Wall Street LAWYER
Securities in the Electronic Age
April 2022 ▪ Volume 26 ▪ Issue 4

CHANGES TO UK PROSPECTUS REGIME: UK GOVERNMENT PROPOSES MOST SIGNIFICANT CHANGES IN A GENERATION

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Summary

On March 1, 2022, the U.K. Government published its response to a consultation started in July 2021 to reform the UK's prospectus regime. The consultation built on the recommendations of the UK Listing Review, which was led by Lord Hill, formerly the UK's European Commissioner.[1] The Government's stated aims are to simplify the regulation in this area, to facilitate wider participation in the ownership of public companies, to improve the quality of information investors receive and to ensure that the regulation of prospectuses will be better able to respond to innovation and change.

The proposed changes set out in the response are broadly aligned with the proposals made in the consultation and are very significant. In several respects they will, once introduced, overhaul the legislative framework carried over from the European Union (which has been constructed over recent decades) after Brexit. In particular, it is intended that the UK Financial Conduct Authority ("FCA") will assume greater rule-making and supervisory responsibility under the new regime than at present. The proposed changes are part of the Government's post-Brexit strategy for wider reform of the UK's capital markets.

The Proposed Changes

The key proposed changes and themes proposed in the consultation response are set out below.

A. When Will a Prospectus Be Required?

Under the current regime, there are two triggers for when a prospectus may be required: either when securities are to be admitted to trading on a UK regulated market or when securities are to be offered to the public in the UK.

The new regime will retain the admission to trading trigger, such that a prospectus may still

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be required when securities are to be admitted to trading on a UK regulated market. The FCA will, though, be granted enhanced rule-making responsibilities on when a prospectus is required, the contents of a prospectus, the timing and manner of publication of a prospectus and whether a prospectus must be reviewed and approved by the FCA before it is published. It will no longer be a criminal offence to request admission to trading on a UK regulated market without having first published an approved prospectus.

The public offerings trigger, however, will be removed, such that a prospectus will not be required when securities are offered to the public in the UK (unless there is a concurrent admission to trading on a UK regulated market that requires a prospectus). Instead, offerings of securities to the public in the UK will be prohibited unless an exemption applies. The existing exemptions from the requirement to produce a prospectus when offering securities to the public (including the qualified investor, 150 persons, takeover exchange offer and merger and division exemptions) will be carried over as exemptions to the new prohibition and there will also be significant new exemptions that cover:

- Offerings of securities which are, or will be, admitted to a UK regulated market or certain multilateral trading facilities ("MTFs") to be specified;
- Offerings of companies' own securities to existing shareholders pro rata (subject to other, as yet unspecified, conditions);
- Offerings of unlisted companies' securities that are made through a platform operated by a firm specifically authorized for that purpose (see Section C below); and
- Certain offerings made by overseas issuers (see Section D below).

B. Liability for the Contents of a Prospectus

Under the UK's current prospectus regime, persons responsible for preparing a prospectus (including the issuer and, for equity prospectuses, the issuer's directors) have statutory liability for untrue or misleading statements contained in the prospectus or the omission of any matters required to be included in it (the "necessary information" test).

This liability regime will be reformed as follows.

The existing single "necessary information" test will be retained as a basic standard of preparation for prospectuses and the basis for statutory prospectus

Wall Street Lawyer
West LegalEdcenter
610 Opperman Drive
Eagan, MN 55123

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(ISSN#: 1095-2985)

liability. However, it is proposed to reform the current test:

- to clarify that "necessary information" may vary according to whether an offer of securities relates to a first-time admission to a market or a secondary issuance;
- to remove the reference to the denomination of the security (in excess of €100,000) as a factor which permits differing levels of disclosure in retail and wholesale bond prospectuses; and
- to focus the "necessary information" test for debt securities on the issuer's or guarantor's creditworthiness rather than its prospects.

In respect of certain categories of information identified in the prospectus as forward-looking information, the threshold test for liability will be raised from a "negligence standard" to a "recklessness standard." This new standard aligns with the standard that applies in respect of information contained in other published information, such as announcements and annual reports. It is intended that the FCA will specify the categories of forward-looking information to which this standard will apply in due course.

Admission documents published in accordance with the rules of certain (as yet unspecified) MTFs will be brought within the statutory liability regime (including the change to the standard attaching to forward-looking information).

C. Public Offerings by Unlisted Companies

Currently, public offerings of less than €8 million are completely exempt from the prospectus regime (assuming securities will not be admitted to trading). In its consultation the Government recognized that crowdfunding provides one viable route to raise funds from the general public in reliance on this exemption, but also highlighted that the market for offerings by unlisted companies above the €8 million threshold was "largely non-functioning." It therefore now proposes to remove any requirement for a prospectus for offerings by unlisted companies. Instead, unlisted companies will be able to offer securities to the public through a platform operated by a firm specifically authorized for the purpose. The operation of such a platform will (as with current crowdfunding platforms) be a regulated activity (and therefore subject to regulation by the FCA). This is a new development for those active in the crowdfunding space and may encourage larger unlisted companies to access capital via these platforms.

In practice, offerings via these platforms will only be available to unlisted companies that are registered as public limited companies. Under the UK Companies Act 2006, private limited companies are prohibited from offering their securities to the public and the UK Government has not proposed to reform this.

D. Public Offerings by Overseas Issuers

The UK Government plans to introduce a new regime that will permit offerings of securities listed on certain (as yet unspecified) overseas stock exchanges to be extended into the UK on the basis of offering documents prepared according to the rules of the relevant overseas jurisdiction and market. The FCA will, however, be empowered to step in to protect UK investors in exceptional circumstances.

Next Steps

The UK Government has not yet provided a timetable for when the proposed changes will be implemented. It has said it will introduce the required primary legislation when "parliamentary time allows." In addition, the response states that the changes will not take full effect until the FCA has consulted on the new rules for which it will be responsible under its new powers.

The information contained in this article should not be construed as legal advice.

ENDNOTES:

[1]*See* https://www.sullcrom.com/files/upload/SC-Publication-UK-Listing-Review-Recommends-Material-Reforms-To-UK-Listing-Regime.pdf.

TREASURY SUGGESTS LIMITING DEFINITION OF DIGITAL ASSET BROKER

By Anthony J. Carbone, Edward L. Froelich, Rebecca M. Balinskas and Katherine Erbeznik

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Recent correspondence between a group of U.S. Senators and the Department of the Treasury appears to have eased the significant concerns expressed by the digital asset sector regarding the scope of the new broker reporting legislation included in the recently passed Infrastructure Investment and Jobs Act ("IIJA"). The IIJA amended sections 6045 and 6045A of the Internal Revenue Code, which impose information reporting requirements on brokers and certain other persons that facilitate transactions involving "covered securities."

These amendments expand the definition of covered securities to include "digital assets" and the definition of broker to include "[a]ny person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person."[1] For these purposes, "digital assets" are defined as "[a]ny digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary,"[2] which would include digital asset securities (as that term has been used by the SEC staff) as well as any cryptocurrency, utility tokens, and non-fungible tokens ("NFTs"), among other digital assets.

As amended by the IIJA, the Internal Revenue Code now generally requires any person who regularly facilitates transfers of digital assets to report basic information about each transaction, including the name and address of the parties and details regarding the transaction's gross proceeds. This requirement currently applies whether or not the digital asset is actually transferred to, or within the control of, the person or persons acting as brokers within the new definition.

Unsurprisingly, the breadth of the new reporting requirement alarmed the relatively nascent digital asset sector. That alarm was not without reason. To see the potential scope of the new legislation, consider the following example:

> Person X, using the cryptocurrency ETH (the native token of the Ethereum blockchain), purchases on OpenSea.io a NFT created by Person Y. Person X transfers ETH to OpenSea.io from her digital wallet, powered by MetaMask software. Person X and Person Y directly interface only with OpenSea; however, the transaction involves multiple other intermediaries: the community that runs and maintains the Ethereum protocol, the miner who validates the transaction and causes it to be stored on the Ethereum blockchain, and the creator of the digital wallet software, MetaMask, which stores the private keys controlling Person X's ETH. Moreover, several of these parties receive a transaction fee for facilitating the transaction.

New section 6045 on its face could bring the community maintaining the Ethereum protocol, the miner, and the software provider of the digital wallet into the definition of "broker," potentially subjecting each of these parties to information reporting requirements. The problem is that the nature of the functions provided by several of these parties do not generally allow them to obtain the information required to be reported by section 6045. Although some of these parties interact directly with Person X or Person Y, others—*e.g.*, the miner and the community maintaining the protocol—do not interact with either Person.

Recognizing these concerns, Sens. Patrick J. Toomey (R-Pa.), Ron Wyden (D-Ore.), and Cynthia M. Lummis (R-Wyo.) proposed an amendment to the IIJA prior to

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its passage that would have excluded miners, sellers of hot and cold wallets, and blockchain protocol developers from the definition of "broker." However, this amendment was ultimately rejected.

Correspondence Between the Senate and Treasury

On December 14, 2021, a group of U.S. Senators issued a joint letter to Treasury Secretary Janet Yellen urging Treasury to provide informal assurance (and, eventually, formal regulatory guidance) that the IIJA's amendments to sections 6045 and 6045A would be interpreted to prevent the undesirable result described above. Recently, on February 11, 2022, Treasury responded with its own letter, stating that "ancillary parties who cannot get access to information that is useful to the IRS are not intended to be captured by the reporting requirements for brokers." As an example of an ancillary party not captured by the IIJA's amendments, Treasury offered "persons who are just validating transactions" (*i.e.*, miners) and "persons who merely write software code" (*e.g.*, MetaMask). This informal guidance may dispel some of the uncertainty generated in the digital asset sector by the IIJA.

Further, Treasury's letter confirmed that it will "consider the extent to which other parties in the digital asset market, such as centralized exchanges and those often described as decentralized exchanges and peer-to-peer exchanges" (*e.g.*, OpenSea) should "be treated as brokers" for purposes of 6045 and 6045A. Treasury pointed to existing section 6045 regulations which impose broker reporting obligations on "market participants" whose activities grant "access to information about sales of securities by taxpayers" as opposed to participants such as miners or software providers who do not have such access.

Interestingly, in support of the position outlined in its letter, Treasury referred to a "colloquy" between Sens. Rob Portman (R-Ohio) and Mark Warner (D-Va.) conducted on the Senate floor in August 2021, when the IIJA was still being considered. A colloquy is a scripted conversation between members of Congress that is entered into the congressional record, becoming part of a bill's legislative history. Colloquies can serve to give context when the black letter of a bill is open to broad interpretation.[3] A colloquy may provide a persuasive indication of a bill's legislative intent, which regulators may draw upon when promulgating guidance.[4]

Notwithstanding this informal guidance and insight into the intent of the lawmakers, the digital asset sector continues to push for a formal amendment to or regulations clarifying the narrower definition of digital asset broker in section 6045 to dispel any confusion and to better prepare for future regulatory guidance on the rapidly developing digital asset industry.

ENDNOTES:

[1]26 U.S.C.A. § 6045(c)(1)(D).

[2]26 U.S.C.A. § (g)(3)(D).

[3]The IIJA was passed under the Senate's budget reconciliation rules, which generally may only be used to pass laws related to spending or raising revenue. To avoid adding language into a bill that might disqualify it from passing through budget reconciliation, the Senate may express its intent for a bill in a colloquy rather than in the bill's actual language.

[4]For example, Sens. Keating and Ervin participated in a colloquy in April 1964 to build the legislative history regarding the Civil Rights Act of 1964. 88 Cong. Rec. S6717 (1964).

SHOULD COMPANIES TAKE A STAND?

By John Wilcox

John Wilcox is chairman emeritus of Morrow Sodali, and a member of the ***Wall Street Lawyer*** *editorial board.*

One of the most controversial questions confronting business leaders today is whether they should speak out publicly on environmental, social and governance ("ESG") issues.

In the past the answer to this question was largely discretionary, the issue being whether it was appropriate for corporate CEOs to act as "business statesmen" and take a stand on contentious issues in the public domain. The prevailing assumption was that the CEO's job is to make a profit, not to opine on issues beyond the scope of the business.

Today, however, corporate involvement in public affairs gives rise to questions that go beyond business statesmanship: ***To what degree do environmental, social, governance and political issues impact a company's business risks and value drivers?*** And the obverse: ***Do the activities of a company have an impact on the environment, the economy and society?***

These are questions that business leaders ignore at their peril. The public role of companies is in the headlines every day, reflecting a business environment transformed by climate change, stakeholder capitalism, corporate purpose and, most immediately, the global pandemic.

The emergence of ESG issues has generated a wholesale reevaluation of corporations' so-called "social compact." It has upended the concept of "shareholder primacy" and raised questions about traditional methods of auditing and evaluating companies. Corporate "externalities," "intangibles," "purpose," "culture," "values" and other qualitative factors—formerly characterized as "non-financial"—are now recognized as integral to a company's risk profile, financial health and long-term value. Accordingly, corporate executives and boards of directors are expected to attend to an expanding list of ESG topics. These include climate change, human capital management, pay equity, gender and ethnic diversity, Black Lives Matter, #MeToo, the wealth gap, human rights, immigration, gun control, domestic terrorism, voting rights, political contributions, and more.

Simultaneously with their impact on corporations, ESG issues are having a transformative effect on institutional investors and shareholders. Giant financial institutions such as BlackRock, State Street, Vanguard and Fidelity, joined by many other asset owners and managers around the globe, are including ESG factors in their investment decision-making and stewardship of portfolio companies. A new generation of millennial and Gen X shareholders is bringing their personal concerns about the environment, society and politics into their selection of asset managers, their choice of asset classes and directly into their engagement with the companies they own. ESG issues have become a dominant focus for shareholder activists and have contributed to their growing record of success. Social media are further accelerating the process by which corporations are linked to ESG issues in the news.

ESG issues are predicted to play a prominent role in the 2022 annual meeting season. The Conference Board recently published its *C-Suite Outlook-2022*, which contains the following observation:

> ***CEOs worldwide are far more concerned about stakeholder pressure than shareholder activism***. Evolving stakeholder expectations of the role of business in society ranks far above shareholder activism as a factor that CEOs expect to have an impact on their company this year. This is most pronounced in the US, where CEOs rank the impact of stakeholder expectations as 11th, far ahead of shareholder activism at #26.[1]

The takeaway: in 2022 CEOs need to be prepared to take a stand on ESG issues of concern to their stakeholders. Public attention to ESG issues means that a company's "ESG/stakeholder profile" is as important today as its ownership profile was during the era of shareholder primacy. In response, corporate communications, investor relations and board engagement programs must address ESG topics and stakeholder concerns in the context of business strategy and financial results.

E and S Versus G

The transition to "ESG engagement" presents company managers with substantial new challenges. In particular, the monitoring of environmental and social policies cannot rely on the compliance methodology

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used for corporate governance. While governance can be evaluated across different companies using a standardized checklist of best practices (albeit often with a comply-or-explain option), a prescriptive, one-size-fits-all approach does not work for environmental and social issues. E and S factors vary widely at individual companies, depending on their industry, size, location, competitive standing and a variety of other considerations. This problem of variability is apparent in the proliferation of competing global standards that have been developed to measure climate risk and assess responses to climate change across different industries and in different markets. SASB's 77 industry standards are a case in point.

However, global E and S standardization remains an important goal. Companies, investors, NGOs and regulators deem standardization essential to achieve comparability and ensure fair valuation of both listed and private companies. An important move toward standardization is the recent creation of the International Sustainability Standards Board ("ISSB"), a consolidation of the International Financial Reporting Standards Foundation, the Climate Disclosure Standards Board and the Value Reporting Foundation (which in turn combines the Sustainability Accounting Standards Board and the International Integrated Reporting Council).

Despite the push for standardization and even if ISSB does achieve its objective of providing "a comprehensive global baseline of sustainability disclosures," bespoke analysis of individual companies on E and S issues will continue to be necessary.

Thinking Differently About Materiality, Or Not?

Experts and regulators pondering the growing need for customized treatment of E and S factors have suggested that the traditional concept of "financial materiality" should be supplemented with alternative definitions. Among the new definitions are "double materiality," "dynamic materiality" and "pre-financial materiality."

It is important to consider carefully whether the financial materiality standard is sufficiently comprehensive to embrace ESG issues. If so, alternative definitions may confuse materiality analysis rather than clarifying it.

In an April 27, 2021, comment letter to the Securities and Exchange Commission on the subject of "Climate Change Disclosures," Uber Technologies, Inc. recommended an expanded approach to materiality that would not require a redefinition. While endorsing an ISSB-type "harmonized climate change disclosure framework" that " . . . would not only provide the standardization, comparability and reliability sought by investors and other stakeholders, but would allow . . . companies to streamline reporting and communications on climate change," Uber made the following statement:

> " . . . we encourage the Commission to consider requiring that companies perform a ***company-specific materiality assessment*** to identify the ESG issues most relevant to their businesses. We believe that the most useful ESG disclosures will be ***grounded in the specific issues that are relevant to the particular company***, as opposed to generic ESG disclosures that may or may not apply in a company's individual circumstances." [Boldface added]

Uber's "company-specific materiality assessment" contemplates a two-step analytical process that, in addition to determining what an average investor would want to know, asks additional questions: ***What issues do we, the people running the business, think are strategically important? What do our stakeholders want? To what degree are third-party standards applicable to our business? What are peer companies doing? What do our statement of corporate purpose, our company values, our culture, our reputation, our branding and our public image require?***

These are important business questions whose answers are contextual and specific to individual companies. They in no way depart from the traditional standard of financial materiality. In fact, they rely on it. **A company's determination as to whether an ESG**

issue is material ultimately turns on whether the issue has an actual or potential financial impact on the business. Once the financial materiality determination has been made, the ESG issue is no longer theoretical. It is redefined as a business issue grounded in the company's specific activities and circumstances.

While Uber's company-specific materiality assessment rests on traditional financial criteria, the approach will over the long term require companies to undertake substantial organizational and behavioral adjustments. ISSB standards will provide helpful guidance for companies willing to adopt reforms such as integrated reporting, holistic management, stakeholder engagement and greater board transparency as a means to achieve ESG integration.

The concept of company-specific materiality assessments also impacts institutional investors. It will require them to dig more deeply into the inner workings of individual portfolio companies and to engage with their managements systematically. It will further reduce their reliance on standardized metrics, regulatory guidelines and the wholesale recommendations from outside advisors and service providers.

Conclusion

The answer to whether a company should take a stand on specific ESG issues should be resolved internally well before the question arises in the public domain. Because materiality carries with it an obligation to disclose, a company's corporate reporting and communications should provide a narrative that enables stakeholders and the public to understand how the company has dealt with its material ESG issues. That narrative in turn provides a script if the company chooses to speak out publicly. Non-material ESG issues that fall outside a company's business should require no public stance and should be left for debate among advocacy groups, academics, politicians and the media.

Supplement: Where to Begin With ESG?

So, what lies ahead for companies? How should they prepare for a future in which ESG plays a central role in their strategic planning, corporate reporting and engagement? How will ESG affect their communication with institutional investors, beneficial owners, employees and other stakeholders? What internal processes will companies need to develop to determine whether an ESG issue is material and how to respond when it surfaces in a public forum?

Here is an approach taken by **Kate Rebernak**, founder and CEO of FrameworkESG: ***To know where you're going, understand where you are.***

In the past several years, companies have come under increasing pressure from key stakeholders to integrate ESG considerations into their operations and disclose ESG-related performance with greater rigor and particularity. Where to begin?

1. Know where you are

Take an inventory of all your activities that related to ESG issues to see what you can already get credit as well as gaps in performance and disclosure.

Conduct a materiality analysis to better understand the concerns of key stakeholders about your sector and your business. Consider whether your enterprise risk management ("ERM") framework and process account for external perspectives. If you don't have an ERM framework, a materiality assessment is one place to start.

Conduct a benchmark analysis. Look at direct competitors, indirect competitors, customers, and peers, and throw in a couple of leaders for good measure. What issues do they say are important? Do they have stated goals? What metrics do they use? How do they communicate? How do you stack up?

2. Chart where you want to be

Do you want to be a leader? A fast follower? Run with the pack? No one wants to be a laggard. Decide where you want to be. Prioritize the issues you want to address. Set internal goals, even if they are, at first, to

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understand what your baseline performance is so that you can set realistic, measurable, and achievable targets.

3. Look for early and easy—or easier—wins

Consider using renewables to reduce cost and environmental impact. Look for ways to increase employee engagement: such efforts are often low budget and high impact. One is to connect your company's purpose to the United Nations Sustainable Development Goals, or SDGs. Which of the SDGs are most closely aligned with your business and its contribution to society?

4. Use ESG as a lens through which to assess and drive performance

Align ESG issues with your core strategy, products and services, and operations. Here again, you might be surprised that some things you're already doing fall into one of the three buckets: E, S. or G. Manage and measure your ESG performance using accepted frameworks and standards such as the Global Reporting Initiative, SASB, or the TCFD.

5. Don't go it alone

Look for partners—nonprofit organizations, universities, other complementary companies, or even clients—to support and advance the efforts you've undertaken to address the highest-priority issues for your company. Investing in partnerships with reputable organizations can amplify both your impact and your message and help you build trust with key stakeholder groups.

6. Embrace transparency

Communication is a two-way street. Use every engagement as an opportunity to understand and respond to stakeholders' expectations. Though you won't always satisfy them, there's enormous trust-building potential in listening, even if you ultimately decide to go in another direction. The key is to communicate your understanding of your stakeholders' expectations and how the direction you take will help the company create value for them in the long term.

Stakeholders don't expect perfection. They do expect transparency. So articulate your goals and measure, track, and communicate progress, even if it's not great. Companies that communicate transparently about their ESG efforts—both successes and challenges—have invested in something of an insurance policy. If an issue bubbles up, the fact that you've been seeking to understand it, manage it, and communicate about it will help you avoid a schism in trust with key stakeholders.

ENDNOTES:

[1]The Conference Board, ESG Alert: What CEOs Think of ESG & Other Big Issues in 2022 and Ways to Reduce Growing ESG Disclosure Risk, January 14, 2022.

PLANNING FOR THE PAYMENT OF TAXES ON PRIVATE COMPANY STOCK AWARDS

By Craig Tanner and Thomas White

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Stock awards are a common and valuable compensation tool for companies to recruit and incentivize key service providers, such as employees, non-employee board members, and independent contractors. Many companies adopt stock incentive programs for these purposes, featuring several types of awards, including stock options, restricted stock, and restricted stock units ("RSUs").

There are many factors to consider when designing and administering a stock incentive program, including the number of shares to reserve, the types of stock awards, exercise or purchase prices, vesting schedules, restrictions on the sale or transfer of shares, repurchase rights, and forfeiture provisions.

In this article, we focus on a critical factor for a suc-

cessful stock incentive program that is often overlooked—the payment of federal and state income tax and payroll tax (collectively referred to as "tax" or "taxes") attributed to the stock awards. This critical factor impacts all companies with shares that are not freely tradeable. The tax obligations require either or both the company and the service provider to come up with the funds to pay the taxes due. All too often, the obligation to pay taxes comes as an unwelcomed surprise to both the company and the service provider that can result in the stock incentive program becoming a financial headache rather than a valuable incentive. Even though information about the tax obligations is communicated by the company to the service provider, the tax obligations typically are not fully explained or understood by the service provider.

All stock awards are subject to taxes at some point in time. While a summary of stock award taxation is beyond the scope of this article, it is important to understand when the company and service provider become responsible to pay the taxes due. Generally, taxes are due for stock awards when the fully vested shares underlying the stock awards are issued to the service provider. For non-statutory stock options, the taxable event is at the time of exercise. For restricted stock, the taxable event is either at the time of grant (with a Section 83(b) election) or at the time of vesting. For RSUs, the taxable event is when the shares are issued after the vesting date. The taxable value of the shares is the difference between the fair market value of the shares at the time of the taxable event and the price paid by the service provider to acquire the shares, if any.

The payment of the taxes attributed to the stock awards can be a significant problem for the company and the service provider. Even though the service provider receives the shares, he or she typically may not sell any of the shares to raise the funds needed to pay the taxes due. Notwithstanding that the service provider is unable to sell the shares, the company must collect and remit the taxes due if the service provider is a current or former employee. The company typically is not responsible for collecting and remitting the taxes due for non-employee service providers. While the taxes attributed to the stock awards are ultimately the service provider's responsibility, the company may face penalties and fines imposed by the IRS if it fails to properly collect and remit the taxes due.

The Alternatives

There are multiple alternatives for collecting taxes that the company and service provider should consider. The most common alternatives are the company withholding the taxes from the service provider's regular payroll or the service provider making an out-of-pocket payment to the company or tax agency. Other alternatives to raise the funds for the tax payments include the company paying a bonus to the service provider, a loan by the company to the service provider, a net-share delivery, or a third-party purchase of shares. Each of the alternatives, as discussed below, have pros and cons.

Withholding from service provider's regular payroll. Because the service provider is not receiving extra cash in his or her payroll at the time of the taxable event, the taxes attributed to the stock award will be withheld from his or her regular salary. Depending on the amount of taxes due, the service provider's regular salary may not be sufficient to cover the tax obligation. The outcome may be that after the taxes are withheld, the service provider has little or no money left for living expenses. The impact on the service provider of having all, or a large portion, of his or her payroll withheld for the taxes can be financially devastating.

Out-of-pocket payment by the service provider. With this alternative, the service provider pays the taxes due either to the company for remittance to the tax agencies or directly to the tax agencies. The service provider must have sufficient cash reserves on hand to pay the taxes out-of-pocket. In order to receive the tax payments from the service provider, the company must have a process in place to inform the service provider of the taxes due, timely receive the payments from the

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service provider, and account for the receipt of the service provider's tax payment. If the service provider has not planned ahead for the out-of-pocket payment of the taxes, this alternative may not be practical.

Company bonus to the service provider. The company may schedule a cash bonus payment to the service provider at the time of the taxable event for the purpose of paying the taxes due. The cash bonus is taxable income to the service provider and the bonus amount paid by the company must be sufficient to pay the taxes due on both the stock award and the bonus. While this alternative removes the issue of the service provider paying the taxes from salary or out-of-pocket, it places the payment burden on the company. Without advance planning for the payment of the taxes, this alternative may not be practical for the company as the payment of a cash bonus to the service provider increases the costs of the stock incentive program and depletes the company's cash reserves. In addition, the company may have several service providers with the same stock award tax issues that would greatly increase the company's cash outlay.

Company loan to the service provider. In some situations, a loan in the amount of the taxes due from the company to the service provider may be considered. The terms of a company loan must be carefully considered to avoid additional taxes imposed on the service provider. This alternative allows the service provider to delay his or her payment of the taxes due but requires the company to pay the loan amount out of its cash reserves. If all or a portion of the loan amount is forgiven by the company, the amount forgiven is taxable income to the service provider. The company also bears the risk that the service provider is unable or unwilling to repay the loan amount when the payments are due. Collection actions on defaulted loans against current or former service providers can be costly for the company.

Net-share delivery. Through a net-share delivery, the company calculates the amount of taxes due and withholds the number of shares with a value necessary to cover the tax obligation. The company will issue to the service provider the number of shares vested or exercised less the number of shares withheld for the payment of taxes. The company will remit the cash value of the withheld shares to the tax agencies. The withheld shares are returned to the incentive stock program for future awards. An upside to this alternative is that the service provider has no out-of-pocket cost for the taxes due and the withholding of shares reduces the dilutive effect of the stock incentive program because the withheld shares are available for future awards. The downside to this alternative is that the company must pay the amount of taxes due to the tax agencies on behalf of the service provider from its cash reserves.

Company-sponsored third-party sale. An alternative that is becoming more common with private companies is a company-sponsored sale of shares to a third party, which is usually a strategic investor. Here, the company partners with a third party to purchase the service provider's shares. The company and third party will set the terms as to when the share purchase will occur, how many shares may be sold, and the purchase price. With this alternative, the company is able to provide liquidity to the service provider, avoid spending its cash reserve, and maintain control over the share ownership percentage of the third-party purchaser. From the service provider's perspective, however, he or she has no control over if and when a third-party sale will be offered, and if it is, whether the terms will be acceptable. This alternative also has regulatory concerns for the company and the third party. Because the service provider and third party will be entering into a stock transaction, the company and third party must carefully consider and comply with the securities disclosure and corporate law requirements for a sale of shares.

Conclusion

Each of the tax collection alternatives mentioned in this article have pros and cons for the company and the service provider. While none of the alternatives are a

perfect solution to the problem of collecting taxes due on stock awards when the underlying shares are not freely tradeable, the service provider and the company have an opportunity to work together to plan for alternatives to collect the taxes. The company should consider the tax collection alternatives well in advance of when service providers acquire shares under the stock incentive program so that it may communicate the alternatives to the service providers before the taxable event occurs. The common practice of including general tax information in the stock incentive plan communications has not proven effective for the service provider to fully appreciate the tax obligations that he or she may experience with the stock awards. Early attention to the collection of taxes for the stock awards can help to avoid the potential financial hardship and result in a successful stock incentive program for both the company and service provider.

SEND LAWYERS, GUNS AND MONEY: (OVER-) ZEALOUS REPRESENTATION BY CORPORATE LAWYERS

By Allison Herren Lee

Allison Herren Lee is a commissioner in the Securities and Exchange Commission. The following is edited from remarks that she gave at PLI's Corporate Governance: A Master Class on March 4, 2022. On March 15, Lee announced she intended to leave the SEC.

I take great pride in being a member of the bar and this is the lens that I bring to the topic I want to address today. I want to talk about supporting securities lawyers, both in-house and outside counsel, in upholding the best traditions of the profession. Specifically, by fulfilling a mandate in the Sarbanes-Oxley Act designed to do just that. As we near the 20th anniversary of its passage, we still have not fulfilled Congress' mandate under Section 307 of Sarbanes-Oxley to adopt minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of issuers.[1]

A key element of Sarbanes-Oxley, passed in the wake of the massive financial failures of the Enron era, was to create structures of accountability for professionals—executives, accountants and auditors, and, under Section 307 of the Act, accountability for lawyers. In considering Section 307, Congress recognized that executives and accountants did not "work alone," and that lawyers were "virtually always there looking over their shoulders."[2] Congress was concerned, however, that counsel often acted in the interests of the executives who hired them rather than the company and its shareholders to whom their duty and responsibility is owed.

Unfortunately, in response to this mandate, the SEC adopted only one standard: the so-called "up-the-ladder" rule, requiring lawyers to report certain potential violations up the chain of management inside a corporate client.[3] We did not adopt a broader set of rules as Congress directed, and quite significantly, even this single standard has not been enforced in the nearly 20 years since it was adopted.[4]

The policies behind this unfulfilled mandate—which are designed to support lawyers in their gatekeeping role—are as relevant and compelling today as they were 20 years ago, if not more so. Indeed the role of corporate lawyers as gatekeepers in the capital markets—distinct from the litigator's role—has long been acknowledged by a broad and bipartisan group from William O. Douglas, to A.A. Sommer and Stanley Sporkin.[5] It also includes Independent, Republican, and Democratic Chairs of the SEC.[6]

And it wasn't just during the Enron era that we saw lapses in the gatekeeping role.[7] We saw such lapses with stock option backdating and mutual fund market timing cases,[8] and to some extent in the 2008 financial crisis.[9] More recently, we have seen an entirely new, multi-trillion dollar industry develop around cryptocurrency and digital assets that largely defies existing laws and regulations.[10] The role of lawyers in enabling this approach remains to be fully fleshed out, but the failure

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to comply with well-known principles of the securities laws has already been costly for many firms. The bottom line is this: when corporate lawyers give bad advice, the consequences befall not just their clients, but the investing public and capital markets more broadly—especially when it comes to disclosure advice.[11]

But we do not currently have sufficient standards in place upon which to assess this kind of advice. Standards for professional conduct could help both lawyers and regulators navigate this difficult terrain where bad legal advice can, in the words of a prior Commission, "inflict substantial damage on the Commission's processes, and thus the investing public, and [] the level of trust and confidence in our capital markets."[12] It's time to revisit this unfulfilled mandate and consider whether the SEC should adopt (and enforce) a minimum set of standards for lawyers who practice before the Commission to better protect investors and markets.

"Can-do" Corporate Lawyering

The "bad advice" I refer to arises from a type of "can-do" approach to lawyering that is ill-suited to lawyers in a gatekeeping role. It is born from a desire to give management the answer that it wants. Or, as a Delaware court recently stated, it stems from a "contrived effort to generate the client's desired result when real-world facts would not support it."[13]

If you haven't read this particular Delaware decision (*Bandera Master Fund v. Boardwalk Pipeline*) from late last year, I commend it to you as a study in the perils of modern corporate law practice. It involves sophisticated counsel who, as the court put it, engaged in "goal-directed reasoning" to provide an opinion designed to allow the client to exercise a lucrative call right. However, the court concluded the opinion was based on artifice and sleight of hand. It thus ruled that the opinion was given in bad faith and awarded damages against the client of roughly $700 million.[14]

Unfortunately, this case does not appear to represent an isolated instance of poor judgment by a single lawyer or firm. Indeed, this same court wrote an expansive opinion in 2020 in which it found another preeminent firm had "committed fraud" by holding back important information during a competitive bidding process.[15] In yet another recent case, the court laid out chapter and verse how a large law firm took part in a covert plan to "undermine a merger" while concealing their work so as not to "advertis[e] that [the client] was breaching its obligations" to use best efforts to close the deal.[16]

Though these particular cases were not about disclosure under the securities laws, they are nevertheless emblematic of a dynamic—a kind of race to the bottom—that can occur when specialized professionals like securities lawyers compete for clients in high stakes matters and are pressured to provide the answers their clients seek. As one observer put it: "Can-do lawyering has run amok. Still you don't want to be the lawyer that just says 'no.' You'll never make it."[17]

Of course, this type of conduct is far from the norm for securities law practitioners, but it is not as rare as we would like to think. In my 25 years as a securities lawyer, I have observed this kind of conduct on multiple occasions. It is not easy to strike the right balance between zealous representation in corporate law matters and thoughtful consideration of the potential impact to shareholders, investor protection, and the public interest. Most lawyers generally err on the side of caution. But examples like those I've noted erode public trust in the highly-skilled, principled attorneys in the financial regulatory space and in our markets more broadly.

The Impacts of Bad Advice Related to Corporate Disclosures

Market Harm

When lawyers fail as gatekeepers, when they provide "goal-directed" reasoning to public companies on critical issues like materiality, there is a broader interest at

stake. Investors and financial markets can be harmed through false or misleading disclosure.

And lawyers are frequently involved in disclosure decisions. While management is generally responsible for public company disclosures, they often rightly rely on counsel to review and draft the relevant filings and resolve many questions that arise in the process of crafting disclosures, including critical materiality determinations.[18]

In fact, the role of counsel in the disclosure process has, if anything, only increased in recent years as the Commission has shifted even further toward principles-based rules.[19] Specific disclosure items have been replaced with a more "principles-based" approach that focuses on management's view of the materiality of the information.[20] Critically important, top-of-mind issues for investors such as climate risk and cybersecurity disclosures currently depend mostly upon materiality determinations.[21] Principles-based rules make disclosure decisions more management-centric, requiring officers to exercise greater judgment to determine whether disclosure is necessary. Materiality determinations, which are mixed questions of law and fact, are thus particularly suited for review by counsel.[22]

However, when, as a New York City Bar Task Force found, lawyers "ben[d] to management pressures"[23] or engage in a "contrived effort to generate the client's desired result,"[24] their advice can distort important market-moving information, interfere with price discovery, and lead to misallocations of capital. Indeed, misleading or false disclosure can have a profoundly negative impact on an investor's decision-making process. It can directly impact their savings, investment goals, and overall financial well-being. Misleading or false disclosures also erode integrity and confidence in our financial markets and regulatory system.

Some rightly point out that reputational harm can offer a powerful incentive for lawyers not to succumb to such pressure.[25] However, increased competitiveness in the profession contributes to the problem, and imprecise legal principles, like materiality, "invite interpretation in a self-serving fashion."[26] Lawyers view themselves as problem-solvers for their clients, and failing to give management what it wants can actually be what causes reputational harm.[27]

Reduced Deterrence

Perversely, in addition to inflicting harm on investors and potentially exposing the company to costly litigation, contrived legal advice can actually insulate from liability those individuals within a company who are responsible for false or incomplete disclosure. This turns the role of gatekeeper on its head. Also a lack of individual accountability greatly undermines the deterrent effect of a potential enforcement action or private litigation.[28] Individual accountability for corporate rule-breaking is a singularly effective deterrent, and also a matter of fundamental fairness that promotes public trust in financial markets.

The fact is, however, we are too often hamstrung in our ability to charge individuals, particularly with respect to disclosure violations by public companies.[29] I know, from over a decade of experience as an enforcement lawyer and from reviewing and voting on hundreds of cases as a Commissioner, this is not from a lack of diligence by the Commission's Enforcement staff. In fact, I can say with confidence that in cases alleging disclosure violations by a public company, staff carefully investigates and considers whether individuals are responsible and should be charged.

So, what gets in the way of charging individuals? In some cases, the disclosure failure or misrepresentation truly is not attributable to a specific person or persons within a company, but rather more broadly to a failure by the company to employ sufficient processes and safeguards around disclosures. This is sometimes referred to as "corporate negligence."[30] In other cases, considerations of equity may militate against charging a relatively low-level employee or one who was in some sense a victim of a corrupt corporate culture.

In still another category of cases, however, we know

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who within the company was responsible, but face significant risks in charging them due to the involvement of lawyers in the disclosure decision that forms the basis of the enforcement action. Of course, as I mentioned, it is prudent and beneficial for companies to seek the advice of counsel in making important disclosure decisions. However, if counsel merely contrives to support a pre-determined goal of management, such activity is merely rent-seeking masquerading as legal advice, while providing a shield against liability.

I have seen this scenario on a number of occasions—examples of lawyers providing advice that was, in my view, reckless, but that provided cover for other executives who weren't charged. Because we generally lack standards by which to hold such lawyers accountable, the result is no individual accountability of any kind.[31]

Current Professional Standards Are Inadequate

The existing framework for professional conduct is not adequate to the task—neither through states nor the SEC. State bars don't have the resources[32] and may lack the necessary expertise[33] needed to resolve issues around the legal advice provided to public companies.[34] State disciplinary actions can also lack financial disincentives in the form of monetary sanctions.

The SEC can and does bring actions against lawyers who directly commit violations of the federal securities laws or aid and abet in these violations.[35] Lawyers have been sanctioned where they allegedly misrepresented or concealed information in documents that they drafted, signed, and filed;[36] authored "sham" agreements[37]; or knowingly facilitated a fraud.[38] But these cases are generally premised on claims that the lawyer violated a substantive provision of the securities laws.

Setting aside substantive violations of the securities laws, the Commission's own Rules of Practice are a potential source for lawyer discipline. Under Rule 102(e), the Commission can suspend or bar attorneys when their behavior falls below "generally recognized norms of professional conduct."[39] Nonetheless, we have generally chosen instead to use Rule 102(e) only to impose follow-on bars after attorneys have been found to violate substantive provisions of the securities laws, as though such violations are the only way in which an attorney can violate generally recognized norms of conduct.[40]

More importantly, even if the Commission determined to switch course and consider these types of actions, there is a more fundamental hurdle: what are the "generally recognized norms of professional conduct" by which we would assess lawyers? We could look to state law standards but they are mostly drafted in a one-size-fits-all fashion, arguably more oriented toward litigators, and do not explicitly address norms for those representing public companies.[41] As you are all keenly aware, a lawyer at the largest firm representing the largest public issuers is engaged in a very different type of practice from a solo practitioner handling personal injury or estate law matters.[42] State law standards also focus mostly on the behavior of individual lawyers, assigning few responsibilities to the firm for quality assurance.[43] And while the standards include some useful concepts, they are often aspirational and difficult to enforce.[44]

As I mentioned, however, the Commission has the authority to address these concerns and was directed by Congress to do so. Section 307 mandated that the SEC "issue rules"—plural—adopting "minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers."[45]

While these rules were to include a requirement that lawyers report evidence of certain legal violations up through their client's chain of management, the mandate was broader than that.[46] To date, however, the Commission has adopted only the single "up-the-ladder" standard. And unfortunately, while an entirely new regime for oversight of the accounting profession has grown and evolved, and thousands of executives have certified SEC filings under Section 302, some having their salaries clawed back under Section 304, we

have never brought a single case finding a violation of the up-the-ladder rule under Section 307, a glaring fact of which market observers are well aware.[47] Like a tree that falls in the forest with no one to hear, a rule that is not enforced may fairly be said to be no rule at all. Indeed this calls into question whether we have fulfilled even the narrowest expectations of Congress in adopting Section 307.

Rules to Live By

The time is ripe to return to this unfinished business. Doing so will require careful thought, as well as assistance from the securities bar, experts on professional responsibility, and other interested parties and market participants. I will offer today some thoughts on where we might start, and I'd appreciate hearing from you all on these or other approaches.

We might offer greater detail regarding a lawyer's obligation to a corporate client, including more specifically how their advice must reflect the interests of the corporation and its shareholders rather than the executives who hire them.[48] This distinction is not always an easy one to make in practice, but at a minimum, might require consideration of the impact of the advice on the corporation and its shareholders, including the impact should the disclosure decision ultimately prove incorrect.[49]

Advice on materiality may be deserving of its own treatment in the standards, treatment designed to ensure a sufficiently independent and rigorous analysis. In weighing the importance of information to a reasonable investor, courts have recognized that a materiality analysis is "inherently fact-specific"[50] and "delicate,"[51]and have declined to find information immaterial as a matter of law unless it is "so obviously unimportant . . . that reasonable minds could not differ,"[52] with doubts construed in favor of requiring disclosure.[53] Disclosure counsel should already be applying these concepts, but a standard could make them explicit.

Minimum standards might also address requirements of competence and expertise. As noted in *Bandera Master Fund*, a good faith opinion necessarily requires that the opinion-giver have competence in the relevant area of law.[54] Those rendering advice on disclosure issues may not always have adequate training. Disclosure lawyers, for example, may opine on materiality without sufficient focus or understanding of the views of "reasonable" investors.[55] They may focus instead on defending non-disclosure. The Commission could provide continuing education requirements that apply to securities lawyers advising public companies, much like the PCAOB has done for auditors.[56]

In addition to the adoption of standards applicable to lawyers practicing before the Commission, we could consider some degree of oversight at the firm level.[57] Audit firms for public companies are obligated to have a system of quality control at the firm level;[58]something similar might make sense for securities lawyers.

Other topics that could be addressed in a set of minimum standards could include the need for independence in rendering advice,[59] the obligation to investigate red flags and ensure an accurate factual predicate for legal opinions,[60] and the retention of sufficient contemporaneous records to support the reasonableness of any legal advice, including whether appropriate expertise was brought to bear.[61]

Conclusion

These are just a few ideas[62] regarding what standards might look like that I hope can serve as a starting point for conversation and collaboration. Having read through comments submitted in response to our proposed up-the-ladder rules in 2002, I appreciate the complexity of this task, as well as concerns of the American Bar Association and others regarding protection of the attorney-client privilege.[63] We must give that careful consideration, just as we must also weigh the costs of there being few, if any, consequences for contrived or tortured advice.

The attorney-client privilege is not an end in itself.

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It is a means to an end which is fidelity to law and society. I can hardly say it better than our former Enforcement Director, Linda Chatman Thomsen:

> Underlying all evidentiary privileges—which [] are disfavored at law, for the simple reason that they interfere with fact-finding—is the idea that there is an offsetting benefit that justifies the cost to the truth-seeking process. That somehow—by protecting these relationships with [] lawyers—we, as a society, end up encouraging better conduct, not worse.[64]

That is the goal of standards in this space—to support securities lawyers in giving clients their best advice while living up to the promise of public service that our profession embraces.

ENDNOTES:

[1]*See* Sarbanes-Oxley Act of 2002 § 307, 15 U.S.C.A. § 7245 ("Sarbanes-Oxley Section 307").

[2]*See* 148 Cong. Rec. S6551-52 (daily ed. July 10, 2002) (statement of Sen. Edwards) ("The truth is that executives and accountants do not work alone. . .").

[3]*See* Implementation of Standards of Professional Conduct for Attorneys, Securities Act Rel. No. 8185 (Sept. 26, 2003) (adopting final rules implementing the so-called "up-the-ladder" requirement pursuant to Section 307 of the Sarbanes-Oxley Act). For the purpose of clarity, the up-the-ladder provision is technically codified as several distinct rules in the Code of Federal Regulations. *See* 17 C.F.R. §§ 205.1-205.7. In substance, however, those rules are limited in scope to the up-the-ladder requirement, and I refer to them collectively throughout this speech as a single rule.

[4]This is not to say that lawyers haven't made efforts to comply with this rule. Anecdotally, I am aware that some lawyers in fact have and do report up the ladder, sometimes spurring internal investigations.

[5]William O. Douglas, The Lawyer and The Federal Securities Act (Apr. 22, 1934) ("Service to the client has been the slogan of our profession. And it has been observed so religiously that service to the public interest has been sadly neglected."); *see also*, A.A. Sommer, Jr., The Emerging Responsibilities of the Securities Lawyer, Address to the Banking, Corporation & Business Law Section, N.Y. State Bar Ass'n (Jan. 24, 1974), in Larry D. Soderquist & Theresa Gabaldon, Securities Regulation 617-19 (4th ed. 1999) ("I would suggest that in securities matters. . .the attorney will have to function in a manner more akin to that of auditor than to that of the attorney. . ."); *see also*, Interview of Stanley Sporkin, Former Director, Division of Enforcement, SEC at SEC Historical Society (Sept. 23, 2003) ("We developed the so-called access strategy which to my delight has become one of the underpinnings of Sarbanes-Oxley. Of course, they now call it the gatekeeper strategy. . .").

[6]*See, e.g.*, Gary Gensler, Chair, SEC, Prepared Remarks at the Securities Enforcement Forum (Nov. 4, 2021) (stating that lawyers, among other professionals "play an important role in our capital markets. . ."); Jay Clayton, Chairman, SEC, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017) (discussing questions of the legal status of so-called "utility tokens" and stating: "On this and other points where the application of expertise and judgment is expected, I believe that gatekeepers and others, including securities lawyers, accountants and consultants, need to focus on their responsibilities. . ."); Harvey Pitt, Chairman, SEC, Remarks Before the Annual Meeting of the American Bar Association's Business Law Session (Aug. 12, 2002) ("Although some lawyers believe the roles of outside auditors and corporate lawyers are vastly different, lawyers representing public companies have responsibilities quite similar to those of outside auditors. . .") *But see* Coffee Jr., The Attorney as Gatekeeper: An Agenda for the SEC, 103 Colum. L. Rev. 1293 (2003) (describing a debate amongst the bar over the appropriate role for securities attorneys and whether such attorneys owe a duty to the public or, instead, exclusively to their client).

[7]Even the Supreme Court has acknowledged—in a ruling applying a broad interpretation to the scope of Sarbanes-Oxley's whistleblower protections—that Congress was largely animated in Sarbanes-Oxley by the ways in which professionals of all sorts, and especially accountants and lawyers, failed in their respective gatekeeping roles. *See Lawson v. FMR LLC*, 571 U.S. 429, 447-449, 134 S. Ct. 1158, 188 L. Ed. 2d 158, 37 I.E.R. Cas. (BNA) 1193, 97 Empl. Prac. Dec. (CCH) P 45023, Fed. Sec. L. Rep. (CCH) P 97838, 2014 O.S.H. Dec. (CCH) P 33358 (2014) (identifying numerous instances in which Congress evinced an intent to address auditors' and lawyers' incentives to look the other way when confronted with fraud or other bad conduct, including: 1) citing a finding by a Department of Labor Administrative Review Board that "Congress plainly recognized that outside professional—accountants, law firms, contractors, agents, and the like—were complicit in, if not integral to, the shareholder fraud"; 2) stating that "the Senate Report demonstrates

that Congress was as focused on Enron's outside contractors in facilitating the fraud as it was on the actions of Enron's own officers"; 3) describing as "clear from the legislative record . . . Congress' understanding that outside professionals bear significant responsibility for reporting fraud by the public companies with whom they contract"; and 4) noting Congress' emphasis on the role of outside gatekeepers and the Senate Report's conclusion that "Congress must reconsider the incentive system that has been set up that encourages accountants and lawyers who come across fraud in their work to remain silent").

[8]*See* Coffee, Jr., The Political Economy of Dodd-Frank, Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated, 97 Cornell L. Rev. 1019 (2012). *See also* Linda Chatman Thomsen, Director, Division of Enforcement, SEC, Remarks Before the 27th Annual Ray Garrett, Jr. Corporate and Securities Law Institute 2007 (May 4, 2007).

[9]William Douglas' comments in 1934 make it clear that attorneys' role in financial crises is not a new phenomenon. ("It is true that the high priests of the legal profession were active agents in making high finance a master rather than a servant of the public interest. . .").

[10]*See* Gensler, Chair, SEC, Remarks Before the Aspen Security Forum (Aug. 3, 2021).

[11]*See* Gurbir Grewal, Director, Division of Enforcement, SEC, Remarks at SEC Speaks 2021 (Oct. 13, 2021) ("When gatekeepers are living up to their obligations, they serve as the first lines of defense against misconduct. . ."). *See also* Linda Chatman Thomsen, Director, Division of Enforcement, SEC, Remarks Before the 27th Annual Ray Garrett, Jr. Corporate and Securities Law Institute 2007 (May 4, 2007) ("But, and this is an important but, we cannot talk about the attorney-client privilege without talking about and embracing the reason for that protection. . .").

[12]*In the Matter of William R. Carter Charles J. Johnson*, 47 S.E.C. 471, Release No. 34, 17597, Release No. 17597, 22 S.E.C. Docket 292, 1981 WL 384414, at *3 (S.E.C. Release No. 1981).

[13]*Bandera Master Fund LP v. Boardwalk Pipeline Partners, LP*, 2021 WL 5267734, at *71 (Del. Ch. 2021), judgment entered, 2021 WL 5756146 (Del. Ch. 2021) ("[T]he record as a whole depicts a contrived effort to generate the client's desired result when the real-world facts would not support it.").

[14]*Bandera Master Fund LP v. Boardwalk Pipeline Partners, LP* at *2-3.

[15]*AB Stable VIII LLC v. Maps Hotels and Resorts One LLC*, 2020 WL 7024929, at *17 (Del. Ch. 2020), judgment entered, 2021 WL 426242 (Del. Ch. 2021) and aff'd, 268 A.3d 198 (Del. 2021).

[16]*In re Anthem-Cigna Merger Litigation*, 2020 WL 5106556, at *7 (Del. Ch. 2020), judgment entered, 2020 WL 5874649 (Del. Ch. 2020), aff'd, 251 A.3d 1015 (Del. 2021) and aff'd, 251 A.3d 1015 (Del. 2021).

[17]Sujeet Indap, Delaware Judge Sends Warning to Zealous Lawyers, Financial Times, Dec. 13, 2021.

[18]*See, e.g.*, Bank of America and Merrill Lynch: How did a Private Deal Turn into a Federal Bailout? Joint Hearing before the H. Comm. on Oversight and Gov't Reform and the Subcommittee on Domestic Policy, 100th Cong. 73 (June 11, 2009).

[19]*See, e.g.,* Modernization of Regulation S-K Items 101, 103, and 105, Securities Act Release 10668, at 9 (Aug. 8, 2019) ("We propose to revise Items 101(a) (description of the general development of the business), 101(c) (narrative description of the business), and 105 (risk factors) to emphasize a principles-based approach because the current disclosure requirements may not reflect what is material to every business."). This emphasis on principles-based rules made its way into the Commission's auditor independence rules as well. *See* Qualifications of Accountants, Securities Act Release No. 10876, at 8 (Oct. 16, 2020).

[20]*See, e.g.*, Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information, Securities Act Release No. 10890, at 6 (Nov. 19, 2020); Modernization of Regulation S-K Items 101, 103, and 105, Securities Act Release No. 10825, at 6 (Aug. 26, 2020). *See also* Business and Financial Disclosure Required by Regulation S-K, Securities Act Release No. 10064, at 33 (Apr. 13, 2016); Modernization of Property Disclosures for Mining Registrants, Securities Act Release No. 10570 (Oct. 31, 2018).

[21]*See* Commission Guidance Regarding Disclosure Related to Climate Change, Securities Act Release No. 9106, at 12; Regulation S-K Item 101(c)(2), 17 C.F.R. § 229.101 (requiring issuers to disclose, "to the extent material to an understanding of" the issuer's business, a description of the issuer's human capital resources).

[22]*See* Rosenfeld, The Transformation of the Attorney-Client Privilege: In Search of an Ideological Reconciliation of Individualism, the Adversary System, and the Corporate Clients SEC Disclosure Obligations, 33 Hastings L. J. 495, 537.

[23]Report of the New York City Bar Association Task Force on the Lawyer's Role in Corporate Governance, 62 Bus. Law. 427, 457 (Feb. 2007) ("NYC Bar Task Force").

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[24]*Bandera Master Fund*, supra note 13, at *71. Another academic has summed up the dynamic this way: "the lawyer in the market-driven firm faces a simple[] imperative: do whatever the client wants." Regan, Jr., Corporate Norms and Contemporary Law Firm Practice, 70 Geo. Wash. L. Rev. 931, 941 (2002) ("As devotion to the client becomes the defining value of the legal profession, concerns about craft autonomy and preserving the integrity of the legal system may begin to fade. . .").

[25]*See* Beck, The Legal Profession at the Crossroads: Who Will Write the Future Rules Governing the Conduct of Lawyers Representing Public Corporations?, 34 St. Mary's L.J. 873, 906 (2003) ("[E]ven if no disciplinary sanctions are imposed by the SEC, the specter of alleged disciplinary action by the SEC carries its own costs in terms of the damage to the attorney's reputation, regardless of the outcome.").

[26]Langevoort, Gatekeepers, Cultural Captives, or Knaves?: Corporate Lawyers Through Different Lenses, 88 Fordham L. Rev. 1683, 1692 (2020) ("The often subjective nature of the law also makes the slope more slippery. . ."). *See also* 60 Minutes: Anonymous, Inc. (CBS television broadcast Jan. 31, 2016) (showing a sting operation in which a number of lawyers displayed a willingness to aid an anonymous person with obtaining property such as New York real estate and yachts despite significant red flags that the funds were the proceeds of corruption or other wrongdoing).

[27]*See* Langevoort, supra note 26, at 1692 ("Lawyers covet being thought of as problem solvers for their clients, which puts pressure on them to live up to expectations as a matter of professional identity. . ."); NYC Bar Task Force, supra note 23, at 455 ("We also agree that there are pressures on lawyers to acquiesce in wrongful client conduct, reflecting in part the increased competitiveness of the profession. . ."); John C. Bogle, Founder and Former Chairman, Vanguard Group, Written Testimony for the PCAOB Public Hearing on the Concept Release on Auditor Independence and Audit Firm Resolution, excerpting from John C. Bogle, The Battle for the Soul of Capitalism (2005).

[28]Opinion and Order, *S.E.C. v. Bank of America Corp.*, Fed. Sec. L. Rep. (CCH) P 95614, 2010 WL 624581, at *5 (S.D. N.Y. 2010).

[29]A brief review of just the past few years reveals that individual charges in disclosure cases are exceedingly rare, including in those cases brought against a number of well-known companies. That is not to suggest that individual charges are warranted in all, or even most, of these cases, but the extreme scarcity of individual charges relative to instances of significant disclosure failings warrants close scrutiny.

[30]*See* Mary Jo White, Chair, SEC, Three Key Pressure Points in the Current Enforcement Environment (May 19, 2014).

[31]In fact, lawyer involvement in antifraud violations can operate as an obstacle to establishing individual liability even when we can't fully explore their role. This is the result of what is sometimes referred to as a "presence of counsel" defense—i.e., counsel was involved in some way in the underlying decision. While invoking a "reliance on counsel" defense requires a waiver of privilege, defendants asserting "presence of counsel" typically seek to avoid such a waiver, thus shielding the substance of any communications with the lawyer. The idea is that an individual could not have intended to violate the securities laws when that individual understood that lawyers were aware of the issue but did not intervene. While the validity of such an argument is dubious, Judge Rakoff addressed the issue head on when, in the midst of a trial in which the defendant was not invoking a reliance on counsel defense, defense counsel nonetheless sought to elicit testimony about whether a flip book for the relevant transaction had been sent to lawyers for review. *See SEC v. Stoker*, No. 11-CV-07388 (S.D.N.Y.). Judge Rakoff held that evidence that the defendant "believed that counsel had attested to the legal appropriateness of [] documents [was] just another way of saying reliance on counsel" without carrying the burden of such a defense. *Id.* Judge Rakoff stated that he was "troubled" by the questions and instructed defense counsel to no longer focus on counsel with their questions or to even mention the words "counsel" or "lawyer." *Id.* Nevertheless, the dubious "presence of counsel" defense remains an obstacle to establishing individual liability because some courts have shown a willingness to allow a defendant to introduce evidence that they relied on the advice of counsel without formally asserting the defense. *See, e.g., U.S. S.E.C. v. Snyder*, 292 Fed. Appx. 391, 406 (5th Cir. 2008) ("[R]eliance on the advice of counsel need not be a formal defense; it is simply evidence of good faith, a relevant consideration in evaluating a defendant's scienter.") (quoting *Howard v. S.E.C.*, 376 F.3d 1136, 1147, Fed. Sec. L. Rep. (CCH) P 92891 (D.C. Cir. 2004)); *See also Securities and Exchange Commission v. Sethi Petroleum, LLC*, 2017 WL 3386047, at *4 (E.D. Tex. 2017), aff'd, 910 F.3d 198, Fed. Sec. L. Rep. (CCH) P 100313 (5th Cir. 2018) ("Reliance on counsel is not a formal defense, but rather it is simply a means of demonstrating good faith and represents possible evidence of an absence of any intent to defraud") (citations and quotations omitted). Thus, lawyers can potentially shield individuals from

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liability merely by being present during discussions related to disclosure.

[32]*See* Johnstone, An Overview of the Legal Profession in the United States, How that Profession Recently has been Changing, and its Future Prospects, 26 Quinnipiac L. Rev. 737, 759; Kim, Lawyer Exceptionalism in the Gatekeeping Wars, 63 SMU L. Rev. 73, 86 n.86 (2010); Geoffrey C. Hazard, Jr. & Deborah L. Rhode, The Legal Profession: Responsibility and Regulation 484-87 (2d ed. 1988).

[33]*See* Koniak, When the Hurlyburly's Done: The Bar's Struggle with the SEC, 103 Colum. L. Rev. 1236 (2003).

[34]Guttenberg, Practicing Law in the Twenty-First Century in a Twentieth (Nineteenth) Century Straightjacket: Something Has to Give, 2012 Mich. St. L. Rev. 415, 471 (2012) ("The profession does little to punish incompetence and very few lawyers are disciplined for incompetence.").

[35]*See, e.g.*, SEC Obtains Final Judgment Against Lawyer Who Assisted Fraud, Litig. Release No. 25065 (Apr. 6, 2021) (announcing the settlement of a case alleging that outside counsel "aided and abetted" securities violations by drafting "sham consulting agreements" and failing to disclose to the board of directors "the true purpose of the agreements").

[36]*See, e.g., In re David Lubin*, Exchange Act Release No. 83897 (Aug. 21, 2018).

[37]*See, e.g.*, SEC Obtains Final Judgment Against Lawyer Who Assisted Fraud, supra note 35.

[38]*See, e.g.*, *In re Phillip R. Grogan*, Exchange Act Release No. 84197 (Sept. 19, 2018).

[39]*In re William R. Carter*, supra note 12, at *28.

[40]*See* Disciplinary Proceedings Involving Professionals Appearing or Practicing Before the Commission, Exchange Act Release No. 25893, 1988 WL 1000021, at *10 (July 7, 1988). *But see In re Scott G. Monson*, Investment Company Act Release No. 28323 (June 30, 2008); *In re Ira Weiss*, Exchange Act Release No. 52875 (Dec. 2, 2005) (finding that the conduct of bond counsel in issuing an unqualified opinion in a municipal securities offering "departed from the standard of reasonable prudence and was at least negligent," and charging him with violations of Securities Act Sections 17(a)(2) and (3)). *In re Steven Altman*, Exchange Act Release No. 63306 (Nov. 1, 2010) (finding that Altman's offer to help his client evade a subpoena or testify falsely violated certain provisions of the New York State Bar Association's disciplinary rules and charging Altman attorney under Rule 102(e) for those violations). The Commission stated in Altman, "That the Commission generally has refrained from initiating this type of proceeding does not deprive it of its authority to do so." Id.

[41]*See* Wald, Resizing the Rule of Professional Conduct, 27 Geo. J. Legal Ethics 227, 228 ("[T]he Rules are explicitly meant to be a one-size-fits-all model for all lawyers, irrespective of context."). Indeed, they have been described as having a "litigation bias." *Id.* at 245 ("Most Rules formally address lawyers broadly and not specifically litigators. But a close reading of the Comments often reveals the litigation bias inherent in the Rules."); Regan, Jr., Professional Responsibility and the Corporate Lawyer, 13 Geo. J. Legal Ethics 197, 201 (2000) ("A second disjunction between corporate practice and ethical rules is the fact that the latter traditionally have been formulated primarily with the litigator in mind. Yet transactional work, a staple of corporate practice, raises questions that do not always fit easily within this paradigm.").

[42]*See* Guttenberg, supra note 34, at 460-61.

[43]*See* Wald, supra note 41, at 245 ("In sum, because the majority of American lawyers are no longer solo practitioners, regulating nearly exclusively at the individual level makes little intuitive sense and is no longer self-explanatory. . .").

[44]*See* Preliminary Report of the American Bar Association Task Force on Corporate Responsibility (2003) ("These broad and aspirational principles, while of profound importance, do not afford a sufficient guide to the corporate lawyer confronted with aberrant conduct by corporate officers and insiders."); Model Rules of Prof'l Conduct r. 2.1: Advisor (Am. Bar Ass'n) ("In representing a client, a lawyer shall exercise independent professional judgment and render candid advice. In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation.").

[45]The provision is mandatory. *See* Sarbanes-Oxley Section 307, supra note 1.

[46]*See* Coffee, supra note 11, at 1301-1302. *See also* Cramton, Cohen, & Koniak, Legal and Ethical Duties of Lawyers After Sarbanes-Oxley, 49 Vill. L. Rev. 725, 789-790.

[47]*See* Steinberg, Ethical and Practical Lawyering with Vanishing Gatekeeper Liability, 88 Fordham L. Rev. 1575, 1583-84 (April 2020); Coffee, supra note 13, at 1044.

[48]*See* Model Rules of Prof'l Conduct r. 1.13: Organization as Client (Am. Bar Ass'n) ("(a) A lawyer

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employed or retained by an organization represents the organization acting through its duly authorized constituents."). *See also* 17 C.F.R. § 205.3(a).

[49]*See, e.g.*, Allison Herren Lee, Commissioner, SEC, Living in a Material World: Myths and Misconceptions About Materiality (May 24, 2021) (discussing the erroneous decision by Bank of America and its counsel not to disclose information about losses incurred by Merrill Lynch in advance of its acquisition, leading to substantial damages and penalties assessed against Bank of America). *See also* Wald, supra note 41, at 245 ("[R]ules could caution against too quick a deference to clients in circumstances in which clients' conduct is likely to impose a significant economic harm on third-parties and against boilerplates, and perhaps mandate disclosure in subsections 1.6(b)(2) and 1.6(b)(3) in appropriate circumstances . . .").

[50]*See Basic Inc. v. Levinson*, 485 U.S. 224, 236, 108 S. Ct. 978, 99 L. Ed. 2d 194, Fed. Sec. L. Rep. (CCH) P 93645, 24 Fed. R. Evid. Serv. 961, 10 Fed. R. Serv. 3d 308 (1988) ("Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be over inclusive or under inclusive."). *See also Litwin v. Blackstone Group, L.P.*, 634 F.3d 706, 716-17, Fed. Sec. L. Rep. (CCH) P 96033 (2d Cir. 2011) ("Materiality is an inherently fact-specific finding that is satisfied when a plaintiff alleges a statement or omission that a reasonable investor would have considered significant in making investment decisions.") (citations and internal quotation marks omitted).

[51]*See TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 450, 96 S. Ct. 2126, 48 L. Ed. 2d 757, Fed. Sec. L. Rep. (CCH) P 95615 (1976) ("The determination [of materiality] requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact.").

[52]*ECA, Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187, 197, Fed. Sec. L. Rep. (CCH) P 95263 (2d Cir. 2009) (citations and internal quotation marks omitted). *See also Azrielli v. Cohen Law Offices*, 21 F.3d 512, 518, Fed. Sec. L. Rep. (CCH) P 98150, R.I.C.O. Bus. Disp. Guide (CCH) P 8528 (2d Cir. 1994) ("A fraud claim may not properly be dismissed summarily on the ground that the alleged misstatements were not material unless they would have been so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance."); *Craftmatic Securities Litigation v. Kraftsow*, 890 F.2d 628, Fed. Sec. L. Rep. (CCH) P 94805, 15 Fed. R. Serv. 3d 948 (3d Cir. 1989) ("Only when the disclosures or omissions are so clearly unimportant that reasonable minds could not differ should the ultimate issue of materiality be decided as a matter of law."); *Shapiro v. UJB Financial Corp.*, 964 F.2d 272, 281 n. 11, Fed. Sec. L. Rep. (CCH) P 96651, 23 Fed. R. Serv. 3d 24 (3d Cir. 1992), as amended, (May 27, 1992), as amended, (May 27, 1992), ("Only if the alleged misrepresentations or omissions are so obviously unimportant to an investor that reasonable minds cannot differ on the question of materiality is it appropriate for the district court to rule that the allegations are in actionable as a matter of law."); *Ganino v. Citizens Utilities Co.*, 228 F.3d 154, 162, Fed. Sec. L. Rep. (CCH) P 91210 (2d Cir. 2000) (quoting *Goldman v. Belden*, 754 F.2d 1059, 1067, Fed. Sec. L. Rep. (CCH) P 91950, 1 Fed. R. Serv. 3d 85 (2d Cir. 1985)) ("We have held that . . . 'a complaint may not properly be dismissed . . . on the ground that the alleged misstatements or omissions are not material unless they are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance.' ").

[53]*See TSC Industries*, 426 U.S. at 448. See also Commission Guidance Regarding Disclosure Related to Climate Change, Securities Act Release No. 9106 (Feb. 2, 2010).

[54]*See Bandera Master Fund*, supra note 13, at *53.

[55]For example, following the 2010 Commission Guidance Regarding Disclosure Related to Climate Change, which emphasized the importance of materiality, research suggests that the quality of disclosure actually decreased. *See* Jim Coburn & Jackie Cook, Ceres, Cool Response: The SEC & Corporate Climate Change Reporting (2014). An overall reduction in the quality of climate disclosure can hardly be said to have been the goal of that guidance. *See also* Final Report of the Advisory Committee on Improvements to Financial Reporting (Aug. 1, 2008).

[56]*See* Pub. Co. Acct. Oversight Board, Quality Control Standards, Section 1000.08(d)—Continuing Professional Education of Audit Firm Personnel (requiring at least 20 hours of qualifying continuing professional education every year and at least 120 hours every three years).

[57]This is interrelated with the discussion above regarding reputational harm. A law firm may wish to avoid such harm if it knew of contrived or risky advice being provided by a member, but it usually does not. Instead, it is the relationship partner who knows, and that partner may face different incentives from the firm as a whole. A firm may gauge risk quite differently from

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an individual partner whose compensation may be disproportionately dependent on a specific client.

[58]*See* Pub. Co. Acct. Oversight Board, Quality Control Standards, Section 20.03 (requiring each firm to have a system of quality control, which is "broadly defined as a process to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality").

[59]*See* Coffee, supra note 6, at 1311-12.

[60]*Id.* at 1310 ("Few norms are less controversial among securities attorneys than that they should perform some due diligence in preparing prospectuses or other disclosure documents. Yet no SEC rule actually requires this."). Professor Coffee has also suggested that it may be appropriate for attorneys to certify to the accuracy of a client's disclosures in much the same way that an auditor must certify a client's financials. *See id.* at 1312. He recognizes, however, that the differences in the type and scope of work performed by auditors and attorneys would require a careful calibration of the actual certification required of attorneys. Id.

[61]*See* Pub. Co. Acct. Oversight Board, Auditing Standard 1105: Audit Evidence.

[62]Congress could consider an alternative approach. Just as it created the PCAOB to replace industry oversight of auditing standards in the aftermath of Enron, Congress could consider creating a similar vehicle for the creation and oversight of standards for lawyers practicing before the Commission. A so-called "PCAOB for lawyers" could result in a regulator singularly focused on promoting the integrity of legal advice in the securities markets, where attorneys serve as gatekeepers and their advice can affect the investing public more broadly. Regulating securities lawyers who advise public companies would involve complex tradeoffs that require a balancing of the interests of investors and the public against the need to protect the confidential relationship between client and counsel. A standalone entity may be in a position to better develop the necessary expertise to accomplish this mission. Moreover, such an organization could enhance compliance through a carefully crafted system of peer reviews, or even an inspections process. These ideas present thorny issues related to client confidentiality which could prove to be quite challenging. Still, they may be worthy of consideration as lessons learned during either peer reviews or inspections could in turn facilitate the development and ongoing maintenance of effective standards. In any event, such an approach is, of course, entirely at the discretion of Congress. And there are any number of complex issues to resolve, including funding, oversight, and, most importantly, protecting the attorney-client privilege and open communication between clients and lawyers. However, to the extent lawyers play a similar gatekeeping function to auditors, the PCAOB model could be duplicated (and possibly improved upon) for the legal profession.

[63]The American Bar Association, among others, has argued that "subjecting lawyers to discipline by the SEC for negligence would have a chilling effect on the ability of lawyers to represent their client's interests zealously and independently." *See* Letter from Alfred P. Carlton, President, ABA to Harvey L. Pitt, Chairman, SEC (Dec. 18, 2002). I am, of course, cognizant of the complexity and sensitivity inherent in this area. Nevertheless, much as the Commission must weigh similar concerns in the context of Chief Compliance Officers, I am confident that, with the benefit of robust public engagement, the Commission is well-situated to craft rules designed to elevate—not disrupt—attorney conduct as it relates to the representation of issuers. And Congress has tasked us to do just that.

[64]*See* Thomsen, supra note 11.

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SEC/SRO UPDATE: SEC PROPOSES CYBERSECURITY RULES; SEC PROPOSES SHORT SALE DISCLOSURE RULE; SEC PROPOSES CYBERSECURITY RISK MANAGEMENT RULES AND AMENDMENTS FOR REGISTERED INVESTMENT ADVISERS AND FUNDS; SEC CHARGES INFINITY Q FOUNDER WITH ORCHESTRATING MASSIVE VALUATION FRAUD

By John A. Elofson and Stephanie G. Danner

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SEC Proposes Cybersecurity Rules

On March 9, 2022, the SEC proposed rule amendments intended to enhance and standardize rules regarding disclosure of cybersecurity risk management and related topics.[1] SEC Chair Gary Gensler described the purpose of the rules by stating that "cybersecurity is an emerging risk with which public issuers increasingly must contend. Investors want to know more about how issuers are managing those growing risks. A lot of issuers already provide cybersecurity disclosure to investors. I think companies and investors alike would benefit if this information were required in a consistent, comparable, and decision-useful manner."[2]

Key elements of the proposed rules are requirements for companies to provide:

- *Current reporting about material cybersecurity incidents*: The rules would add a new item in Form 8-K pursuant to which a company would have to disclose any material cybersecurity incidents within four days of determining that such an incident occurred. Required disclosures would include when the incident was discovered, the scope of the incident, whether any data was stolen, altered, accessed, or used for any unauthorized purpose, the effect of the incident on the company's operations and whether the registrant has remediated the incident.

- *Periodic disclosure about cybersecurity policies*: Form 10-K would be amended to require (i) disclosure of a company's policies and procedures for identifying and managing cybersecurity risks, (ii) its "cybersecurity governance," including the board of directors' oversight role regarding cybersecurity risks and how those risks and related issues are communicated to the board, and (iii) management's role, and relevant expertise, in assessing and managing cybersecurity-related risks and implementing related policies, procedures and strategies. Relatedly, Regulation S-K would be amended to require disclosure of information regarding the cybersecurity expertise, if any, of members of the board of directors. The description of policies and procedures would include whether the company engages third parties in connection with its cybersecurity efforts, its policies regarding oversight of vendors and other counterparties, and whether and how previous incidents have informed its policies.

- *Updates regarding previously-reported cybersecurity incidents*: The rules would amend Forms 10-K and 10-Q to require updated disclosure regarding previously reported cybersecurity incidents, and when a series of undisclosed immaterial incidents have become collectively material. The updated disclosure would include, but not be limited to, the company's remediation

efforts, any existing or potential material effects of the incident, and any related changes to the company's policies and procedures.

The SEC has previously issued interpretive guidance regarding how its existing rules may require cybersecurity-related disclosures—which appear most frequently in the "risk factors" section of SEC filings—but the proposed rules would be the first to address cybersecurity issues specifically.

SEC Proposes Short Sale Disclosure Rule

On February 25, 2022, the SEC proposed a new rule under the Securities Exchange Act of 1934, as amended, to require institutional investment managers exercising investment discretion over short positions meeting specified thresholds to report on a proposed Form SHO information relating to short positions and certain daily activity affecting such positions.[3] SEC Chair Gary Gensler stated that "[p]roposed Rule 13f-2 would make aggregate data about large short positions available to the public for individual equity securities. This would provide the public and market participants with more visibility into the behavior of large short sellers."[4] The proposed rule comes on the heels of highly-publicized short selling events involving so-called "meme stocks" such as GameStop that resulted in an unusual level of public interest in short selling strategies and scrutiny of the SEC's oversight by prominent politicians across the political spectrum.[5]

The SEC's proposing release states that short sales—sales of securities that the seller does not own—can provide important benefits to the market by providing hedging options and improving pricing efficiency, but can also be used for manipulative purposes. Existing SEC Regulation SHO imposes certain requirements in connection with short sales, and in particular addresses the risk that the short seller will be unable to obtain the security subject to the sale by the time of settlement. But proposed Rule 13f-2 would go beyond existing requirements to provide greater public transparency relating to short selling activity. Among other benefits, the SEC believes that greater transparency may facilitate regulatory oversight of potentially manipulative activity such as "short squeeze" and "short and distort" schemes. At the same time, according to the SEC, public disclosure of individual short positions could unduly chill short selling and have other unintended consequences. Accordingly, the proposed rule attempts to strike a balance between these competing considerations by facilitating the public disclosure of short selling data on an aggregated rather than an individual basis.

Under the rule, investment managers meeting a specified reporting threshold would be required to file a Form SHO with the SEC within 14 calendar days after the end of a month. The identity of the managers reporting on Form SHO would not be made public and would be treated as confidential. The reporting threshold would be set at (i) for reporting issuers, a gross short position of $10 million or more or a position covering 2.5% or more of the class of security outstanding or (ii) for non-reporting issuers, a gross short position of $500,000 or more. The calculations would not take into account derivative or long positions in the same security. The SEC would then, on a delayed basis, publish aggregated information derived from the reported data, including the number of shares and dollar value of the aggregated gross short positions and a summary of reported hedging information.

Relatedly, the SEC is proposing a new rule under Regulation SHO pursuant to which a broker-dealer would be obligated to mark a purchase order as "buy to cover" if the purchaser has a gross short position in the security in the account for which the purchase is being made. The SEC believes that this requirement would allow it to better understand what it calls the "lifecycle" of short sales by identifying trades that close out short positions. The increased transparency is expected to enhance the SEC's ability to understand and police potentially manipulative trading strategies.

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SEC Proposes Cybersecurity Risk Management Rules and Amendments for Registered Investment Advisers and Funds

On February 9, 2022, the SEC voted to propose rules related to cybersecurity risk management for registered investment advisers, and registered investment companies and business development companies (collectively, "funds"), as well as amendments to certain rules that govern investment adviser and fund disclosures.[6]

According to the SEC's associated press release, the proposed rules and amendments "are designed to enhance cybersecurity preparedness and could improve investor confidence in the resiliency of advisers and funds against cybersecurity threats and attacks."[7] The proposal includes new Rule 206(4)-9 under the Investment Advisers Act of 1940 (the "Advisers Act"), and new Rule 38a-2 under the Investment Company Act of 1940 (the "Investment Company Act") (proposed Rules 206(4)-9 and 38a-2 collectively, the "proposed cybersecurity risk management rules").[8]

Under the proposed cybersecurity risk management rules:

- advisers and funds would be required to adopt and implement written cybersecurity policies and procedures designed to address cybersecurity risks that could harm advisory clients and fund investors;
- Form ADV Part 2A would be amended to require disclosure of cybersecurity risks and incidents to an adviser's clients and prospective clients;
- Form N-1A, Form N-2, Form N-3, N-4, Form N-6, Form N-8B-2, and Form S-6 would be amended to require funds to include a description of any significant fund cybersecurity incidents that have occurred in the last two fiscal years in the fund's registration statements;
- Rule 204-2 of the Advisers Act would be amended to require advisers to maintain certain records related to the proposed cybersecurity risk management rules and the occurrence of cybersecurity incidents;
- funds would be required to maintain copies of its cybersecurity policies and procedures and other related records specified under proposed Rule 38a-2 of the Investment Company Act; and
- advisers would be required to report significant cybersecurity incidents affecting the adviser or its fund or private fund clients on a new confidential Form ADV-C.

The public comment period will remain open until April 11, 2022.

SEC Charges Infinity Q Founder with Orchestrating Massive Valuation Fraud

On February 17, 2022, the SEC charged James Velissaris, the former Chief Investment Officer (the "CIO") and founder of Infinity Q Capital Management ("Infinity") with allegedly overvaluing assets by more than $1 billion.[9]

The SEC's complaint (the "Complaint")[10] alleges that between 2017 to February 2021, the CIO "engaged in a fraudulent scheme to overvalue assets held by the Infinity Q Diversified Alpha mutual fund and the Infinity Q Volatility Alpha private fund"[11] by "altering inputs and manipulating the code of a third-party pricing service used to value the funds' assets."[12] The SEC also alleges that the CIO collected more than $26 million in profit distributions through the fraudulent conduct and without disclosing his activities to investors.[13]

According to the SEC's accompanying press release (the "Press Release"), in February 2021, the CIO was removed from his role with Infinity Q after SEC Staff confronted the firm with information suggesting that the CIO had been adjusting the third-party pricing model.[14]

The Complaint was filed in the U.S. District Court

for the Southern District of New York and charges the CIO with violating antifraud and other provisions of federal securities laws. The Complaint seeks permanent injunctive relief, return of allegedly ill-gotten gains, and civil penalties. The SEC also seeks to bar the CIO from serving as a public company officer and director. In parallel actions, the U.S. Attorney's Office for the Southern District of New York announced on February 17, 2022, criminal charges against the CIO, and the Commodity Futures Trading Commission ("CFTC") announced civil charges against him.

ENDNOTES:

[1]See https://www.sec.gov/rules/proposed/2022/33-11038.pdf.

[2]See https://www.sec.gov/news/press-release/2022-39.

[3]*See* https://www.sec.gov/rules/proposed/2022/34-94313.pdf.

[4]*See* https://www.sec.gov/news/press-release/2022-32.

[5]*See, e.g.*, Trading Curbs Reverse GameStop Rally, Angering Upstart Traders, *N.Y. Times*, Jan. 30, 2021, *available at*: https://www.nytimes.com/2021/01/28/business/gamestop-robinhood.html.

[6]*See* https://www.sec.gov/news/press-release/2022-20.

[7]SEC Press Release 2022-20.

[8]*See* https://www.sec.gov/files/33-11028-fact-sheet.pdf.

[9]*See* https://www.sec.gov/news/press-release/2022-29.

[10]*See* https://www.sec.gov/litigation/complaints/2022/comp-pr2022-29.pdf.

[11]*Supra* Note 9.

[12]*Supra* Note 9.

[13]*Supra* Note 9.

[14]*Supra* Note 9.

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FROM THE EDITOR

When the World Wakes Up From History

Russia's invasion of Ukraine, which began on February 24 and which continues as of the press time of this issue, has resulted in a near-unprecedented show of speed and resolve on part of the West, from the U.S. to even countries who typically keep neutral during geopolitical events (e.g., Switzerland, Finland).

Among the most visible and dramatic responses have been ongoing waves of actions intended to punish and restrict Russia in the global financial markets. As many observers have noted, it took less than a month to essentially push Russia back to where it was in 1990—economically isolated from the West, with its internal economy in tatters.

Actions taken so far include the severing of connections to the U.S. financial system (and those of the UK and European Union) for Russia's largest financial institution, Sberbank, including 25 subsidiaries, by imposing correspondent and payable-through account sanctions. Full blocking sanctions were also imposed on Russia's VTB Bank and on other major Russian financial institutions, including Bank Otkritie, Sovcombank OJSC, and Novikombank.

The U.S., the EU, and G7 countries have also imposed massive debt and equity restrictions on critical major Russian enterprises and entities, including AlfaBank, Credit Bank of Moscow, Gazprombank, Russian Agricultural Bank, Gazprom, Transneft, Rostelecom, RusHydro, Alrosa, Sovcomflot, and Russian Railways.

The Department of the Treasury, through new guidance, now requires all U.S. persons to comply with sanctions regulations regardless of whether a transaction is denominated in traditional fiat currency or virtual currency. Treasury in mid-March said it would be "closely monitoring any efforts to circumvent or violate Russia-related sanctions, including through the use of virtual currency."

What's interesting is how little, relatively, the effects of this coordinated global economic blockade of a major country has been so far on Wall Street. The situation reflects that many banks in the past decade have already substantially limited their exposure to Russian assets. Further, the muted effects so far on trading and investment indicates that Russia has failed to become a player with great leverage in international finance, barring the energy sector.

Whatever the end result of the Ukraine war—and with hope, it ends far sooner than later—one of its many repercussions will be to show how devastating 21st Century economic warfare can be when the world's major financial powers unite. The world is a greatly different place than it was at the start of 2022.

Chris O'Leary

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