THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 56 No. 12 June 28, 2023

SEC REGULATORY AND ENFORCEMENT DEVELOPMENTS: WHAT BOARDS OF DIRECTORS AND AUDIT COMMITTEES NEED TO KNOW

In this article, the authors discuss SEC regulatory and enforcement developments that should be top-of-mind for boards of directors and audit committees. They describe how SEC leadership is pairing the most ambitious rulemaking agenda in decades with an active enforcement docket, and how those two things sometimes operate to reinforce one another.

By Jennifer S. Leete, Elad Roisman, and Lisa M. Kohl *

Over the last year, the SEC has engaged in rulemaking at a frenetic pace while also bringing a significant number of enforcement actions, many of which relate to the subject of new proposed or final rules. In 2022 alone, the SEC voted on more than 40 rules, roughly 30 of which were new rule proposals.[1] The rulemaking activity is so significant that it even drew the attention of the SEC's Office of the Inspector General, which in its annual statement on the SEC's Management and Performance Challenges reported that some SEC managers raised concerns about risks and difficulties managing resources because of the increase in rulemaking activities.[2] If the agency's own staff is having trouble keeping up with the pace of rulemaking, then surely it will be a significant challenge for boards of directors and audit committees to keep pace, given the competing demands on their time.

Nevertheless, keeping up with rulemaking developments will be essential, not just for the obvious reason that new rules must be followed, but also because rulemaking often goes hand-in-hand with enforcement and disclosure review priorities. This is evident in a number of recent enforcement actions that relate to the subject of new proposed or final rules, including topics

[1] Office of Information and Regulatory Affairs, *Office of Management and Budget Regulatory Flex Agenda* (January 2023), https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST¤tPub=true&agencyCode=&showStage=active&agencyCd=3235&csrf_token=E784004B7179D0CF16B65397A32EAC41CF37A3FA3A8FA370CF146938B89DEB92F810C80E78EF46E3429CE082F5EF33869696.

[2] SEC, *The Inspector General's Statement on the SEC's Management and Performance Challenges*, 3 (October 13, 2022), https://www.sec.gov/files/inspector-generals-statement-sec-mgmt-and-perf-challenges-october-2022.pdf.

* *JENNIFER S. LEETE and ELAD ROISMAN are partners and LISA M. KOHL is of counsel in the Washington, DC offices of Cravath, Swaine & Moore LLP. Mr. Roisman is admitted only in New York and Ms. Kohl is admitted only in Virginia. They are practicing under the supervision of D.C. Bar Members. The authors' e-mail addresses are jleete@cravath.com, eroisman@cravath.com, and lkohl@cravath.com.*

RSCR Publications LLC Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call 609-683-4450; fax 609-683-7291; write Subscriber Services, RSCR Publications, PO Box 585, Kingston NJ 08528; e-mail cri.customer.service@comcast.net; or visit our website at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail sarah.s.himmelfarb@gmail.com. To submit a manuscript for publication contact Ms. Himmelfarb. Copyright © 2023 by RSCR Publications LLC. ISSN: 0884-2426. All rights reserved. Reproduction in whole or in part prohibited except by permission. For permission, contact Copyright Clearance Center at www.copyright.com. *The Review of Securities & Commodities Regulation* does not guarantee the accuracy, adequacy, or completeness of any information and is not responsible for any errors or omissions, or for the results obtained from the use of such information.

like erroneously awarded compensation ("clawbacks"),[3] cybersecurity,[4] Rule 10b5-1 trading plans,[5] and climate disclosures.[6]

These actions are significant for boards of directors (and particularly audit committees) because, in some recent rule proposals and enforcement actions, the SEC and its staff have focused heavily on the role of the board, and the policies and procedures the board uses to make decisions, manage risk, and determine disclosures. For example, certain rules that the SEC proposed over the last year would require additional disclosure about companies' policies and procedures for managing risk, and the boards' role in implementing and overseeing such policies and related risks, which will likely require companies to adopt new or more rigorous controls and related policies and procedures. Gurbir Grewal, the Director of the SEC's Division of Enforcement, has also spoken publicly about the need for public companies to step up their game. In prepared testimony before Congress, he declared that "[p]ublic companies and other market participants . . . need to think rigorously about how their specific business models and products interact with both emerging risks and their obligations under the federal securities laws, and tailor their internal controls and compliance practices and policies accordingly."[7] He also cautioned that companies "cannot rely on check-the-box compliance policies, but should consider, where appropriate, developing bespoke policies tailored to their businesses and the associated risks."

Additional evidence of the SEC's focus on board oversight, governance, and controls can be seen in all manner of SEC enforcement cases. For example, the SEC recently issued a settled order finding, among other things, that Activision Blizzard had inadequate disclosure controls in place to ensure that management understood the volume and substance of employee complaints about workplace misconduct despite having made risk factor disclosures pertaining to its workforce. Notably, the SEC did not allege those disclosures to be misleading.[8] In many enforcement actions, the SEC is also demanding increasingly high penalties and bespoke remedies to address internal controls — over financial reporting or otherwise — that it deems to be deficient.

The following discussion describes recent rulemaking and enforcement activity relating to clawbacks, cybersecurity, Rule 10b5-1 plans, and ESG. The discussion is not intended to provide a comprehensive understanding of each new rule. Rather, it illustrates how rulemaking and enforcement efforts reinforce one another, and aims to provide context for audit committees and boards more generally as they navigate the expanding SEC landscape.

CLAWBACKS OF EXECUTIVE COMPENSATION

Rulemaking

Current SEC leadership is very focused on executive compensation, including clawbacks. In late 2022, the SEC adopted final rules regarding clawbacks of the

[3] SEC, *Listing Standards for Recovery of Erroneously Awarded Compensation* (proposed October 26, 2022), https://www.sec.gov/rules/final/2022/33-11126.pdf.

[4] SEC, *Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure* (proposed March 9, 2022), https://www.sec.gov/rules/proposed/2022/33-11038.pdf.

[5] SEC, *Insider Trading Arrangements and Related Disclosures* (finalized December 14, 2022), https://www.sec.gov/rules/final/2022/33-11138.pdf.

[6] SEC, *The Enhancement and Standardization of Climate-Related Disclosures for Investors* (proposed May 9, 2022), https://www.sec.gov/rules/proposed/2022/33-11042.pdf.

[7] Director of SEC Division of Enforcement, Gurbir S. Grewal, *Testimony on "Oversight of the SEC's Division of Enforcement" Before the United States House of Representatives Committee on Financial Services Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets* (July 21, 2022),

footnote continued from previous column…

https://www.sec.gov/news/statement/grewal-statement-house-testimony-071922.

[8] *Activision Blizzard, Inc.*, Securities Act Rel. No. 96796 (February 3, 2023).

erroneously awarded compensation.[9] The rules direct national securities exchanges (e.g., NYSE and NASDAQ) to adopt listing standards that require their listed companies to adopt and disclose procedures to recoup incentive-based compensation from executive officers when there is an accounting restatement.[10] The new rule also specifies the group of individuals whose compensation potentially must be returned to the company to include officers as defined in Rule 16a-1(f), which is an expansion from the Sarbanes-Oxley Act's provision to clawback the compensation of a company's chief executive and chief financial officers. This means that the compensation of a company's chief executive officer ("CEO"), president, chief financial officer ("CFO"), principal accounting officer, and any vice president in charge of a principal business unit will all be subject to mandatory clawback by the company on a pre-tax basis. And clawbacks will be mandated regardless of whether the executive officer bears any responsibility for, or is at fault for, the error(s) leading to a restatement. The new rule will require that a clawback be triggered if the company is required to prepare an accounting restatement, including to correct an error that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period (so, for both so-called "Big R" and "little r" restatements).

Enforcement Activity

Since Section 304 of the Sarbanes-Oxley Act became law more than 20 years ago, the SEC has had the authority to require CEOs and CFOs of public companies to return the incentive-based compensation they received for any period in which their employer was required to prepare an accounting restatement due to misconduct. This provision applies regardless of whether a CEO or CFO was involved in the misconduct, but historically the SEC has generally limited its enforcement of this provision to situations where the CEO and CFO were found culpable. Only on rare occasions has the SEC insisted that CEOs and CFOs reimburse the issuer when they were not actually involved in the misconduct.[11]

In 2022, the SEC signaled a change to this historical policy with two settled cases relating to enforcement actions with Synchronoss Technologies Inc. and Granite Construction.[12] In *Synchronoss,* the company's founder and CEO was charged only with violating Section 304 (and not the underlying misconduct), but agreed to reimburse the company for more than $1.3 million in stock sale profits and bonuses, and to return previously granted shares of company stock.[13] In the press release announcing the settlement, Director Grewal said, "[t]oday's action should also put public company executives on notice that even when they are not charged with having a role in the misconduct at issue, we will still pursue clawbacks of compensation under SOX 304 to ensure they do not financially benefit from their company's improper accounting."[14] In *Granite Construction*, the CEO and two former CFOs were also charged only with violations of Section 304 (and not the underlying misconduct), and they agreed to return their bonuses and compensation to Granite. The settlement orders with each of them state, "Section 304 does not require that a chief executive officer or chief financial officer engage in, or be aware of, misconduct to trigger the reimbursement requirement."[15] Director Grewal was quite pointed in his statement in the press release announcing this case: "[e]xecutives should be on notice that we view SOX 304 as the broad authority in seeking

---

[9] SEC, *Listing Standards for Recovery of Erroneously Awarded Compensation*, Rel. Nos. 33-11126; 34-96159 (January 27, 2023), https://www.sec.gov/rules/final/2022/33-11126.pdf.

[10] In February 2023, the exchanges proposed listing standards related to the recovery of the erroneously awarded compensation as required by Exchange Act Rule 10D-1. We expect companies will be required to adopt clawback policies consistent with exchange rules as soon as early August 2023.

[11] For example, *see SEC Seeks Return of $4 million in Bonuses and Stock Sale Profits from Former CEO of CSK Auto Corp.*, Lit. Rel. No. 21149A (July 23, 2009) ("The SEC's complaint does not allege that Jenkins engaged in the fraudulent conduct.").

[12] *Stephen G. Waldis*, Exchange Act Rel. No. 95054 (June 7, 2022); *Jigisha Desai*, Exchange Act Rel. No. 95611 (August 25, 2022); *Laurel Krzeminski*, Exchange Act Rel. No. 95610 (August 25, 2022); *James H. Roberts*, Exchange Act Rel. No. 95609 (August 25, 2022).

[13] *Stephen G. Waldis*, Exchange Act Rel. No. 95054, 5 (June 7, 2022).

[14] SEC, *SEC Charges New Jersey Software Company and Senior Employees with Accountinig-Related Misconduct* (June 7, 2022), https://www.sec.gov/news/press-release/2022-101.

[15] *Jigisha Desai*, Exchange Act Rel. No. 95611, 4 (August 25, 2022); *Laurel Krzeminski*, Exchange Act Rel. No. 95610, 4 (August 25, 2022); *James H. Roberts*, Exchange Act Rel. No. 95609, 4 (August 25, 2022).

all forms of compensation that should be reimbursed to the company."[16]

The SEC's focus on erroneously awarded executive compensation is not just with respect to the compensated individuals, but also on boards or board committees responsible for awarding compensation. In a recent enforcement action, McDonald's Corporation settled with the SEC charges that it violated Section 14(a) of the Securities Exchange Act by not disclosing that the board exercised discretion in allowing its former CEO to retain certain executive compensation. In this case, McDonald's dismissed its CEO for violating its Standards of Business Conduct in connection with a relationship he had with an employee, but negotiated a separation agreement with the CEO that permitted him to retain certain compensation. McDonald's accurately disclosed the terms of his separation agreement but did not disclose that the board had exercised discretion in determining his termination to be "without cause" and allowing him to retain compensation. Upon finding out that the CEO lied to internal investigators and omitted facts from company disclosures he reviewed, McDonald's sued him in the Delaware Court of Chancery to recoup his compensation and was successful in doing so. The SEC pursued the former CEO for various violations. It also charged the company for not disclosing that the Board had exercised discretion in determining how he was terminated, but notably it did not sanction the company with any penalty. The order noted McDonald's "affirmative remedial steps to recover value for its shareholders by suing [the CEO] . . ., seeking and ultimately recovering the compensation [the CEO] received," as well as its cooperation with the SEC staff's investigation.[17]

These SEC actions are also consistent with the approach of the Department of Justice, which has recently emphasized the importance of companies recovering executive compensation. In a speech announcing new DOJ policy, Deputy Attorney General Lisa Monaco said, "[T]he Department will encourage companies to shape financial compensation around promoting compliance and avoiding improperly risky behavior. These steps include rewarding companies that claw back compensation from employees, managers, and executives when misconduct happens. No one should have a financial interest to look the other way or ignore red flags. Corporate wrongdoers — rather than shareholders — should bear the consequences of misconduct."[18]

CYBERSECURITY

Boards of directors and audit committees must also be cognizant of the SEC's rulemaking and enforcement activity in the cybersecurity space. Several recent cases signal the SEC's continued interest in this area, and the SEC is expected to finalize its proposed cybersecurity rules in 2023.[19] For public companies, the issue is twofold: one, does the company have sufficient controls in place to ensure that cybersecurity incidents are escalated and evaluated appropriately and two, are public companies making timely disclosure of material cybersecurity events? Taking the proposed cybersecurity rulemaking and enforcement actions together, along with continued investor interest, boards of directors and audit committees would be well-served to work now to ensure that internal controls around cybersecurity are robust and that sufficient resources are dedicated to understanding and implementing potential new obligations.

Rulemaking

In March 2022, the SEC proposed new rules for public companies related to disclosures of cybersecurity incidents, risk management, strategy, and governance.[20]

[16] SEC, *SEC Charges Infrastructure Company Granite Construction and Former Executive with Financial Reporting Fraud* (August 25, 2022), https://www.sec.gov/news/press-release/2022-150.

[17] *Stephen J. Easterbrook and McDonald's Corporation*, Securities Act Rel. No. 11144, Exchange Act Rel. No. 96610 (January 9, 2023).

[18] U.S. Department of Justice, *Deputy Attorney General Lisa O. Monaco Delivers Remarks on Corporate Criminal Enforcement* (September 15, 2022), https://www.justice.gov/opa/speech/deputy-attorney-general-lisa-o-monaco-delivers-remarks-corporate-criminal-enforcement.

[19] Office of Information and Regulatory Affairs, *Office of Management and Budget View Rule on Cybersecurity Risk Governance* (Fall 2022), https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202210&RIN=3235-AN08.

[20] *See* SEC, *Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure*, Rel. Nos. 33-11038; 34-94382 (May 9, 2022) https://www.sec.gov/rules/proposed/2022/33-11038.pdf. This proposal builds on a 2018 Commission interpretive release that outlines the Commission's views with respect to cybersecurity disclosure requirements under the federal securities laws and remains valid Commission guidance. *See* SEC, *Commission Statement and Guidance on Public Company Cybersecurity Disclosures*, Rel. Nos. 33-10459; 34-82746 (February 26, 2018) https://www.sec.gov/rules/interp/2018/33-10459.pdf.

The proposed rules would add a number of new annual cybersecurity-related disclosure requirements, as well as new incident reporting obligations. Among other things, the proposed rules would amend Form 8-K to require issuers to disclose a material cybersecurity incident within four business days of determining that such an incident has occurred. Importantly, as proposed, the rule's trigger for disclosure is not the occurrence of a cybersecurity incident, but rather the determination that the incident was material. This means that a company's process for reporting cybersecurity incidents up the chain, and to the appropriate disclosure and reporting personnel, will be critical if the final rule contains a similar trigger. Companies would also be required to comply with new annual requirements to, among other things, disclose information about the company's policies and procedures for the identification and management of risks from cybersecurity threats and whether management considers cybersecurity as part of its business strategy and capital allocation, the board's oversight of cybersecurity risk, and its expertise regarding cybersecurity, including the name(s) of directors with expertise, as well as disclosures about management's role and expertise in addressing and managing cybersecurity risk.[21]

Enforcement Activity

Although the most recent cases in this area have involved regulated investment advisers rather than operating companies, two cases the SEC settled in 2021 illustrate the risks for public companies and preview important things those companies should consider if the proposed rules are finalized. In June 2021, the SEC issued a settled order finding that First American Financial Corporation violated Rule 13a-15(a)[22] and paid a penalty of $487,616.[23] In May 2019, a cybersecurity journalist informed the company of a vulnerability to one of its applications that exposed more than 800 million documents that contained sensitive personal information such as social security numbers. After the journalist's article was published, the company furnished a Form 8-K relating to the vulnerability. However, several months earlier, First American's information security personnel had identified the vulnerability, and the information had not reached the company's senior executives responsible for public disclosures. Accordingly, the senior executives responsible for the company's May 2019 public statements did not previously evaluate whether to disclose the company's prior awareness of, or actions related to, the vulnerability. Furthermore, the company failed to remediate the vulnerability in accordance with its policies. These failures led to the penalty.

In August 2021, the SEC issued another settled order in the cybersecurity space against Pearson PLC, a UK-based educational services company.[24] According to the SEC Order, Pearson made material misstatements and omissions regarding a 2018 cyber intrusion in which the records of several million students were stolen. In a Form 6-K that Pearson furnished to report its interim results, the company included a statement in the "Principal risks and uncertainties" section stating that a "[r]isk of a data privacy incident or other failure to comply with data privacy regulations and standards and/or a weakness in information security. . . could result in a major data privacy or confidentiality breach. . ."[25] However, the company had previously been made aware of a serious breach of its systems and that a sophisticated threat actor had obtained data showing sensitive information including usernames, passwords, and dates of birth. A reporter contacted the company regarding a soon-to-be-published article describing the breach and the company provided a media statement that it later posted on its website, but which the SEC order says was misleading in several respects. The SEC order found Pearson made material misstatements regarding the types of personal information stolen and claims the company had protections in place. The SEC order also found that Pearson had deficient disclosure controls and violated Sections 17(a)(2) and (3) of the Securities Act, and Sections 13(a) and Rules 12b-20, 13a-15(a), and 13a-16. Despite an explicit recognition that it cooperated with SEC staff during the investigation, Pearson was ordered to pay a $1 million penalty.

RULE 10B5-1 PLANS

Rule 10b5-1 provides an affirmative defense to insider trading charges for company insiders who trade

---

[21] SEC, *SEC Fact Sheet, Public Company Cybersecurity; Proposed Rules* https://www.sec.gov/files/33-11038-fact-sheet.pdf.

[22] Rule 13a-15(a) requires issuers to maintain disclosure controls and procedures designed to ensure that information required to be disclosed is recorded, processed, summarized, and reported within the time periods specified in the Commission's rules and forms.

[23] *First American Financial Corp.*, Exchange Act Rel. No. 92176 (June 14, 2021).

[24] *Pearson plc*, Securities Act Rel. No. 10963, Exchange Act Rel. 92676 (August 16, 2021).

[25] *Id.*

pursuant to pre-established trading plans that meet certain criteria. Since shortly after the rule's adoption in 2000, the affirmative defense has come under increasing scrutiny from academics, institutional investors, and other observers because of perceived loopholes in the rule, such as allowing insiders to trade immediately following the adoption of a Rule 10b5-1 plan. Late last year, the SEC adopted amendments to Rule 10b5-1 that add several new conditions to the use of the affirmative defense. The new rules, combined with recent enforcement cases involving insiders trading pursuant to Rule 10b5-1 plans, indicate this will be a continued area of focus for the staff and should be top-of-mind for boards of directors.

Rulemaking

The SEC adopted amendments to Rule 10b5-1 in December 2022.[26] Among other changes, the amendments added a number of new requirements to Rule 10b5-1 that significantly limit the availability of the affirmative defense provided by that rule to violations of Section 10(b) and Rule 10b-5 thereunder. In order to avail themselves of the affirmative defense to insider trading, officers and directors must include in any 10b5-1 plan a cooling-off period for trading extending to the later of 90 days after adoption of the plan or two days after the company's Form 10-Q or 10-K is filed. Additionally, there is a similar 30-day cooling-off period for all employees and insiders other than directors and officers. When adopting a Rule 10b5-1 plan, insiders must now also certify that they are not aware of any material nonpublic information. With limited exceptions, insiders may not have overlapping plans or maintain more than one 10b5-1 plan at a time.

In addition, the new rules create new Item 408 of Regulation S-K, which requires companies to disclose information about officers' and directors' Rule 10b5-1 plans that were entered into during the current reporting period, and file the company's policies and procedures regarding insider trading as an exhibit to the Form 10-K. The SEC also established new Item 402(x) of Regulation S-K, which requires issuers to include in their Forms 10-K a new table that sets out any grants of certain equity awards close in time to the release of material nonpublic information. The new annual disclosure requirements will not be effective until Form 10-Ks are filed in 2025 but boards are well-advised to understand the rules and start preparing now.

[26] SEC, *Insider Trading Arrangements and Related Disclosures*, Rel. Nos. 33-11138; 34-96492 (December 14, 2022), https://www.sec.gov/rules/final/2022/33-11138.pdf.

Enforcement

The policies and priorities that led the SEC to adopt these new rules also motivate the Commission's Enforcement activities in this space, and the Commission has recently pursued a couple of insider trading cases involving the use of Rule 10b5-1 plans. In March 2023, the SEC charged the Executive Chairman of Ontrak, Inc. with insider trading for allegedly selling more than $20 million of Ontrak stock pursuant to Rule 10b5-1 plans that were established while he was in possession of material nonpublic information.[27] This case is particularly notable because the Department of Justice simultaneously announced parallel criminal charges, representing the first time that the DOJ has brought criminal insider trading charges based exclusively on an executive's use of Rule 10b5-1 trading plans.[28] According to the SEC's complaint and related criminal indictment, the Executive Chairman created a Rule 10b5-1 plan while he was aware of material nonpublic information about a tenuous relationship between Ontrak and its largest customer, and again when he was aware of the likely termination of the relationship between the company and its customer, selling more than 600,000 shares and avoiding more than $12.7 million in losses. The Executive Chairman allegedly refused to engage in any "cooling-off" period following the establishment of the Rule 10b5-1 plans, in each case selling the day after the plan was established. In the complaint and related criminal indictment, DOJ and the SEC allege that the Rule 10b5-1(c) affirmative defense is not available to the Executive Chairman because he established the Rule 10b5-1 plans while in possession of material nonpublic information and as part of a scheme to evade insider trading prohibitions.

In September 2022, the SEC also issued a settled order finding that the CEO of Cheetah Mobile, a mobile internet company and a foreign private issuer, made misstatements regarding Cheetah's revenue trends, and that he and the company's president illegally traded while in possession of material nonpublic information. Although the trading was pursuant to a previously established plan that purported to be a Rule 10b5-1 plan, the SEC's order found that the CEO and the president had possessed material nonpublic information when they

[27] SEC, *SEC Charges Ontrak Chairman Terren Peizer with Insider Trading* (March 1, 2023), https://www.sec.gov/news/press-release/2023-42.

[28] DOJ, *CEO of Publicly Traded Health Care Company Charged for Insider Trading Scheme* (March 1, 2023), https://www.justice.gov/opa/pr/ceo-publicly-traded-health-care-company-charged-insider-trading-scheme.

created the plan, rendering it ineffective as a defense to charges of insider trading.[29] In addition to disgorging their trading profits and paying civil penalties totaling more than $750,000, the CEO and president agreed to undertakings relating to their future trading of Cheetah Mobile securities. Notably, the CEO also agreed to certain provisions that mirror requirements of the new rule, including, but not limited to, agreeing to cause any future Rule 10b5-1 plan to provide that he not transact in Cheetah securities until the expiration of a cooling-off period of at least 120 days from the adoption of the plan and not maintain more than one Rule 10b5-1 plan at a time.

ENVIRONMENTAL, SOCIETAL, AND GOVERNANCE ("ESG")

The topic of ESG is front-of-mind for management and boards and also for the SEC. While this area will continue to be important to stakeholders, the SEC has been focused on it from both a regulatory and enforcement context. Much is still in the works and boards must stay apprised of SEC developments as they occur.

Rulemaking

The SEC has proposed several rules in the ESG space and additional proposals are likely forthcoming. The proposal that has garnered the most attention relates to rules requiring additional disclosure of a registrant's climate-related risks including Green House Gas ("GHG") emissions.[30] A full description of the rule proposal is far beyond the scope of this article, but the proposal includes significant new line-item disclosures in a number of climate-related areas, such as the company's process for identifying and managing climate risk, and the oversight and governance of climate-related risks by the board. It also contains requirements to report Scope 1 and Scope 2 and, in some cases, Scope 3 emissions[31]greenhouse-gas-emission-reduction targets, if any, and new requirements for climate-specific disclosures in a new note to companies' audited financial statements.

In part because of its expansive requirements, this rule proposal is especially controversial, and it is unclear in what form any final rule will be adopted. But boards of directors and audit committees can draw lessons from overarching trends and focus on ensuring that public statements about ESG-related topics are supported by well-documented facts and that companies are devoting sufficient resources to building strong internal controls around the climate-related information companies disclose.

Enforcement

In March 2021, the SEC announced the formation of the Division of Enforcement's Climate and ESG Task Force.[32] It was charged with developing initiatives to identify ESG-related misconduct, including the use of data analysis to mine information across registrants to identify potential violations. The task force was initially expected to focus on material misstatements or omissions in issuers' disclosure of climate risks under existing rules. As Director Grewal noted in a November 2021 speech, "there is nothing 'new' about how the Task Force — or the Enforcement Division as a whole — investigates possible climate and ESG-related misconduct." He elaborated:

> As with any investigation, we look to make sure our current rules and laws are being followed. For issuers, this means that we apply long-standing principles of materiality and disclosure. If an issuer chooses to speak on climate or ESG — whether in an SEC filing or elsewhere — it must ensure that its statements are not materially false or misleading, or misleading because they omit material information — just as it would when

[29] *Sheng Fu and Ming Xu*, Securities Act Rel. No. 11104, Exchange Act Rel. No. 95847, 7-8 (September 21, 2022).

[30] SEC, *The Enhancement and Standardization of Climate-Related Disclosures for Investors* (proposed May 9, 2022), https://www.sec.gov/rules/proposed/2022/33-11042.pdf.

[31] The Greenhouse Gas Protocol ("GHG Protocol") was created through a partnership between the World Resources Institute and the World Business Council for Sustainable Development. The GHG protocol established "scopes" of emissions to differentiate between direct and indirect sources of emissions. *See* World Business Council for Sustainable Development and World Resources Institute, *The Greenhouse Gas Protocol, A*

footnote continued from previous column…

Corporate Accounting and Reporting Standard REVISED EDITION, *available at* https://ghgprotocol.org/corporate-standard.

[32] SEC, *SEC Announces Enforcement Task Force Focused on Climate and ESG Issues* (March 4, 2021), https://www.sec.gov/news/press-release/2021-42.

disclosing information in its income statement, balance sheet, or cash flow statement.[33]

As anticipated by Director Grewal, to date, actions against public companies in the ESG space have involved material misstatements or omissions and traditional legal theories. For example, in April 2022 the SEC filed a civil action against Vale S.A. claiming that it violated various anti-fraud provisions of the securities laws by taking various acts to conceal the condition of one of its dams, which led to its disclosures to be materially false and misleading. The Complaint alleges, "Vale's deceit misled investors regarding several material issues: the stability of Vale's dams; the nature of Vale's safety practices in the wake of the Mariana dam disaster; and the actual risk of catastrophic financial consequences should any of its high-risk dams . . . collapse."[34] In another recent case, *Healthcare Insurance Innovations*, the company and its former CEO made misrepresentations to investors involving specific verifiable facts about its compliance program, repeatedly highlighted the importance of compliance as a competitive strength, and claimed that it held its distributors to high compliance standards.[35] Finding that the company and the former CEO repeatedly highlighted the importance of compliance as a competitive strength in the highly regulated insurance industry, and that the misstatements were material to investors, the SEC found that they violated Sections 17(a)(2) and (3) of the Securities Act. It also found that the company violated Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-11, and that the former CEO caused those violations. The underlying facts of these cases relate to environmental, societal, or governance concerns, and so they are ESG cases, but they do not break new legal ground.

The SEC employed perhaps a slightly more aggressive theory in the ESG-related aspect of a recent case that focused on a lack of sufficient internal controls. In September 2022, the SEC issued a settled order finding that Compass Minerals lacked sufficient controls to properly assess the financial risks of mercury contamination by a chemical plant owned by one of its subsidiaries in Brazil, among other things not relevant here.[36] Compass Minerals learned, following a complaint on its ethics hotline, that its chemical plant had been discharging mercury above permissible levels, and that the misconduct had been inaccurately reported by officials at the facility. The conduct had been ongoing for several years without the company's knowledge. The SEC's order states that this misconduct created several uncertainties, including that Brazil could have suspended the facility's operating permit, or that third parties who had been impacted by the elevated mercury could have brought civil claims against the company. However, Compass Minerals did not assess the probability of these risks coming to fruition or attempt to quantify the financial impacts if they were to occur, and it did not have in place controls obligating it to do so. As a result of the conduct, the SEC ordered Compass Minerals to pay a $12,000,000 civil penalty and Compass undertook to retain an independent compliance consultant to review and make recommendations concerning its disclosure controls and procedures.

CONCLUSION

In light of the regulatory landscape and enforcement actions described above, boards of directors and audit committees should act now to evaluate whether existing company policies and related controls and procedures need to be refreshed, and may want to discuss their current processes with counsel. In considering whether policy or control refreshes are required, boards should consider how information from subject-matter experts and personnel across the company is filtered up to and evaluated by the board and senior management. And they must remain alert to further developments from the SEC, particularly where rulemaking and enforcement activity intersect. ■

[33] Director of SEC Division of Enforcement, Gurbir S. Grewal, *2021 SEC Regulation Outside the United States – Scott Friestad Memorial Keynote Address* (November 8, 2021), https://www.sec.gov/news/speech/grewal-regulation-outside-united-states-110821.

[34] *SEC v. Vale, S.A.*, Civil Action No. 1:22-cv-02405 (E.D.N.Y), paragraph 16 (April 28, 2022).

[35] *Health Insurance Innovations, Inc., now named Benefytt Technologies Inc., and Gavin D. Southwell*, Securities Act Rel. No. 11084, Exchange Act Rel. No. 95323 (July 20, 2022).

[36] *Compass Minerals International, Inc.*, Securities Act Rel. No. 11107, Exchange Act Rel. No. 95889 (September 23, 2022).