• As discussed in the adopting release, because a PPM is a required communication, information provided in a PPM about material terms, objectives and risk of a fund offering will generally not be considered an advertisement, but other information included in a PPM could constitute an advertisement of the adviser, depending on the relevant facts and circumstances (*e.g.*, related performance information). Additionally, pitch books and similar communications that may accompany a PPM are likely to constitute advertisements.
Current and Prospective Clients and Investors	• On its terms, applicable only to communications with current or prospective clients (but not investors in private funds). • However, it has generally been the private funds industry's practice to apply the rule to private fund investors as well.	• Applicable to communications with current or prospective clients and investors in private funds.
Services Offered	• Applicable to communications intended to retain existing clients as well as to offers of services to prospective clients.	• Applies to communications that offer advisory services to potential clients and investors as well as to communications offering *new* or *additional* advisory services to current prospective client and investors.
Forms of Communication	• Applicable to specific forms of communication (*e.g.*, written; radio; television).	• Applicable to a broad range of communications (*e.g.*, emails, text messages, video files, blogs, podcasts and social media), focusing on *goal* rather than *form* of communication.
Communications to One Person	• Applies only to communications to more than one person.	• The first prong of the definition generally applies only to communications to more than one person (whether a single natural person or household or multiple natural persons representing, employed by, or owning a single entity or account); • however, communications including hypothetical performance are advertisements even if provided to only one person unless provided in response to an unsolicited investor request or to a private fund investor. • The second prong of the definition (regarding testimonials and endorsements) applies to communications to a single person, as further discussed in *Annex B*.
Direct and Indirect Communications	• Does not generally apply to third-party content, such as articles by independent third-parties published without the involvement of the adviser; however, once an adviser references such independent article or provides reprints of it, essentially using it for its own purposes, the content may be attributable to the adviser as an advertisement.	• Includes "direct or indirect" communications by the adviser, including certain communications by third parties that are attributable to the adviser. • Whether a particular communication is attributable to an adviser is a facts and circumstances determination, including (1) whether the adviser has explicitly or implicitly endorsed or approved the information after its publication ("adoption") or (2) the extent to which the adviser has involved itself in the preparation of the information ("entanglement"). • Note that the adopting release includes specific guidance for adviser's online presence and use of social media in this context.

	Old Advertising Rule	New Marketing Rule
Communications Not Intended to Offer Advisory Services		• Does not include communications intended to raise the general profile of the adviser without offering investment advisory services with regard to securities, educational communications providing general information about investing or general market commentary.
General Prohibitions	• Antifraud rules prohibit advertisements that contain untrue statements of material fact. • Catch-all provision prohibits advertisements that are otherwise false or misleading. • SEC does not need to prove scienter; negligence is sufficient.	• Generally, all information is required to be presented in a "*fair and balanced*" manner. • The Marketing Rule prohibits the following in any advertisement: (1) any untrue statement of a material fact, or omission of a material fact necessary to make the statement, in light of the circumstances in which it was made, not misleading (*i.e.*, a "10b-5" standard); (2) a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC; (3) information that is reasonably likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the investment adviser; (4) discussion of potential benefits to clients or investors in connection with the investment adviser's services or methods without a fair and balanced discussion of any material risks or limitations associated with the potential benefits; (5) reference to specific investment advice provided by the investment adviser where such advice is not presented in a fair and balanced manner; (6) performance results that include or exclude certain results or time periods in a manner that is not fair and balanced; (7) and otherwise being materially misleading. • SEC does not need to prove scienter; negligence is sufficient.
Performance Advertising	• Prohibits presentation of performance results that contains false or misleading statements. • Allows the use of references to past specific recommendations (which were, or would have been, profitable), subject to conditions and specific disclosure requirements. • A number of no-action letters prescribed specific requirements with regard to advertisements using performance results, including (among others):	• Presentation of performance results remains subject to the general prohibitions described above, along with the following requirements: • Gross performance must be accompanied by net performance, calculated over the same time period and using the same type of return and methodology, presented with equal prominence in a format designed to facilitate comparison with gross performance. The adopting release includes a non-exhaustive list of fees and expenses to be considered in calculating net performance (*e.g.*, the deduction of private fund fees (including performance-based fees and performance allocations) and expenses that the investor has paid or would have paid in connection with the investment adviser's investment advisory services to the relevant fund);

	Old Advertising Rule	New Marketing Rule
	• Clover Capital Management (October 28, 1986) – use of performance information in advertisement, whether actual or model performance, is misleading without certain disclosures, such as describing the effect of market conditions on the results; • Great Lakes Advisors, Inc. (April 3, 1992) – an adviser's use of a predecessor's performance results in advertisement is misleading if another individual, other than the successor's portfolio manager, played a significant part in achieving such results; • J.P. Morgan Investment Management (May 7, 1996) – calculation of advertised net performance during a certain period may use the maximum fees charged, even if some investors paid lower rates during this period; • Horizon Asset Management, LLC (September 13, 1996) – presenting an adviser's past performance under a different fund in an advertisement is not misleading if both previous and current accounts are managed by the same persons and are substantially similar; • Franklin Management, Inc. (December 10, 1998) – displaying certain, but not all, performance results is allowed if the criteria used is non-performance based and is used consistently, *i.e.*, practice is not considered prohibited "cherry-picking"; and • The TCW Group, Inc. (November 7, 2008) – use of best and worst performance results in advertising is allowed, if presented in equal number and prominence, using a consistent methodology.	• Performance results, *other than performance results of a private fund*, must be presented over one-, five- and ten-year time periods with equal prominence (performance for other periods may be provided in addition to performance for the three prescribed periods); • Any express or implied statement that the calculation or presentation of performance results has been approved or reviewed by the SEC is prohibited; • If performance results from any related portfolio (*i.e.*, a portfolio with substantially similar investment policies, objectives and strategies as that being offered in the advertisement) is included, the performance of all related portfolios must be included, *however*, related portfolios may be excluded if (x) the advertised performance results are not materially higher than if all related portfolios had been included, and (y) the exclusion does not alter the presentation of any applicable prescribed time period; • Extracted performance (*i.e.*, performance of a subset of a single portfolio) is permitted so long as the advertisement provides, or offers to provide promptly, performance results of the total portfolio; The adopting release does not provide prescribed disclosures for references to specific investment advice; such information should be presented in a manner that is tailored to be "fair and balanced" based on facts and circumstances (*e.g.*, it would not be fair and balanced for an adviser to present case studies only reflecting profitable investments when the portfolio also included losing investments); • Hypothetical performance (*i.e.*, performance results that were not actually achieved by any portfolio of the adviser[1]) may be presented only if the adviser (x) adopts and implements policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience of the advertisement, and (y) provides sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating the hypothetical performance; and • Predecessor performance (*i.e.*, performance of a portfolio that was not advised at all times during the relevant period by the advertising adviser) is permitted only if (x) there is sufficient similarity with regard to the personnel and accounts at the predecessor adviser and the personnel and accounts at the advertising adviser that the prior performance would provide relevant information to clients or investors; (y) all relevant prior accounts are included, subject to certain exceptions, and (z) certain required disclosures are included clearly and prominently, including that the performance results were from accounts managed at another adviser.

	Old Advertising Rule	New Marketing Rule
Third-Party Ratings	• Does not expressly address third-party ratings.	• An advertisement may include a third-party rating, only if the investment adviser: (1) has a reasonable basis for believing that any questionnaire or survey used in the preparation of the third-party rating is structured to make it equally easy for a participant to provide favorable and unfavorable responses, and is not designed or prepared to produce any predetermined result; and (2) clearly and prominently discloses, or the investment adviser reasonably believes that the third-party rating clearly and prominently discloses, (a) the date on which the rating was given and the period of time upon which the rating was based, (b) the identity of the third party that created and tabulated the rating, and (c) if applicable, that compensation has been provided directly or indirectly by the adviser. • By definition, a third-party rating must be produced by someone who is not a related person of the adviser and who provides such ratings or rankings in the ordinary course of its business.
Testimonials and Endorsements	• Testimonials prohibited; endorsements not addressed.	• Both testimonials (from clients) and endorsements (from non-clients) are permitted, subject to certain requirements intended to ensure that their use is not misleading. • Certain uncompensated testimonials and endorsements may be captured by the first prong of the definition, and would therefore be subject to the general prohibitions and require appropriate disclosure as well as the adviser's oversight. • See chart below for more detail.
Record-Keeping; Form ADV Disclosure	• Advisers must keep a record of advertisements sent to 10 or more persons.	• Records of all advertisements disseminated must be kept. • For oral advertisement, the adviser may retain a copy of any written or recorded materials used by the adviser in connection with the oral advertisement; if the advertisement includes a compensated oral testimonial or endorsement, the adviser may, instead of recording and retaining the advertisement, keep a record of the disclosures provided to investors. • Supporting materials for certain calculations presented in advertisements must also be retained. • A copy of any questionnaire or survey used in the preparation of a third-party rating, as well as materials that allow the adviser to demonstrate the adviser's reasonable belief that testimonials, endorsements and third-party ratings are compliant with the Marketing Rule. • Documentation of communications relating to, and substantiation for, predecessor performance must be retained. • New subsection added to Part 1A of Form ADV, requiring additional disclosure regarding the adviser's advertising practices (*e.g.*, use of performance results, testimonials, endorsements and third-party ratings); advisers will only be required to update responses to these questions in their annual updating amendments due after the effective date. Other than annual amendments to this item will not be required.

[1] Hypothetical performance includes, without limitation, performance of model portfolios, backtested performance and targeted or projected performance, but does not include interactive analysis tools that produce simulations and statistical analyses or predecessor performance (which is subject to its own requirements).

Overview of Differences between the Old Solicitation Rule and the New Marketing Rule

	Old Solicitation Rule	New Marketing Rule
Scope of Rule	• A solicitor is any person who, directly or indirectly, solicits any client for, or refers any client to, an investment adviser. • Determination is based on facts and circumstances of solicitation activities.	• Solicitation activities are included in the definition of "advertisement" under the second prong of that definition which picks up any testimonial or endorsement, with "endorsement" being defined to include solicitation or referrals of current or prospective clients or private fund investors for which an adviser provides cash or non-cash compensation directly or indirectly. • Note that, as confirmed by the adopting release, this makes a placement agent an endorser and communications by the placement agent become advertisements of the adviser, subject to the adviser's compliance and oversight functions. • Excludes information contained in a statutory or regulatory notice, filing or other required communication; *does not exclude* extemporaneous, live, oral communications, one-on-one communications or communications that include hypothetical performance information. • Use is subject to the general advertising prohibitions (described in chart above).
Audience of Solicitation Activities	• Applies to solicitation activities directed at existing and prospective clients. • Mayer Brown LLP (July 28, 2008) exempted solicitations of investors in private funds managed by the adviser from the scope of the rule (explaining that the rule only applies to direct clients of the adviser, which, in the case of a private fund, is the private fund itself).	• Expands to solicitation and referral of prospective and existing clients *and* private fund investors.
Compensation Involved	• Applies to direct and indirect cash payments.	• Applies to *any* form of direct or indirect cash and non-cash compensation for endorsements or testimonials (*e.g.*, cross-referrals and discounted advisory services).
Required Disclosure *Content of Disclosure*	• Solicitor must provide a separate disclosure, including the adviser and solicitor's names, relationship, compensation arrangement.	• An advertisement may not include any testimonial or endorsement, and an adviser may not provide compensation, directly or indirectly, for a testimonial or endorsement, unless the adviser discloses, or reasonably believe that the person giving the testimonial or endorsement discloses, at the time the testimonial or endorsement is disseminated:

	Old Solicitation Rule	New Marketing Rule
		(1) clearly and prominently (x) that the testimonial was given by a current client or private fund investor, and the endorsement was given by a person other than a current client or private fund investor, as applicable, (y) that cash or non-cash compensation was provided for the testimonial or endorsement, if applicable, and (z) a brief statement of any material conflict of interest on the part of the person giving the testimonial or endorsement resulting from the adviser's relationship with such person; (2) the material terms of any compensation arrangements; and (3) a description of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the adviser's relationship with such person and/or any compensation arrangement. • "Material terms" of the compensation agreement that would need to be disclosed may include, for example: (1) the specific value of the cash or non-cash compensation involved, and (2) whether the rate of compensation is dependent on the performance of the adviser and is therefore likely to affect the promoter's incentives in promoting the adviser.
Written Disclosure	• The disclosure must be written.	• The disclosure does not have to be written (*e.g.*, electronic or oral disclosures are acceptable).
Party Providing the Disclosure	• Disclosure must be given by the *solicitor.*	• The adviser must provide the disclosures or reasonably believe that the person giving the testimonial or endorsement provides the disclosures.
Delivery of Adviser's Brochure	• The solicitor must deliver the brochure (Part 2 of Form ADV) to clients as part of the disclosure.	• The requirement to deliver the brochure as part of the disclosure was eliminated.
Agreement	• Requires a written agreement between the solicitor and the adviser, in which the solicitor agrees to provide the solicitation disclosure to clients.	• A written agreement must be entered into between the adviser and any person giving a testimonial or endorsement that describes the scope of the agreed upon activities and the terms of the compensation for those activities (subject to a *de minimis* threshold and aside from certain affiliates).
General Compliance	• Solicitor required to obtain a signed acknowledgment from the client for receiving the solicitor's disclosure. • Additional compliance requirements for solicitation activities involving governmental entities (explicit reminders of fiduciary duties with respect to solicitation of government entities).	• Adviser must have a reasonable basis for believing that the testimonial or endorsement complies with the requirements of the Marketing Rule. • The determination of what would constitute a reasonable basis for belief will depend on the facts and circumstances (*e.g.*, to form reasonable belief, the adviser can periodically make inquiries of a sample of the investors solicited or referred by a promoter to assess whether the promoter's statements comply with the rule). • Eliminates certain compliance requirements, including the requirement to obtain written client acknowledgment.

	Old Solicitation Rule	New Marketing Rule
Disqualifications		• Advisers are prohibited from using certain *compensated* testimonials and endorsements made by certain "bad actors" and other ineligible persons (*e.g.*, a person who is subject to an SEC opinion or order barring, suspending or prohibiting such person from acting in any capacity under the Federal securities laws). • For persons who are "covered persons" with respect to a Reg. D offering in connection with the advertisement (including, for example, a placement agent), the Reg. D disqualification list will apply.
Exemptions *Impersonal Investment Advice*	• Partial exemption for solicitors that refer investors as part of an impersonal investment advice.	• No exemption for solicitation activities for impersonal investment advice.
In-House Solicitors	• Partial exemption for in-house solicitors and affiliate solicitors, provided that the nature of the affiliation is disclosed	• Partial exemption still applies for an adviser's affiliated personnel; provided that the affiliation between the adviser and such person is readily apparent to or is disclosed to the client or investor at the time the testimonial or endorsement is disseminated and the adviser documents such person's status at the time the testimonial or endorsement is disseminated. • Partial exemption for broker-dealers registered with the SEC waiving the conflicts disclosure requirement where Reg BI applies, provided they are not subject to statutory disqualification under the Exchange Act.
De Minimis Compensation	• No *de minimis* exemption.	• Endorsements or testimonials that are uncompensated or for which compensation is *de minimis* compensation (up to $1,000 over 12 months) are not subject to the disqualification provisions or the written agreement requirement, but must comply with the disclosure and oversight requirements.

CORPORATE LITIGATION

Delaware Supreme Court Addresses Stockholders Access Books and Records

The Delaware Supreme Court has issued important guidance on stockholders' rights to access books and records under Section 220 of the Delaware General Corporation Law. It reiterated that a stockholder need only show a proper purpose for demanding corporate records.

By Shannon E. German, Lori W. Will, Brad Sorrels, and Amy L. Simmerman

On December 10, 2020, the Delaware Supreme Court issued a key decision addressing stockholders' rights to access books and records under Section 220 of the Delaware General Corporation Law.[1] Because the Supreme Court rarely weighs in on the scope of Section 220, the decision is an important guide for corporations and practitioners navigating stockholder demands for books and records under Delaware law. In the 43-page opinion, the Delaware Supreme Court reiterated that a stockholder need only show a proper purpose for demanding corporate records, such as investigating potential wrongdoing, but need not, at least in many circumstances, show that the wrongdoing is "actionable" or identify the particular course of action the stockholder will take if the books and records confirm the stockholder's suspicions. The decision follows on the heels of another recent decision by the Delaware Court of Chancery[2] that reiterated that merits-based defenses to stockholder plaintiffs' potential claims are not appropriate at the Section 220 stage.

Shannon E. German, Lori W. Will, Brad Sorrels, *and* **Amy L. Simmerman** *are attorneys at Wilson Sonsini Goodrich & Rosati, P.C.*

Background

The defendant, AmerisourceBergen Corp., distributes opioid medications to pharmacies, hospitals, and other licensed dispensaries and is therefore subject to federal regulations requiring it to maintain effective controls and reporting over its distribution systems. In recent years, its distribution systems and controls have been the subject of investigations and litigation in multiple states and by various state and federal government agencies, causing it to incur significant expenses. Analysts estimated it potentially could pay up to $100 billion to achieve a global settlement. The stockholder plaintiffs made a books and records demand to AmerisourceBergen for four purposes: (1) to investigate possible breaches of fiduciary duty, mismanagement, and other violations of law by the board of directors and management in connection with the company's distribution of opioids; (2) to consider any potential remedies for the conduct; (3) to evaluate the interests and independence of the board members; and (4) to use the information obtained to evaluate possible litigation or other corrective measures with respect to some of the matters. After AmerisourceBergen denied the demand in its entirety, the plaintiffs brought a Section 220 action in the Court of Chancery.

The Chancery Court Decision

Following a trial on the papers, the Court of Chancery ordered AmerisourceBergen to produce documents to the plaintiffs for the purpose of investigating possible breaches of fiduciary duty, mismanagement, and other wrongdoing—even though the plaintiffs had neither identified what they intended to do with the documents if they confirmed their suspicions of wrongdoing nor established a credible basis to suspect "actionable" wrongdoing, a term used in prior Court of Chancery decisions as a basis for denying inspection. The Court of Chancery also, *sua sponte*, ordered AmerisourceBergen to produce a witness for a deposition so that the plaintiffs could "explore what types of books and records exist[ed] and who ha[d] them."

The Supreme Court Decision

On appeal, the Supreme Court affirmed the Court of Chancery's decision, holding that a stockholder need not identify the specific objective of the demand or the course of action it will take if the books and records confirm the stockholder's suspicions of wrongdoing. In this case, the plaintiffs had preserved the ability to consider all possible courses of action that their investigation might warrant pursuing. The Supreme Court explained that exploring corporate wrongdoing is "in and of itself 'a legitimate matter of concern that is reasonably related to [a stockholder's] interest[] as [a] stockholder[].'"

The Supreme Court also held that a stockholder need not establish that the wrongdoing it seeks to investigate is legally "actionable," although "the actionability of wrongdoing can be a relevant factor for the Court of Chancery to consider when assessing the legitimacy of a stockholder's stated purpose." In particular, AmerisourceBergen had argued that the plaintiffs only sought books and records for the purpose of bringing a *Caremark* claim regarding the board's oversight of the company's legal compliance, which was barred by the company's charter provision exculpating directors and by the stockholder's own delay. The Supreme Court agreed with the Court of Chancery, holding that

1. The plaintiffs sought the books and records for more purposes than bringing a potential *Caremark* claim;
2. A stockholder can obtain books and records without having to introduce evidence from which the Court can infer an "actionable" claim because it can use the information for non-litigation purposes; and
3. The company's defenses to a *Caremark* claim based on the exculpatory charter provision and the untimeliness of the claims were unavailing because the plaintiffs could uncover non-exculpated claims and the doctrines of fraudulent concealment and equitable tolling could affect whether the claims were time-barred.

Courts should look to whether the stockholder has shown a credible basis to suspect wrongdoing.

The Supreme Court emphasized that, at the books and records stage, courts should look to whether the stockholder has shown by a preponderance of the evidence a credible basis to suspect wrongdoing warranting further investigation. The Supreme Court used the occasion to clarify recent Court of Chancery precedent, some of which had "trended" away from prevailing books and records law, by reaffirming the "credible basis" standard by which to judge the adequacy of a stockholder's inspection demand and overruling its summary affirmance of a prior Court of Chancery decision to the extent the affirmance could be read as supporting a different standard.[3] The Supreme Court explained "the interjection of merits-based defenses—defenses that turn on the quality of the wrongdoing to be investigated—interfere[]" with what is supposed to be a "summary" process that is "managed expeditiously."

Finally, the Supreme Court held that the Court of Chancery did not abuse its discretion by ordering the company to produce a witness for a deposition post-trial to discuss the types of documents the company had and where they were kept. In doing so, the Supreme Court disagreed with AmerisourceBergen's arguments that permitting such a deposition would relieve the plaintiffs of their burden to identify documents essential to their stated purposes, noting that the trial court had ordered the deposition after

AmerisourceBergen created "an additional obstacle" to the stockholders' effort to get targeted access to books and record by refusing to disclose in discovery the types of records it maintained.

Key Takeaways

It is important for companies and practitioners to keep this case in mind when responding to Section 220 demands, particularly where a stockholder seeks books and records to investigate wrongdoing but procedural bars (such as statutes of limitations) might impact potential litigation on the merits. Though those defenses may be relevant in the court's analysis of a Section 220 demand, they generally should not be used to deny the demand outright—especially where a stockholder has multiple stated purposes. This case also serves as a reminder to companies to be cautious of appearing as if they are not being forthright with stockholders regarding the types of documents the company has that could be responsive to a books and records demand and the sources and custodians of those documents, given the potential for Delaware courts to order additional discovery (such as a deposition) on those issues.

Notes

1. AmerisourceBergen Corp. v. Lebanon County Employees' Retirement Fund, *et al.*, No. 60, 2020 (Del. Dec. 10, 2020).
2. Pettry v. Gilead Sciences, Inc., 2020 WL 6870461 (Del. Ch. Nov. 24, 2020).
3. S.E. Penn. Trans. Authority v. AbbVie, Inc., 2015 WL 1753033 (Del. Ch. Apr. 15, 2015), *aff'd*, 132 A.3d 1, 2016 WL 235217 (Del. Jan. 20, 2016) (TABLE).

EDITORIAL

Supporting the Nasdaq Board Diversity Proposal

The following letter (excerpted) was submitted to the Securities and Exchange Commission by Amy L. Goodman and John F. Olson in support of Nasdaq's proposed rule change to adopt listing rules related to board diversity.

Re: File Number SR-NASDAQ2020-081

(Notice of Filing of Proposed Rule Change to Adopt Listing Rules Related to Board Diversity)

* * * * *

We are writing to comment in support of Nasdaq's proposal related to board diversity (Proposal). We write as lawyers and experts in corporate governance who have each spent the better part of the last half-century advising boards of directors on corporate governance matters. We are retired partners of Gibson, Dunn & Crutcher LLP who were involved in founding the firm's Securities Regulation and Corporate Governance practice group.

* * * * *

As veteran legal advisors and students of corporate governance who have personally observed boardroom deliberations over a collective period of more than 80 years, we have the following comments:

1. *Based on our many years of experience in boardrooms, we believe diversity enhances the quality of board deliberations and decisions.*

Based on our observations of directors as they have engaged in deliberations and decision making in the boardroom, we strongly believe that increased diversity of backgrounds and life experiences of board members enhances both the quality of deliberations and the substance of the decisions that are made. Over the years, as we have worked closely with boards that have become more diverse, we have witnessed a discernible, positive impact on the boardroom environment. Deliberation and discussion have become more focused, and the group has benefited from the additional perspectives contributed by women and individuals from other historically underrepresented groups. In addition, we believe Nasdaq's proposal to elicit disclosure about a minimum of two directors who are "Diverse" (as defined in the Proposal) is an appropriate threshold. We have seen firsthand that the presence of at least two diverse directors in the boardroom is integral to creating a supportive environment that fosters full participation. A single director brought onto a board who is a woman or a member of another previously unrepresented group has a potentially lonely role and is less likely to be able to fully and effectively contribute to the quality of thought and decision making by the group.

As we have described above, our experience is also consistent with the sizeable body of academic research Nasdaq cites to support the Proposal and the benefits of diversity. In this regard, we agree that diversity is beneficial based on our many years of experience working with boards. We also note that we are unaware of any academic research, nor has it been our experience, that adding directors of diverse backgrounds impedes sound decision making.

2. *The Proposal simply requires more transparency. It is not a mandate or "quota."*

In recent years, investor interest in board diversity has grown exponentially and investors have sought more disclosure about this subject. The Proposal has been criticized by some commentators as a mandate by a "woke," activist regulator seeking to impose quotas on corporate boards. In our view, this criticism misunderstands the Proposal. The Proposal aims to increase transparency by eliciting and standardizing disclosures about diversity. The Proposal would do this by requiring disclosure based on the same categories companies already use to report workforce diversity data to the Equal Employment Opportunity Commission on the EEO-1 Report. Moreover, directors would not be required to provide companies with information about their diversity attributes, and for directors who choose not to self-identify as members of a qualifying group, companies could respect their privacy and note their status as "undisclosed."

The Proposal also aims to increase transparency by adopting a "comply-or-explain" framework. This is consistent with the approach to corporate governance taken in a number of other countries, including the United Kingdom, Canada, Australia, France and Germany. Under this framework, Nasdaq companies would not be required to have to at least two "Diverse" directors under the Nasdaq definition, but only to disclose whether their boards have at least two such directors and if not, why not. There is nothing in the Proposal that would preclude boards from considering attributes that go beyond those in the Nasdaq definition, such as being a veteran or having a disability, in determining their board composition.

There is an abundance of qualified diverse candidates as many companies have discovered in recent years.

Some commenters have suggested that the Proposal would result in the selection of directors who are unqualified or underqualified by prioritizing diversity above credentials. This is simply not borne out by our experience, which suggests that there is an abundance of qualified diverse candidates as many companies have discovered in recent years. In connection with the Proposal, Nasdaq has announced that it will offer resources to aid Nasdaq-listed companies in identifying diverse candidates. Diversity, of course, is not just a matter of personal identity and background. For years now, boards have increasingly realized that diversity of relevant experience is critical to success in a fast-changing global world. Thus, boards have increasingly realized that focusing their search on candidates who have CEO experience, most of whom have been male and not diverse, is not adequate. Increasingly, the most effective boards we have seen have recruited individuals with backgrounds in critically important fields such as science and technology, cybersecurity, risk management and government service, reaching out to candidates who occupy or have held relevant senior non-CEO corporate, academic or government positions and who are more likely than the current or former CEO candidates previously sought to be diverse in their gender, ethnic or other identities.

3. *The Proposal is consistent with the historical role of the stock exchanges in advancing the quality of corporate governance.*

Historically, Nasdaq and other stock exchanges have played an important role in fostering accountability, transparency and investor confidence in the securities and financial markets. The development of corporate governance listing standards covering matters ranging from financial statements to audit committees and director independence have been a key component of this role. As contemplated in the self-regulatory organization provisions of the Securities Exchange Act of 1934 (1934 Act), which are the primary regulatory regime for the exchanges, the Commission has supported and encouraged stock exchange efforts to strengthen corporate governance at listed companies, including in connection with the extensive rulemakings undertaken by the exchanges to implement the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, where the Congress specifically expected that important governance reforms would be implemented by the exchanges under Commission oversight pursuant to the 1934 Act regime.

In this regard, the Proposal builds on prior work done by the stock exchanges to advance the quality of listed company corporate governance. In formulating the Proposal, Nasdaq has made a judgment that the Proposal would promote the public interest and the protection of investors. We believe the Commission should defer to this judgment, which is backed by the practical experience of Nasdaq listed companies and the exchange's market participants, as well as investor groups.

4. *Investor and other stakeholder interest in board diversity is significant.*

As noted above, in recent years, investor and other stakeholder interest in board diversity has grown exponentially, fueled in part by sentiments in some quarters that, as America has grown increasingly diverse, the pace of change in the boardroom has been relatively slow. Institutional investors are keenly focused on board composition and diversity, and they have become increasingly vocal in communicating their expectations about diversity practices and disclosures to the companies in which they invest. Boards, too, have increased their dialogue about diversity in the boardroom. In addition, state legislatures, as well as foreign governments, have turned their attention to board diversity. In its filing with the Commission seeking approval of the Proposal, Nasdaq states that "during its discussions with stakeholders, Nasdaq found consensus across every constituency that there is inherent value in board diversity."

Given the continued, ongoing level of interest in this subject, we believe the Proposal is both timely and constructive. We believe it strikes an appropriate balance between providing investors and other stakeholders with additional information about diversity in a format that facilitates greater comparability across companies, and giving listed companies and boards needed flexibility to consider the particular mix of backgrounds, skills and experience that will work best for the growth and sustainability of their businesses within the Nasdaq disclosure framework, which provides ample room for individual variation within the proposed disclosure format. In this regard, the Proposal is also respectful of the developing state law experience as several states have adopted and others are considering statutory diversity standards for boards of directors.

* * * * *

For the reasons stated above, we support the Proposal and urge the Commission to approve it.

We note that these comments are our own views, and we do not speak for, or represent that they are, the views of the law firm from which we are retired, or any other association or organization with which we are affiliated. We have not been compensated by Nasdaq or any other entity for the preparation and submission of this letter.

CLIENT MEMOS

A summary of recent memoranda that law firms have provided to their clients and other interested persons concerning legal developments. Firms are invited to submit their memoranda to the editor. Persons wishing to obtain copies of the listed memoranda should contact the firms directly.

Alston & Bird LLP Washington, DC (202-756-3300)

Financial Services Regulators and Investors Gearing Up for Climate Change Reforms (December 1, 2020)

A discussion of expected reforms by financial regulators, including the Securities and Exchange Commission (SEC), during the administration of President-Elect Biden.

Ballard Spahr LLP Philadelphia, PA (215-665-8500)

SEC Action on Misleading COVID-19 Disclosures: Implications for the Municipal Market (December 30, 2020)

A discussion of a SEC settled enforcement action against a corporate issuer of registered securities for misleading disclosures about the impact of the COVID-19 pandemic on its business operations and financial condition and its implications for municipal issuers.

Cahill Gordon & Reindel LLP New York, NY (212-701-3000)

SEC Adopts Amendments to Auditor Independence Requirements (December 3, 2020)

A discussion of the SEC's adoption of amendments to Rule 2-01 of Regulation S-X to update auditor independence requirements.

SEC Imposes Significant Penalty Related to Stock Buyback Not Subject to Proper Internal Controls (December 8, 2020)

A discussion of a SEC settled enforcement action with Andeavor LLC due to its failure to devise and maintain internal accounting controls to ensure that certain stock buyback transactions were made in accordance with its board of directors' authorization.

Cleary, Gottlieb, Steen & Hamilton LLP New York (212-225-2000)

SEC's Proposed Amendments of Rule 701 and Form S-8 (December 11, 2020)

A discussion of the SEC's proposal of amendments to Rule 701 and Form S-8 under the Securities Act of 1933 (Securities Act) to simplify and redesign the manner in which issuers grant securities to employees in compensatory transactions.

SEC Issues Statement and Request for Comment Regarding Broker-Dealer Custody of Digital Asset Securities (December 8, 2020)

A discussion of a SEC statement and request for comment regarding the custody of assets that are issued and/or transferred using distributed ledger or blockchain technology and that meets the definition of "security" under the federal securities laws.

Covington & Burling LLP Washington, DC (202-662-6000)

Glass Lewis Issues 2021 Updates to Policy Guidelines (December 8, 2020)

A discussion of Glass Lewis updates to its proxy voting guidelines for annual shareholder meetings to be held after January 1, 2021.

SEC Provides SPACtacular Disclosure Guidance (December 30, 2020)

A discussion of disclosure guidance issued by the SEC Division of Corporation Finance applicable to transactions involving SPACs.

Davis Polk & Wardwell LLP New York, NY (212-450-4000)

Preparing Your Form 20-F (December 10, 2020)

A discussion of considerations for the preparation of the annual report on Form 20-F, including US-related enforcement matters and other developments of interest to foreign private issuers.

Debevoise & Plimpton LLP New York, NY (212-909-6000)

OCIE Discusses Proper Authority of CCOs and Other Compliance Hot Topics (December 9, 2020)

A discussion of a Risk Alert published by the SEC Office of Compliance Inspections and Examinations (OCIE) highlighting the most commonly cited deficiencies it has observed in examining registered investment advisers relating to Rule 206(4)-7 (the compliance rules) under the Investment Advisers Act of 1940 (Advisers Act).

SEC Approves NYSE Primary Direct Listings (Again) (December 24, 2020)

A discussion of the SEC's approval of the NYSE's proposed rule change that allows a company to conduct a primary offering as part of a direct listing on the exchange.

Dechert LLP Philadelphia, PA (215-994-4000)

Dechert on ESG (December 2020)

A practical guide for asset managers on using principles and frameworks for ESG reporting and disclosure.

Dorsey & Whitney LLP Minneapolis, MN (612-340-2600)

The SEC and SARs (December 7, 2020)

A discussion of a case decided by the Second Circuit Court of Appeals, *SEC v. Alpine Securities Corporation*, addressing the question of broker-dealer compliance with suspicious activity reports (SARs) and the SEC's authority under Section 17(a) and Rule 17a-8 under the Securities Exchange Act of 1934 (Exchange Act).

Eversheds-Sutherland Ltd. Atlanta, GA (404-853-8000)

SEC Adopts Rules to Streamline Private Offering Exemptions (December 1, 2020)

A discussion of the SEC's adoption of amendments to "simplify, harmonize, and improve certain aspects of the exempt offering framework" under the Securities Act.

Congress Passes Bipartisan Legislation Requiring Chinese and Other Firms Listed on US Exchanges Meet US Audit Standards (December 3, 2020)

A discussion of a new law, the Holding Foreign Companies Accountable Act directed at the audit practices of Chinese companies that establishes a process to delist from US exchanges those companies that do not meet certain US auditing standards.

Fenwick West LLP
Mountain View, CA (650-988-8500)

SEC Issues Final Rules Amending MD&A Requirements and Other Financial Disclosures (December 4, 2020)

A discussion of the SEC's adoption of amendments to certain financial disclosure requirements and to the disclosures required by Management's Discussion and Analysis (MD&A).

Delaware Chancery Court Rules that Fiduciary's Use of Email Account Provided by Separate Employer Destroys Privilege (December 24, 2020)

A discussion of a Delaware Chancery Court decision determining that Softbank must hand over otherwise privileged emails because two Softbank representatives used email accounts at a different company (where they were also employed) and thus the confidentiality and privilege of the communications was destroyed.

Gibson, Dunn & Crutcher LLP
Los Angeles, CA (213-329-7870)

Proxy Advisory Firm Updates and Action Items for 2021 Annual Meetings (December 3, 2020)

A discussion of updated proxy voting guidelines for 2021 issued by Institutional Shareholder Services and Glass Lewis & Co.

SDNY Denies Motion to Dismiss Breach of Fiduciary Duty Claims against Former Directors (December 30, 2020)

A discussion of a Southern District of New York decision, *In re Nine W. LBO Sec. Litig.*, denying a motion to dismiss a breach of fiduciary duty claims against the former directors of a company arising from their approval of a buyout transaction that distributed funds to the company's shareholders, while allegedly rendering the company insolvent.

Linklaters LLP
New York, NY (212-424-9000)

CCO Liability (December 2020)

A discussion of when chief compliance officers (CCOs) are exposed to SEC enforcement actions.

SEC Enforcement Actions: Valuation and Fees (December 2020)

A discussion of three SEC settled enforcement actions against fund service providers relating to the valuation of securities.

Manatt, Phelps & Phillips LLP
Los Angeles, CA (310-312-4000)

New York Drags Its Securities Filings into the 21st Century (December 10, 2020)

A discussion of regulatory amendments governing registration of securities sold to residents of the state of New York.

Mayer Brown LLP
Chicago, IL (312-782-0600)

US Representatives Urge SEC to Take Action on Custody of Digital Securities (December 15, 2020)

A discussion of a letter to the SEC submitted by a bipartisan group of members of the US House of Representatives urging the SEC and Financial Industry Regulatory Authority (FINRA) to address the issue of broker-dealer custody of digital securities.

Proposed Amendments to Rule 144 (December 28, 2020)

A discussion of SEC proposed amendments to Rule 44 and Form 44 and related rules and forms to revise the holding period requirement in the case of certain market-adjustable securities and to revise filing requirements.

Perkins Coie LLP
Seattle, WA (206-359-8000)

SEC Modernizes Filing Process by Permitting Electronic Signatures (December 2, 2020)

A discussion of the SEC's adoption of changes to Rule 302 of Regulation S-T to permit the use of electronic signatures for filings made through EDGAR.

Preparing for the 2021 Public Company Reporting Season (December 7, 2020)

A discussion of rule changes, guidance and trends for public companies to consider in preparing annual report and proxy statement disclosures in 2021.

Proskauer Rose LLP
New York, NY (212-969-3000)

Supreme Court to Consider Securities Class Action Issue (December 5, 2020)

A discussion of the US Supreme Court grant of certiorari in a shareholder securities litigation against Goldman Sachs in which it argues that federal securities laws permit issuer defendants to rebut the presumption of reliance where the allege misstatements are of such a generic nature that they could not be expected to have impacted the stock price.

Ropes & Gray LLP
Boston, MA (617-951-7000)

SEC Issues Disclosure Guidance for China-Based Issuers (December 1, 2020)

A discussion of guidance issued by the SEC Division of Corporation Finance that highlights certain risks associated with investments in China-based issuers and summarizes the Division's views on the enhanced disclosures that such issuers should make regarding those risks.

BlackRock Publishes 2021 Stewardship Expectations—Takeaways for US Companies (December 16, 2020)

A discussion of BlackRock's issuance of its 2021 Stewardship Expectations that update its Global Principles and market-specific voting guidelines.

Sidley Austin LLP
Chicago, IL (312-853-7000)

SEC Finalizes Framework for Registered Fund Valuation Practices (December 16, 2020)

A discussion of the SEC's adoption of new Rule 2a-5 under the Investment Company Act of 1940 (Investment Company Act) addressing registered fund valuation practices and the role of a fund's board of directors in the fair valuation process.

US Department of Labor Changes Rules on Proxy Voting (December 17, 2020)

A discussion of the Department of Labor's issuance of a rule amending its 1979 investment duties regulation under the Employee Retirement Income Security Act of 1974 (ERISA) to add new rules for plan fiduciaries to follow when voting proxies or exercising other shareholder rights on behalf of ERISA plans.

Skadden, Arps, Slate, Meagher & Flom LLP
New York, NY (212-735-3000)

SDNY Holds that Cryptocurrency Is a Security (December 2020)

A discussion of a decision by the US District Court for the Southern District of New York granting summary judgment to the SEC on its claims against a cryptocurrency coin issuer alleging it violated Section 5(a) and Section 5(c) of the Securities Act by offering and selling securities without a registration statement or an exemption from registration.

Proposed Legislation Would Enhance Closed-End Fund Protections (December 1, 2020)

A discussion of legislation introduced in the US House of Representatives, the Increasing Investor Opportunities Act, that, among other things, would require private funds to comply with the 10 percent limitation on investment in registered closed-end funds and business development companies contained in Section 12(d)(1) of the Investment Company Act.

Sullivan & Worcester LLP
Boston, MA (617-338-2800)

Corporate Disclosures of Climate-Related Risks and Fulfilling Sustainability and Climate Commitments (December 3, 2020)

A discussion of the impact on corporations of increased pressure from the ESG movement, financial institutions and investment managers to disclose climate-relate risks and to fulfil sustainability an climate commitments.

Troutman Sanders LLP
Atlanta, GA (404-885-3000)

SEC Eliminates "Competitive Harm" Requirement for Confidential Treatment of Material Contracts and Agreements (December 9, 2020)

A discussion of the SEC's adoption of amendments to simplify and harmonize certain aspects of the exempt offering framework, which included changes to Item 601 of Regulation S-K to eliminate the "competitive harm" requirement to file reacted material contracts and agreements.

Vinson & Elkins L.L.P.
Houston, TX (512-542-8400)

SEC Enforcement Annual Report (December 1, 2020)

A discussion of the issuance of the SEC Enforcement Division's annual report highlighting the Division's priorities for the upcoming fiscal year and reviewing its enforcement action for the prior year.

Wilmer Cutler Pickering Hale and Door
Washington, DC (202-663-6000)

SEC Proposes Amendments to Regulation ATS (December 7, 2020)

A discussion of the SEC's proposal of amendments to Regulation ATS under the Exchange Act for alternative trading systems (ATS) that trade government securities or repurchase and reverse repurchase agreements on government securities.

Wilson, Sonsini Goodrich & Rosati LLP
Palo Alto, CA (650-493-9300)

California Courts Rule Federal Forum Selection Provisions in Chartering Documents Enforceable (December 9, 2020)

A discussion of a California Superior Court decision, *In re Dropbox, Inc. Securities Litigation*, holding that the Federal Forum provision in the company's bylaws was enforceable and requires litigation of the plaintiff's Securities Act claims in federal court.

Finder, Keepers: SEC Proposes New Exemptive Order for Finders (December 5, 2020)

A discussion of a SEC proposed exemptive order that would allow finders to receive transaction-based fees without broker-dealer registration, under certain circumstances.

INSIDE THE SEC

Congress Buries Expansion of SEC Disgorgement Authority in Annual Defense Budget

By Barry R. Goldsmith, Helgi C. Walker, M. Jonathan Seibald, and Brian A. Richman

On December 11, 2020, Congress fulfilled its constitutional obligation "to provide for the common defense,"[1] passing for the 60th consecutive year the National Defense Authorization Act (NDAA), H.R. 6395. Buried on page 1,238 of this $740.5 billion military spending bill is an amendment to the Securities Exchange Act of 1934 (Exchange Act). That amendment gives the Securities and Exchange Commission (SEC), for the first time in its history, explicit statutory authority to seek disgorgement in federal district court. It also doubles the current statute of limitations for disgorgement claims in certain classes of cases. The amendment appears to be a direct response to recent Supreme Court decisions limiting the SEC's authority.

Although the Exchange Act does not by its terms authorize the SEC to seek "disgorgement" for Federal Court actions, the agency has long requested this remedy, and courts have long awarded it under their power to grant "equitable relief."[2] In *Liu v. SEC*,[3] however, the Supreme Court made clear that while disgorgement could qualify as "equitable relief" in certain circumstances, to do so, it must be bound by "longstanding equitable principles."[4] Generally, under *Liu*, disgorgement cannot be awarded against multiple wrongdoers under a joint-and-several liability theory, and any amount disgorged must be limited to the wrongdoer's net profits and be awarded only to victims, not to the US Treasury. And, just three years earlier, in *Kokesh v. SEC*,[5] the Court added other limitations on the SEC's ability to seek disgorgement, holding that disgorgement as applied by the SEC and courts is a "penalty" and therefore subject to the same five-year statute of limitations as the civil money penalties the SEC routinely seeks.[6]

The SEC has not responded positively to either decision, particularly *Kokesh*. Former Chairman Clayton stated that he was "troubled by the substantial amount of losses" he anticipated the SEC would suffer as a result of the five-year statute of limitations applied in *Kokesh*.[7] And, for that reason, he urged Congress to "work with" him to extend the statute of limitations period for disgorgement.[8]

Section 6501 of the NDAA appears to grant the SEC its wish, at least in part. The bill authorizes the SEC to seek "disgorgement . . . of any unjust enrichment by the person who received such unjust enrichment," establishing that the SEC has statutory power to seek disgorgement in federal court. And it provides that "a claim for disgorgement" may be brought within 10 years of a scienter-based violation—twice as long as the statute of limitations after *Kokesh*. As one Congressman put it in reference to a similar provision in an earlier bill, this "legislation would reverse the Kokesh decision" by allowing the SEC to seek disgorgement for certain conduct further back in time.[9] The amendment applies to any action or proceeding that is pending on, or commenced after, the enactment of the NDAA.

While the President vetoed the NDAA on December 23, 2020 over unrelated provisions, Congress overrode his veto on January 1, 2021,

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making the NDAA, and its expansion of SEC disgorgement authority, law. The NDAA likely will embolden the SEC on numerous levels. It will, for instance, likely encourage the agency to charge scienter-based violations to obtain disgorgement over a longer period. It also likely will incentivize the SEC to use this authority to eschew the equitable limitations placed on disgorgement in *Liu* and even to apply that expanded conception of disgorgement retroactively to pending cases. It is not clear, however, whether courts would go along. If Congress, for example, had wanted to free the SEC from all equitable limitations identified in *Liu*, it could have said so explicitly. Courts may be especially reluctant if, as the SEC may claim, the disgorgement provision of the NDAA can be applied retroactively. Because the "[r]etroactive imposition" of a penalty "would raise a serious constitutional question,"[10] the courts would not lightly find that disgorgement had slipped *Liu*'s equitable limitations, the one thing potentially keeping disgorgement from "transforming . . . into a penalty" after *Liu*.[11]

Notes

1. U.S. Const. pmbl.; *see also* U.S. Const. art. I, § 8, cls.12–14.
2. 15 U.S.C. § 78u(d)(5); *see Liu v. SEC*, 140 S. Ct. 1936, 1940–41 (2020).
3. Liu v. SEC, 140 S. Ct. 1936 (2020).
4. *Liu*, 140 S. Ct. at 1946.
5. Kokesh v. SEC, 137 S. Ct. 1635 (2017).
6. The Supreme Court's cabining of the SEC's disgorgement authority to "longstanding equitable principles" in *Liu* raised at least some doubt whether SEC disgorgement continued to be a "penalty" for statute of limitations purposes under *Kokesh*.
7. Jay Clayton, Chairman, SEC, Keynote Remarks at the Mid-Atlantic Regional Conference (June 4, 2019), *https://www.sec.gov/news/speech/clayton-keynote-mid-atlantic-regional-conference-2019*.
8. *Id.*
9. 165 Cong. Rec. H8931 (daily ed. Nov. 18, 2019) (statement of Rep. McAdams), *https://www.congress.gov/116/crec/2019/11/18/CREC-2019-11-18-pt1-PgH8929.pdf*.
10. *Landgraf v. United States*, 511 U.S. 244, 281 (1994).
11. *Liu*, 140 S. Ct. at 1944.

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