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CORPORATE GOVERNANCE

Counting Shareholder Votes

Careful attention to shareholder voting matters is particularly important given the patchwork system of organizational documents, state laws, and stock exchange regulations that govern the counting of stockholder votes.

By Douglas K. Schnell and Angela Chen

For corporate lawyers, no task is more fundamental than ensuring that shareholder votes are properly counted. Unfortunately, a patchwork system of organizational documents, state laws and stock exchange regulations governs this critical exercise. Making sense of it all—and ensuring that corporate action has been validly taken—requires a careful understanding of this system.[1]

Quorum Requirements

The first step in determining whether shareholder approval has been, or can be, obtained is to determine the presence of a quorum. A quorum is the number of shares that must be present for valid action to be taken at a shareholder meeting.[2] Without a quorum, a meeting cannot be validly held.

Under Section 216 of the Delaware General Corporation Law (DGCL), the default rule is that a quorum consists of "a majority of the shares entitled to vote, present in person or represented by proxy." A company's organizational documents may alter this default quorum requirement, but may not lower it to less than one-third of the shares entitled to vote at the meeting. Treasury stock and stock of a parent corporation held by its own subsidiary is not votable and should not be included in the quorum calculation.

Companies listed on the New York Stock Exchange (NYSE) or the Nasdaq Stock Market (Nasdaq) also must consider the quorum requirements under exchange rules. Where shareholder approval is required, NYSE Rule 310.00 provides that a quorum should be "sufficiently high to insure a representative vote" and NYSE Rule 310.00(A) notes that "in authorizing listing[,] ...careful consideration is given to provisions fixing any proportion less than a majority of the outstanding shares as the quorum for shareholders' meetings."[3] Nasdaq Rule 5620(c) requires a company to abide by the quorum requirements in its bylaws, but also states that such requirement may not be less than one-third of the outstanding shares of common stock.

Shareholder Voting Standards

Once a quorum has been established, the next task is to determine whether a sufficient number of votes has been cast to approve the action. The number of votes required for valid shareholder action under state law depends on the matter being voted on. The DGCL specifies voting standards for certain enumerated matters (such as the approval of a merger or the amendment to a certificate of incorporation) and then provides a catch-all voting standard for everything else.[4]

Under DGCL Section 216(3), directors by default are elected by a plurality of the shares present in person or by proxy at the meeting and entitled to vote in the election of directors. Under a plurality voting standard, where two nominees are running for the same seat, the nominee receiving the highest number

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of "for" votes is elected.[5] In contrast, the removal of a director requires the approval of a majority of the shares entitled to vote in the election of directors (DGCL Section 141(k)). Most charter amendments (DGCL Section 242(b)(1)), most mergers (DGCL Section 251(c)), sales of all or substantially all assets (DGCL Section 271(a)), and dissolutions (DGCL Section 275(b)) require the approval of a majority of the outstanding shares entitled to vote on the matter. Nearly all other matters require the approval of a majority of shares present in person or by proxy at a meeting and entitled to vote on the matter (DGCL Section 216(2)).[6]

NYSE Rule 312.07 provides that

> where shareholder approval is a prerequisite to the listing of any additional or new securities of a listed company, or where any matter requires shareholder approval, the minimum vote that will constitute shareholder approval for such purposes is defined as approval by a majority of votes cast on a proposal.[7]

Nasdaq Rule 5635(e) provides that

> where shareholder approval is required, the minimum vote that will constitute shareholder approval shall be a majority of the total votes cast on the proposal.

It is important to keep in mind that these vote standards may be "layered." Depending on the wording of a bylaw, if the company has set a minimum vote standard—for example, by providing that a majority of shares present in person or by proxy at a meeting and entitled to vote on the matter is necessary for approval of *any* matter—the more difficult bylaw voting standard may continue to apply, notwithstanding a more lenient stock exchange requirement.[8]

Exhibit 1 accompanying this article summarizes the various voting standards and the treatment of different types of votes.

Broker Non-Votes, Abstentions, and "Withhold" Votes

Broker Non-Votes

In the United States, the majority of public company shareholders hold their shares through a bank, broker, trustee or other nominee, rather than directly in their own name. When shares are so held, the shareholder is considered the "beneficial owner" of shares held in "street name" and the broker will request voting instructions from the beneficial owner. NYSE Rule 452[9] permits brokers to vote on behalf of beneficial owners on "routine" matters if instructions have not been received from the beneficial owner by the 10th day before the date of the shareholder meeting.[10] For non-routine matters, if the beneficial owner does not provide voting instructions, then the broker is not permitted to vote on behalf of the beneficial owner on that matter. A broker non-vote occurs when a broker does not receive voting instructions from the beneficial owner and is not otherwise permitted to vote the underlying shares on a given matter.

Amendments to NYSE Rule 452 have reduced substantially the number of matters considered "routine." In some cases, this has had the effect of making it more difficult for companies to establish a quorum because the shares underlying broker non-votes are deemed to be present at a meeting only if there is at least one "routine" matter to be voted on at the meeting. As a method of ensuring the presence of a quorum, many companies include at least one "routine" matter (typically the ratification of auditors) on their meeting agendas. If all matters to be considered at a stockholder meeting are non-routine (as is frequently the case at, for example, a meeting to approve a merger), extra effort and cost may be required to ensure the presence of a quorum.

Under Delaware law, broker non-votes are not considered "votes cast" and therefore have no effect when "a majority of votes cast" is the relevant voting standard. Broker non-votes also have no effect when a "majority of the shares present and entitled to vote on the matter" is the voting standard (because broker

Exhibit 1—Voting Standards

Voting Standard	Majority of Votes Cast (More For than Against)	Majority of *Shares* Present and Entitled to Vote on the Subject Matter (Delaware default per DGCL Section 216(2))	Majority of the *Voting Power* Present in Person or Represented by Proxy[16]	Majority of *Shares* Present and Entitled to Vote at the Meeting/Present in Person or Represented by Proxy (sometimes referred to as "Majority of Quorum")	Majority of Outstanding Shares
Formula:	$\frac{\text{For}}{\text{For+Against}}$	$\frac{\text{For}}{\text{For+Against+Abstain}}$	$\frac{\text{For}}{\text{For+Against+Abstain}}$	$\frac{\text{For}}{\text{For+Against+Abstain+Broker Non-Vote}}$	$\frac{\text{For}}{\text{All Outstanding Shares}}$
Effect of Broker Non-Votes:	no effect	no effect	no effect	same as Against vote	same as Against vote
Effect of Abstention:	no effect	same as Against vote	same as Against vote	same as Against vote	same as Against vote

non-votes are not considered "entitled to vote" on the matter due to the broker not having voting instructions from the beneficial owner). When a voting standard calls for the approval of "a majority of the outstanding shares" or "a majority of the quorum," broker non-votes have the same effect as a vote "against" the proposal (because they are outstanding shares that count toward the size of the quorum, but are not voted in favor).[11]

Abstentions

An abstention occurs when a shareholder represented at the meeting in person or by proxy makes the affirmative choice not to vote for or against a matter. Abstentions are considered both "present" and "entitled to vote" on the matter. An abstention counts as a vote "against" any proposal where the voting standard is "a majority of the shares present and entitled to vote," "a majority of the outstanding shares" or "a majority of the quorum" (because the abstained shares are present, entitled to vote, and do have the capacity to cast a vote on the proposal).

When the voting standard is "a majority of votes cast," Delaware law treats abstentions as having no effect (because the abstained shares are not considered votes cast for or against the proposal and are, instead, the affirmative decision not to vote for or against).

NYSE guidance[12] has the practical effect of providing that, where the NYSE listing rules separately require shareholder approval, abstentions are treated as "against" votes.[13] Nasdaq does not have a similar concept.

"Withhold" Votes

"Withhold" votes are only applicable to director elections using a plurality standard. Under plurality, if a person runs unopposed, a single "for" vote is sufficient to elect that person, assuming that a quorum is present. Therefore, an "against" vote would be meaningless.[14] Instead, shareholders are given the option to "withhold" authority to vote their shares in favor of a nominee in order to express their dissatisfaction concerning, or otherwise consciously decide not to provide support for, that nominee.[15] Although they have no legal effect, a significant number of "withhold" votes on a nominee—in that they are tangible evidence of shareholder dissatisfaction—may influence future decisions by the company.

Proxy Disclosure of Voting Standards

Item 21 of Schedule 14A provides that a company must disclose in its proxy statement "the method by which votes will be counted, including the treatment and effect of abstentions and broker non-votes under applicable state law as well as registrant charter and by-law provisions."

In February 2016, the Division of Corporation Finance of the Securities and Exchange Commission expressed concern over sloppy and inaccurate disclosure of voting standards. Each time a company solicits stockholder approval, the relevant quorum and voting standards should be clearly and accurately described (including how those voting standards may be impacted by relevant stock exchange rules). The disclosure should explain, in straightforward terms, the vote required and the voting methodology for each of the proposals subject to vote.

Finally, companies should be careful not to offer extraneous or inapplicable voting options. For example, the only options that should be offered under a plurality voting standard in directors elections are "for" and "withhold." Of course, the reverse is true for companies transitioning from plurality to majority voting in director elections.

Inaccurate or ambiguous disclosure of voting standards may lead to disclosure-related lawsuits. Even more importantly, failing to correctly apply a voting standard creates the risk of a corporate action being deemed invalid if a challenge is brought to the outcome of the shareholder vote. Companies and their counsel must be aware of the critical role that this disclosure serves in ensuring a meaningful shareholder franchise.

Conclusion

Shareholder votes matter and shareholders are entitled to expect that companies will correctly count the votes at any meeting. Careful attention to this crucial but confusing area is required.

Notes

1. This discussion is focused on shareholder approval requirements applicable to Delaware corporations pursuant to organizational documents, corporate and securities laws (primarily the Delaware General Corporation Law (DGCL), and stock exchange regulations. An analysis of the shareholder approval requirements under tax laws (*e.g.*, with respect to Section 162(m) of the Internal Revenue Code) and blue sky laws (*e.g.*, with respect to equity compensation plans in various states), or for corporations incorporated in states other than Delaware, is beyond the scope of this discussion.
2. By default under the DGCL, each share is entitled to one vote. However, if the company's certificate of incorporation provides for more or less than one vote for any share, then Section 212(a) directs that references in the DGCL to a majority or other proportion of shares are to be read as references to such majority or other proportion of the votes of such shares. This article refers to a majority or other proportion of shares, but should be understood as references to voting power if the relevant company has altered the default voting power of its shares.
3. In July 2013, the NYSE eliminated its requirement that the total votes cast on a proposal must represent over 50 percent in interest of all securities entitled to vote on the proposal. This had the effect of imposing a higher quorum requirement than that potentially required by state law or the company's organizational documents.
4. Delaware permits the altering of this default voting standard through the company's charter and, in certain instances, its bylaws. For example, many companies have adopted supermajority vote requirements to approve mergers or amend their charters.
5. Over at least the past 15 years, the evolution of corporate governance best practices has seen many public companies adopt majority voting standards in uncontested director elections. Although there is substantial variation in how companies approach majority voting in director elections, in general they provide that in order to be elected, a director must receive more "for" than "against" votes.
6. Higher voting standards apply under the DGCL to certain antitakeover matters under Section 203, conversion into another entity under Section 266(b), dissolutions conducted under Section 275(c), actions to change into or out of "public benefit corporation" status under subsections (a) and (c) of Section 363, and domestication in a foreign jurisdiction under Section 390(b). Other standards also may apply by statute from time to time. For example, class or series votes can apply to certain types of charter amendments under Section 242(b)(2) of the DGCL.
7. NYSE Rule 312.03 requires shareholder approval (thereby implicating NYSE Rule 312.07) for securities issuances in connection with equity compensation plans, certain

related party transactions, and stock issuances above 20 percent of the outstanding shares, and issuances that will result in a change of control.

8. *See* In re Cheniere Energy Inc., C.A. No. 9766, Tr. at 92 (Del. Ch. Mar. 23, 2015) (finding "quite strong" an argument that a corporation miscounted and misdisclosed a vote over an increase to a stock option plan by looking to the stock exchange listing requirement, rather than a bylaw provision that tracked "the Delaware default rule under Section 216(2), under which abstentions count as no votes unless a company's bylaws or certificate of incorporation otherwise provides").
9. NYSE Rule 452 governs the conduct of brokers that are NYSE members. As a result, it is applicable to companies listed on NYSE and Nasdaq.
10. Rule 452 does not define "routine" matters and instead prohibits brokers from voting without instructions on non-routine items enumerated in the rule, such as director elections and shareholder proposals.
11. The words used in the bylaws to describe the voting standard can have significant consequences. For example, many bylaws describe the default Delaware voting standard as requiring "a majority of shares present in person or by proxy at a meeting and entitled to vote on the subject matter," where "on the subject matter" refers to the particular matter being voted on. In that case, broker non-votes would have no effect. However, if this standard is phrased as "a majority of shares present in person or by proxy at a meeting and entitled to vote thereat," the use of thereat (referring to shares present at the meeting) has the likely effect of increasing the necessary vote to secure approval because broker non-votes represent shares that are present at the meeting (and if they are registered as broker non-votes, that likely means that there was a "routine" matter that those shares were voted on, such that the shares were entitled to vote on a matter at the meeting); accordingly, they would be included in the denominator.
12. See: *https://www.nyse.com/publicdocs/nyse/regulation/nyse/2017_NYSE_Listed_Company_Compliance_Guidance_Memo_for_Domestic_Companies.pdf.*
13. NYSE Rule 312.03 requires shareholder approval for securities issuances in connection with equity compensation plans, certain related party transactions, and stock issuances above 20 percent of the outstanding shares, and issuances that will result in a change of control. Here, too, keep in mind the "layering" concept of voting standards.
14. Companies transitioning from plurality to majority voting in director elections should use care to ensure that their proxy statements and proxy cards correctly provide for "against" and "abstention" votes in director elections rather than "withhold" votes.
15. Some companies have adopted "plurality-plus" voting standards for director elections. Under this standard, directors continue to be elected by a plurality but any nominee who fails to receive the affirmative vote of a majority of votes cast must tender his or her resignation.
16. Per Delaware Supreme Court case law, "Voting power present is synonymous with the number of shares represented which are 'entitled to vote on the subject matter.'" *Berlin v. Emerald Partners*, 552 A.2d 482, 493 (Del. 1988).

SECURITIES REGISTRATION

SEC Publishes First-Ever No-Action Letter for a Cryptocurrency Enterprise and a Framework for When a Cryptocurrency Is a Security

The SEC has issued guidance, in the form of a no-action letter and a framework, on how to design and distribute a digital asset that does not implicate the securities laws. It provides certainty for the digital asset industry but it remains to be seen whether it will thaw the chill that the industry currently is suffering.

By Charles J. Clark, Stephanie R. Breslow, Donald J. Mosher, and Bayard P. Brown

On April 3, the US Securities and Exchange Commission (SEC) published a framework aimed at assisting in determining whether a digital asset is a security (Framework).[1] Alongside the Framework, the SEC also published a no-action letter for TurnKey Jet, Inc., the first ever no-action letter for a digital asset enterprise.[2]

This is an important development for any parties interested in developing, selling, or investing in digital assets, as it is the most robust analysis yet published on how the SEC sees these assets and finally provides concrete information on how to avoid an SEC enforcement action in an industry that recently has suffered from regulatory uncertainty. The Framework and the conditions the SEC notes in advising TurnKey that it will not recommend an enforcement action, however, lead to the conclusion that, in the eyes of the SEC, digital assets *cannot* be used to raise capital without implicating US securities laws. Furthermore, many of the Framework's considerations go beyond the traditional test for determining whether an asset is a security. A thorough understanding of the SEC's position as reflected in these documents is essential for any party interested in dealing with digital assets.

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Background

The question of whether a cryptocurrency is a security has a significant impact on the regulatory implications of dealing in digital assets or conducting an initial coin offering (ICO). The SEC previously has acknowledged that the sale of digital assets may not implicate US securities laws and may be an efficient way to raise proceeds.[3] Nevertheless, prior to April 3, the SEC had provided only limited guidance as to how to sell an unregistered digital asset or conduct an ICO without risking an SEC enforcement action.

Before the Framework, the most robust SEC analysis of when a digital asset was a security was published in July 2017, when the SEC released a Report of Investigation on an offering of digital tokens by an entity called The DAO.[4] In this report, the SEC analyzed The DAO's digital tokens under the test established in *SEC v. Howey*, [5] which holds that an asset is an investment contract, and therefore a security, when there is (1) an investment of money, (2) in a common enterprise, (3) with the reasonable expectation of profits derived from the efforts of others. The SEC concluded that The DAO tokens were securities under the *Howey* test, noting that holders of The DAO's digital tokens had limited control over The DAO and stood to receive a share from the profits of The DAO's enterprises.[6]

For more than two years following the release of The DAO Report, the SEC largely only took action against digital asset ventures that it accused of actually defrauding purchasers, such as two ICOs that purported to be backed by real estate and diamonds.[7] In December 2017, however, the SEC began taking action against digital asset ventures that it did not allege attempted to mislead customers.[8] The SEC's expanded focus included digital asset ventures where the only apparent wrongdoing was failing to register their ICOs as security offerings, even where those ventures did not offer digital asset holders a share of the ventures' profits.[9] The cryptocurrency venture Paragon Coin Inc. was the subject of one such action.[10] Paragon had to pay a civil money penalty but was given the opportunity to pursue registration of its digital assets as a class of securities, which appears, based on the Framework, to be the way of the future for many digital asset ventures.[11]

The SEC began taking action against digital asset ventures that it did not allege attempted to mislead customers.

In the wake of the SEC actions targeting cryptocurrency ventures where the only wrongdoing was failing to register their digital assets, there was significant uncertainty in the digital asset industry as to how to design a digital asset that would not run afoul of the SEC's prohibition of the sale of unregistered securities. Many believe that this regulatory uncertainty has had a chilling effect on the digital asset industry.[12] The amount raised through ICOs, for instance, has dropped significantly in the past year.[13] Now, with its publication of the Framework, the SEC has attempted to address this uncertainty with the most robust presentation yet of its perspective as to when a digital asset is a security.

The Framework

As with The DAO Report, the Framework centers on the *Howey* test.[14] The SEC quickly disposes of the first two prongs of the test, stating that the sale of a digital asset typically is an investment of money in a common enterprise, so the majority of the Framework concerns when the sale of a digital asset satisfies the final *Howey* test element of a reasonable expectation of profits from the efforts of others.[15] The SEC lists a myriad of characteristics to consider in analyzing this element of the *Howey* test, with the Framework broken down into subsections on: (1) reliance on the efforts of others; (2) reasonable expectation of profits; and (3) other considerations.[16]

Some key takeaways from the "Reliance on the Efforts of Others" subsection are that the more important and involved the promoter, sponsor, or other third party (defined by the Framework as an "Active Participant") in the continuing success of the underlying venture, the greater the likelihood that the digital asset holder is relying on the efforts of others.[17] To reduce the chances that a digital asset holder will be relying on the efforts of others, tasks, responsibilities, and decisionmaking should be performed by a decentralized network, not an Active Participant.[18] If the Active Participant can profit from the appreciation of the digital asset, by distributing the digital asset to itself, or by owning the intellectual property affiliated with the digital asset, the Framework states that a digital asset purchaser reasonably would expect the Active Participant to be putting in effort to enhance the value of the digital asset or affiliated network.[19] Many of these specified considerations are beyond those typically considered when analyzing an asset under the *Howey* test. Regarding reevaluating digital assets previously sold as securities, the Framework states that it should be considered whether the Active Participant is still important to the digital asset's value, or whether the Active Participant no longer impacts the enterprise's success.[20]

The Framework goes on to state in the "Reasonable Expectation of Profits" subsection that the expectation of profits is more reasonable where the digital asset is able to appreciate and is transferable through a secondary market, or is expected to be in the future. [21] The Framework further states that there is a more reasonable expectation of profits when the digital asset is offered to a wider swath of potential purchasers rather than those that are expected to actually use the asset's functionality, where the digital asset is offered or purchased in quantities larger or smaller than what a purchaser would reasonably need to take advantage of the asset's functionality, and where the Active Participant raised more funds than what may be needed to establish the digital asset or associated platform.[22] These listed considerations again suggest that the SEC's Framework goes beyond the traditional *Howey* analysis. Regarding reevaluating digital assets previously sold as securities, the Framework includes as considerations whether the Active Participant's involvement is still key, the stability of the digital asset value at a level correlated to the functionality offered, the trading volume of the digital asset, and whether the digital asset can be used for its intended functionality.[23]

The SEC's Framework goes beyond the traditional Howey *analysis.*

The "Other Relevant Considerations" subsection distills much of the Framework and states that the chances of a digital asset being a security decrease when the digital asset and any affiliated platform are fully developed and operational, where holders of the digital asset can use it for its intended functionality immediately, where the digital asset's creation and structure focuses on user functionality rather than feeding value speculation, and where the prospects for the digital asset appreciating are limited.[24] Marketing of the digital asset should be consistent with these factors to minimize the chance that the digital asset is a security.[25]

The end of the Framework provides a concrete example of when a digital asset would not constitute a security: In a pre-existing retail business, where the business markets a non-transferrable digital asset to its existing customer base, and that digital asset can be immediately used in that retail business upon receipt to purchase products at prices commensurate to the prices for those items in real currency, that digital asset would not be a security in the eyes of the SEC.[26] The retail venture in this example is substantially different from the vast majority of digital asset ventures. The example also emphasizes the Framework's position that, to help ensure a digital asset is not a security, the digital asset must be sold in the context of an already established and operational venture that has functional utility at the time of sale, not sold in the context of a capital raise so as to establish a venture offering utility in the future.

The Framework establishes that whether a venture is fully functional and able to provide utility is not only crucial in the analysis of digital assets going forward, but also will be central in the SEC's reevaluation of digital assets previously sold as securities.[27] It is important to note, however, that the Framework is not a formal set of rules or regulations, that the Commission has not approved its contents, and that it is not binding on the SEC.[28]

TurnKey No-Action Letter

In its first-ever no-action letter for a digital asset, issued in response to a letter by TurnKey, the SEC reiterates the key factors set forth in its Framework: To avoid a possible enforcement action, the platforms for using a digital asset already should be fully developed and operational prior to the digital asset being sold, and the digital asset should have immediate functionality on those platforms at the time of sale.[29]

TurnKey is a private aircraft charter service that has not yet launched a digital token but already operates multiple business jets and has had over 140 customers.[30] TurnKey's proposed token would allow holders to redeem those tokens for air charter services at an exchange rate of one token to one

US dollar, and the tokens would be fully backed by an equal amount of US dollars in a US escrow account.[31] Furthermore, TurnKey only can repurchase the tokens for less than one US dollar, and token purchasers would have to agree that they are not acquiring the tokens to resell or distribute them.[32] Furthermore, TurnKey agents and employees will not mention profits or investment opportunities when selling its tokens.[33] The SEC found the pre-existing nature of TurnKey's business as well as the aspects of TurnKey's plan that would prevent the TurnKey token from being used or perceived as a profit vehicle, particularly noteworthy in deciding that it would not recommend an enforcement action if TurnKey carried out its token sales plan.[34]

The TurnKey No-Action Letter does not address whether TurnKey would be subject to other regulatory regimes for engaging in the described activity, such as federal anti-money laundering (AML) regulations administered by the US Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) or state money transmitter laws. Under FinCEN guidance, administrators and exchangers of convertible virtual currency are money transmitters and are subject to federal AML regulations such as the requirement to maintain a written AML program and file suspicious activity reports with FinCEN.[35] Additionally, depending on how the service is structured, and the particular facts and circumstances, state money transmission laws may be implicated,[36] or the business could be engaged in federally regulated activity as a "provider" or "seller" of prepaid access.[37]

It remains unclear whether the structure proposed by TurnKey would even be viable for the majority of cryptocurrency enterprises.

Many of the digital assets that already have been developed and sold through ICOs also raise additional complications not presented by TurnKey, and it remains unclear whether the structure proposed by TurnKey would even be viable for the majority of cryptocurrency enterprises. Even with TurnKey appearing to be relatively straightforward in satisfying the SEC's Framework, securing this no-action letter took substantial time and effort on the part of TurnKey, with TurnKey's attorney reporting that the process took over 10 months and required an estimated 50 phone calls between counsel and the SEC.[38]

Implications

The Framework finally provides clear guidance on how to design and distribute a digital asset that does not implicate securities laws in the view of the SEC. However, following the guidance essentially prohibits such digital assets from being sold for the purposes of raising capital to fund the development of new ventures or future functionality, the typical reasons that ICOs were conducted in the digital asset industry. To lower the likelihood that the SEC will conclude that a digital asset is a security, the digital asset venture already must be up and running before any digital asset sale. This is without even addressing the large number of other characteristics listed in the Framework that a digital asset venture would have to consider and adhere to so as to minimize the chance that the SEC will consider the asset a security, many of which go beyond the *Howey* test.

What is left, then, when the SEC's Framework is adhered to? TurnKey and the retail business example provided in the SEC's Framework have digital assets operating with close similarities to fiat currency, though with even more restrictions in some respects. These additional restrictions may well dissuade some businesses from exploring the creation of digital assets. The Framework thus has provided certainty in the digital asset industry, but it remains to be seen if its publication will thaw the chill that the industry is suffering currently. It also remains to be seen whether courts will agree with the analysis in the SEC's Framework and endorse the considerations it lists, or if the courts will have a different view of when a digital asset is not a security.

Notes

1. *Framework for 'Investment Contract' Analysis of Digital Assets*, US Securities and Exchange Commission (April 3, 2019).
2. TurnKey Jet, Inc., SEC No-Action Letter (April 3, 2019).
3. Jay Clayton, *Statement on Cryptocurrencies and Initial Coin Offerings*, US Securities and Exchange Commission (Dec. 11, 2017).
4. *See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, Release No. 81207 (July 25, 2017).
5. SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946).
6. *Id.*
7. *SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds*, US Securities and Exchange Commission (Sept. 29, 2017).
8. Press Release, *Company Halts ICO After SEC Raises Registration Concerns*, US Securities and Exchange Commission (Dec. 11, 2017).
9. *See* In the Matter of Munchee Inc., File No. 3-18304 (Dec. 11, 2017).
10. *See Two ICO Issuers Settle SEC Registration Charges, Agree to Register Tokens as Securities*, U.S. Securities and Exchange Commission (Nov. 16, 2018).
11. *See* Press Release, *Paragon Reaches Settlement with the U.S. Securities and Exchange Commission*, Paragon Coin Inc. (Nov. 16, 2018).
12. *See* Mike Orcutt, "Blockchain boosters warn that regulatory uncertainty is harming innovation," *The Technology Review* (March 8, 2019).
13. *See* Paul Vigna, "Raising Money in the Crypto World Has Gotten a Lot Harder," *The Wall Street Journal* (March 31, 2019).
14. *Framework for 'Investment Contract' Analysis of Digital Assets*, U.S. Securities and Exchange Commission (April 3, 2019).
15. *Id.*
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.*
22. *Id.*
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.*
27. *Id.*
28. Bill Hinman and Valerie Szczepanik, *Statement on* "Framework for 'Investment Contract' Analysis of Digital Assets," U.S. Securities and Exchange Commission (April 3, 2019).
29. TurnKey Jet, Inc., SEC No-Action Letter (April 3, 2019).
30. *See* Letter from James P. Curry to the Division of Corporate Finance (April 2, 2019).
31. *Id.*
32. *Id.*
33. *Id.*
34. TurnKey Jet, Inc., SEC No-Action Letter (April 3, 2019).
35. FIN-2013-G001, Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies (March 18, 2013).
36. *See,* e.g., Texas Supervisory Memorandum 1037, Regulatory Treatment of Virtual Currencies Under the Texas Money Services Act (Jan. 2, 2019).
37. 31 C.F.R. §§ 1010.100(ff)(4) and (7).
38. Brady Dale, *SEC's First Crypto 'No Action' Letter Took 11 Months to Secure*, Coindesk (April 3, 2019).

MERGERS AND ACQUISITIONS

Olenik v. Lodzinski: More on Structuring Controlling Stockholder Buyouts

The Delaware Supreme Court has provided transaction parties and practitioners with additional guidance on structuring controlling stockholder buyouts. Specifically, the Court provided clarity concerning the point in time certain conditions must be in place for restoration of the presumption of the business judgment rule.

By John Mark Zeberkiewicz and Robert B. Greco

In *Olenik v. Lodzinski*,[1] the Delaware Supreme Court provided further guidance regarding the circumstances under which the deployment of procedural protective devices pursuant to the so-called *MFW* standard—namely, the transaction's negotiation and approval by an independent special committee and its adoption by a majority-of-the-minority vote—can operate to restore the presumption of the business judgment rule to a controlling stockholder buyout. Specifically, the Court provided additional clarity around the point in time in the process by which the controller must affirm that its transaction will not proceed without those conditions in place.

Background

The Court's opinion in *Olenik* is the most recent installment in a series of rulings on controlling stockholder buyouts, commencing with the 1994 opinion in *Kahn v. Lynch Communication Systems, Inc.*[2] In *Lynch*, the Court held that the rigorous entire fairness standard of review—requiring an inquiry into the "fair price" and "fair process" elements of a transaction—is the exclusive standard of review applicable to a cash-out merger by a controlling or dominating stockholder.[3] Under the *Lynch* Court's holding, in a controlling stockholder buyout, the initial burden of proof on fairness is placed on the defendants, but the transaction's approval by a fully functioning committee of independent directors or by an uncoerced, fully informed vote of a majority-of-the-minority stockholders could shift the burden of proof to the plaintiffs.[4] "Nevertheless," the *Lynch* Court held,

> even when an interested cash-out merger transaction receives the informed approval of a majority of minority stockholders or an independent committee of disinterested directors, an entire fairness analysis is the only proper standard of judicial review.[5]

Although the shift in the burden of proof may have been designed to encourage transaction planners to deploy procedural mechanisms designed to promote fair outcomes for minority stockholders, it did not, in and of itself, provide a material benefit in terms of allowing for transaction litigation to be dispensed with at a preliminary stage. As the Court of Chancery has noted, "[t]he practical effect" of the burden shift is "slight," given that it only applies in rare circumstances where "the evidence is in equipoise."[6] "Certainly, at a pre-trial stage, it is hard to imagine how this shift in burden would change the outcome of a typical motion for dismissal for failure to state a claim or for summary judgment."[7]

While the *Lynch* standard continued to apply to controlling stockholder buyouts effected by statutory

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merger, cases in the Court of Chancery allowed for more favorable standards of review to be applied to controlling stockholder tender offers followed by a back-end merger.[8] In *In re Cox Communications, Inc. Shareholders Litigation*, the Court of Chancery, ruling on an objection to a fee request, pointed out the disconnect in the law applicable to controlling stockholder buyouts effected through a tender offer followed by a back-end merger, and those effected by statutory merger.[9] With respect to the latter, the Court observed that the *Lynch* standard made

> it impossible for a controlling stockholder ever to structure a transaction in a manner that will enable it to obtain dismissal of a complaint challenging the transaction,

with the result that "each *Lynch* case has settlement value, not necessarily because of its merits but because it cannot be dismissed."[10]

The *Cox* Court accordingly proposed a reform in Delaware law that would allow for the invocation of the business judgment rule in cases in which a going-private merger with a controller "mirrored *both* elements of an arm's-length merger" through the approval by disinterested directors *and* disinterested stockholders, noting that those two elements would have to be "complementary and not substitutes."[11] The Court argued that its reform would not only "provide an incentive for transactional planners to use the transactional structure that virtually all informed commentators believe is most advantageous to minority stockholders," but would also "bring together both lines of [Delaware's] going-private jurisprudence in a sensible manner, providing stockholders with substantial procedural guarantees of fairness that work in tandem while minimizing the rote filing of makeweight cases."[12]

Years later, in *In re CNX Gas Corp. Shareholders Litigation*, the Court of Chancery, after reviewing the disparate lines of cases governing controlling stockholder buyout transactions generally, applied what it referred to as the "unified standard" articulated in *Cox Communications*, stating that

> if a first-step tender offer is both (i) negotiated and recommended by a special committee of independent directors and (ii) conditioned on the affirmative tender of a majority of the minority shares, then the business judgment standard of review presumptively applies to the freeze-out transaction.[13]

While much was written in these early opinions regarding the composition and efficacy of the special committee as well as the adequacy of the disclosure to stockholders, there was little guidance on the manner in which the majority-of-the-minority condition had to be imposed.

Imposition of Procedural Protective Devices

In its 2013 opinion in *In re MFW Shareholders Litigation*, the Court of Chancery, while noting that *Lynch* had been read to suggest that a controlling stockholder proposing to merge with the company would receive "no extra legal credit" for consenting to *both* of the minority stockholder protections, nevertheless found that the question had "never been squarely presented to [the Delaware] courts."[14] The *MFW* Court ultimately concluded that

> when a controlling stockholder merger has, *from the time of the controller's first overture*, been subject to (i) negotiation and approval by a special committee of independent directors fully empowered to say no, and (ii) approval by an uncoerced, fully informed vote of a majority of the minority investors, the business judgment rule standard of review applies.[15]

The Supreme Court affirmed the Court of Chancery's opinion in *MFW*, albeit using slightly different terminology, noting that, for the business judgement standard to be invoked, the controlling stockholder merger would have to be "conditioned *ab initio*" upon the two conditions.[16]

Despite the Supreme Court's clear articulation of the *MFW* standard, a few questions regarding its application remained unanswered, particularly with regard to the point in time at which the controller had to communicate its consent to the imposition of the conditions. The Supreme Court first squarely addressed the question in *Flood v. Synutra International, Inc.*[17] In *Synutra*, the plaintiff argued that the defendants were not entitled to invoke the protection of the business judgment rule under *MFW* since the controller's first expression of interest was not subject to the two *MFW* conditions. The Supreme Court rejected that argument, stating that

> what is critical for the application of the business judgment rule is that the controller accept that no transaction goes forward without special committee and disinterested stockholder approval early in the process and before there has been any economic horse trading.[18]

The *Synutra* Court noted that the controller in that case promptly had course-corrected, subjecting its transaction to the two *MFW* conditions before any of the economic negotiations had occurred—and even before the special committee had retained counsel and commenced its substantive deliberations.[19] Thus, the *Synutra* Court was satisfied that the controller had satisfied the "*ab initio*" requirement.[20]

Demarcating the Line of Substantive Economic Negotiations

The Supreme Court's most recent statement on the "*ab initio*" requirement appears in *Olenik*. The dispute in *Olenik* arose out of the stock-for-stock business combination between Earthstone Energy, Inc. (Earthstone) and Bold Energy III LLC (Bold), both of which were alleged to be controlled by EnCap Investments, L.P.[21] The Earthstone-Bold transaction, which resulted in the legacy Earthstone stockholders obtaining roughly 40 percent of the combined company, was first formally proposed by a special committee of Earthstone's independent directors in a written offer letter dated August 19, 2016.[22] In that letter, the Earthstone special committee stated that any transaction between Earthstone and Bold would be subject to the committee's approval as well as a majority-of-the-minority vote.[23] The Court noted, however, that the Earthstone-Bold transaction had "its roots in mid-2015 when EnCap began looking for ways to sell Bold or take it public" and that in the months leading up to Earthstone's formal proposal, Earthstone's chief executive officer had engaged in discussions with EnCap regarding an opportunity to combine Earthstone and Bold.[24]

The plaintiff, a stockholder of Earthstone, challenged the transaction, arguing that EnCap Investments, L.P., as controller, had caused Earthstone's minority stockholders to approve the transaction on the basis of misleading disclosures. The defendants moved to dismiss on *MFW* grounds, noting that the transaction was appropriately made subject to the two *MFW* conditions.[25] In dismissing the plaintiff's claims, the Court of Chancery found that the initial offer letter from Earthstone to Bold, which was sent on August 19, 2016, effectively constituted the controller's first overture for *MFW* purposes. That offer letter, the Court of Chancery stated, "announced and made clear from the outset—at the start of negotiations on the proposal—that any transaction between Earthstone and Bold" would be subject to the twin procedural protections.[26]

Reviewing the Court of Chancery's decision *de novo*, the Delaware Supreme Court found that the lower court erred when it found that the *MFW* protections had been in effect from the outset of the transaction. Although recognizing that the Court of Chancery correctly had determined that "preliminary discussions" between a controller and the controlled company do not "pass the point of no return" for purposes of the imposition of the two *MFW* conditions, the Court found that the conditions were not put in place before the substantive deal terms of the Earthstone-Bold transaction occurred.[27] The Court catalogued several discussions and other matters relating to the transaction that were alleged to have occurred or been raised before the August 2016 offer letter was submitted. These included: (1) EnCap's providing Earthstone in November 2015 the presentation that its investment banker had used to market Bold; (2) Earthstone's December 2015 entry into a confidentiality agreement with Bold, along with its gaining access to due diligence materials; (3) Earthstone management's meetings in April 2016 with representatives of EnCap to discuss the potential Bold transaction; (4) Earthstone management's May 2016 presentations to EnCap regarding the potential equity valuation of Bold; and (5) the conduct of due diligence meetings among Earthstone, EnCap and Bold throughout June and July 2016.[28]

The Court recognized that some of the "early interactions" between Earthstone and Bold could be characterized as "preliminary discussions"—and therefore not sufficient to eliminate the potential invocation of the *MFW* protections—but nevertheless found that the plaintiffs had adequately pled that the discussions among the parties had transitioned into substantive economic negotiations once they began engaging in the exercise to value Earthstone and Bold.[29] The Court found it was reasonable to infer that the valuation presentations "set the field of play" for the economic negotiations to come by fixing the range in which offers and counteroffers might be made."[30]

Key Takeaways

The Supreme Court's opinion in *Olenik* provides transaction parties and practitioners additional guidance with respect to structuring controlling stockholder buyouts. While the *Olenik* Court again eschewed a bright line test for determining the point in time at which the controller must self-disable by conditioning a transaction on the twin *MFW* conditions, it did reiterate that the conditions have to be in place before the parties engage in discussions over substantive deal terms. Transaction parties and their counsel should be mindful, however, that, depending on the facts and circumstances, discussions over substantive deal terms may be alleged to arise not only through negotiations over pricing or indications of interest, but also through the sharing of information on valuation and other terms. Thus, a controlling stockholder seeking to avail itself of favorable treatment under *MFW* should make clear, in any circumstance in which it is contemplating engaging in a transaction with the controlled company, that no transaction will proceed in the absence of the *MFW* protections before engaging in discussions over, or sharing information with respect to, the pricing or other material terms of the deal. This would include engaging in any discussions or sharing materials that would "set the field of play" of valuation for the ultimate transaction.

Notes

1. 2019 WL 1497167, --- A.3d --- (Del. Apr. 5, 2019).
2. 638 A.2d 1110 (Del. 1994).
3. *Id.* at 1116.
4. *Id.*
5. *Id.*
6. *In re Cysive, Inc. S'holders Litig.*, 836 A.2d 531, 548 (Del. Ch. 2003); *see also* In re Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 617 (Del. Ch. 2005) (characterizing the burden shift as "a modest procedural benefit").
7. *Cysive*, 836 A.2d at 548.
8. *See, e.g.*, Solomon v. Pathe Commc'ns Corp., 1995 WL 250374 (Del. Ch. Apr. 21, 1995) (holding that a controlling stockholder had no duty to provide minority stockholders with a "fair price" in a non-coercive tender offer), *aff'd*, 672 A.2d 35 (Del. 1996); In re Siliconix Inc. S'holders Litig., 2001 WL 716787 (Del. Ch. June 19, 2001) (declining to apply entire fairness standard of review to tender offer conditioned on majority-of-the-minority condition); In re Aquila Inc., 805 A.2d 184 (Del. Ch. 2002) (declining to apply entire fairness to a controlling stockholder exchange offer subject to a majority-of-the-minority tender condition and coupled with a commitment on the part of the controller to effect a short-form merger on the same terms as the offer); In re Pure Res., Inc., S'holders Litig., 808 A.2d 421 (Del. Ch. 2002) (indicating that entire fairness would not apply to a controlling stockholder exchange offer if the offer was subject to

negotiation by a duly empowered special committee of independent directors, a non-waivable majority-of-the-minority tender provision, and a commitment by the controller to consummate a short-form merger on the same terms as the exchange offer).

9. 879 A.2d 604.
10. *Id.* at 606.
11. *Id.* at 607.
12. *Id.* at 606–07.
13. 4 A.3d 397, 414 (Del. Ch. 2010).
14. 67 A.3d 496, 500–01 (Del. Ch. 2013), *aff'd sub nom.* Kahn v. M & F Worldwide Corp., 88 A.2d 635 (Del. 2014). The Court elaborated: "Although admitting that there is language in prior Supreme Court decisions that can be read as indicating that there are no circumstances when a merger with a controlling stockholder can escape fairness review, the court concludes that this language does not constitute a holding of our Supreme Court as to a question it was never afforded the opportunity to answer. In no prior case was our Supreme Court given the chance to determine whether a controlling stockholder merger conditioned on both independent committee approval and a majority-of-the-minority vote should receive the protection of the business judgment rule." *Id.* at 502.
15. *Id.* (emphasis added). Later in the opinion, the Court dilated further upon the structural protections, stating: "The business judgment rule is only invoked if: (i) the controller conditions the procession of the transaction on the approval of both a special committee and a majority of the minority stockholders; (ii) the special committee is independent; (iii) the special committee is empowered to freely select its own advisors and to say no definitively; (iv) the special committee meets its duty of care; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority." The Court then observed that a stockholder plaintiff would be entitled to plead facts to support a rational inference that one or more of the conditions was lacking and, as a result, could proceed to discovery. If the plaintiff's discovery were to lead to triable issues of fact in respect of the conditions, the Court noted, the plaintiff would then proceed to trial on substantive fairness." *Id.* at 535.
16. *M & F Worldwide*, 88 A.3d at 644.
17. 195 A.3d 754 (Del. 2018).
18. *Id.* at 756.
19. *Id.*
20. Dissenting from the majority's decision in *Synutra*, Justice Valihura argued that the majority's focus on the commencement of negotiations would only "invite[] factual inquiries that defeat the purpose of what should be more of a bright line and narrower pathway for pleading-stage dismissals in this context." *Id.* at 769 (Valihura, J., dissenting). Although conceding that the term "*ab initio* . . . lacks some precision in the abstract," Justice Valihura argued that, viewed in the *MFW* context, it was meant to refer to "the time of the controller's first written proposal." *Id.* at 773.
21. The defendants objected to the characterization of EnCap as Earthstone's controlling stockholder, noting that the EnCap-affiliated stockholder owned only 41 percent of Earthstone's outstanding stock from and after the time of Earthstone's first formal proposal.
22. 2019 WL 1497167, at *5–6.
23. The fact pattern in *Olenik* differs from the customary fact pattern in which a controlling stockholder is proposing a freeze-out. The customary *MFW* framework requires that the *controller* subject itself to the conditions at the time it makes its offer. In *Olenik*, it was the controlled company's special committee that imposed the conditions. Despite this distinction, the Supreme Court operated under the traditional *MFW* framework, noting that "the same principles" applicable to a controlling stockholder buyout "apply whether the controller is directly or indirectly exerting its influence over the transaction," and observing that the technical failure of the conditions to be imposed by the controller made no difference to the analysis, since "EnCap indirectly controlled Earthstone and appeared to agree with the special committee's insistence on the MFW conditions." *Id.* at *8 nn.50, 58.
24. *Id.* at *2–3.
25. The defendants separately moved to dismiss the claims on the grounds that, because EnCap could not fairly be characterized as a controller, the transaction should be dismissed under the *Corwin* doctrine applicable in transactions in which a controller does not appear on both sides. The Court of Chancery stated: "Because I am satisfied that Earthstone's decision to employ the *MFW* framework was well-executed by all concerned, I need

not decide whether [EnCap] was Earthstone's controlling stockholder because, even if it was, business judgment deference is the appropriate standard by which to evaluate the Transaction, even at the pleadings stage." Olenik v. Lodzinski, 2018 WL 3493092, at *14 (Del. Ch. July 20, 2018).

26. *Id.* at *15.
27. *Olenik*, 2019 WL 1497167, at *8.
28. *Id.* at *9.
29. *Id.*
30. *Id.* The Court then found that, based on the complaint, the initial valuations did indeed set the field of play, as Earthstone's first offer as well as its final offer were within the bands of valuation reflected in the first and second presentations that Earthstone management made to EnCap.

IN THE COURTS

Implied Consent to Personal Jurisdiction on Basis of Controlled Board's Adoption of a Forum-Selection Bylaw

By Christian A. Matarese, Emily Standen and Daniel Rubin

In a decision with potentially far-reaching implications for private equity sponsors and other controlling stockholders, the Delaware Court of Chancery expanded the potential for liability for foreign-based controllers by holding that a controlling stockholder gave its implied consent to personal jurisdiction in Delaware when its designees on a subsidiary's board of directors participated in the board's adoption of a Delaware forum-selection bylaw.[1] The decision in *Pilgrim's Pride* also expands directors' potential exposure to liability by holding that the mere act of voting in favor of a resolution to approve a self-dealing transaction, with no other action taken by such directors, represented enough involvement in the deal for the Court to allow the suit against the directors to continue.

At the same time, the Chancery Court signaled an openness to deferring to directors' business judgment in deals that ordinarily would be subject to entire fairness review if "enhanced-independence" directors have approved the challenged transaction. The new approach, if established as Delaware law, would allow controlling stockholders and directors to qualify for the presumptions of the business judgment rule in self-dealing transactions even when the transaction is not conditioned on approval by a majority of the minority stockholders.

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Background

The case arose from an acquisition engineered by the Batista family of Brazil, whose investment-holding company agreed in May 2017 to pay a fine of US$3.2 billion to the Brazilian government. To raise the necessary funds, JBS S.A., a large Brazilian meat-processing company controlled by the Batista holding company, was alleged to have caused its subsidiary Pilgrim's Pride Corporation, a Nasdaq-quoted Delaware corporation that sells chicken in the United States, to acquire a separate, wholly owned subsidiary of JBS, Moy Park, Ltd., for a purchase price of US$1.3 billion.

At the time of the acquisition, JBS owned 78 percent of the common stock of Pilgrim's Pride and controlled the company through its right to appoint six of the board's nine members. The remaining three seats on the board were designated for the holders of the company's remaining equity. A special committee of those three directors (whom the Court considered independent for pleading purposes) was formed to consider, negotiate and decide on the proposed acquisition of Moy Park. Over the course of several weeks, the special committee and JBS negotiated price and timing, eventually coming to terms on price and on an agreement for exclusivity while the deal documents were negotiated. Soon after, JBS breached the exclusivity agreement and discussed a competing bid for Moy Park with a third party, which JBS used to raise Pilgrim's Pride's offer. The special committee ultimately agreed to a higher price and approved the acquisition and deal documents.

In addition to the approval by the special committee, the full board of Pilgrim's Pride approved the transaction to satisfy a covenant in the company's bond indenture that required board approval for certain material transactions. On that same day, the full board also adopted a company bylaw designating the Delaware Court of Chancery as the sole and exclusive forum for disputes related to the company's internal affairs.

The plaintiffs, minority stockholders of Pilgrim's Pride, filed suit against JBS as controlling stockholder and five of the directors designated by JBS, alleging breach of their fiduciary duties for having caused Pilgrim's Pride to consummate the acquisition at an inflated price. The plaintiff stockholders claimed that Pilgrim's Pride did not engage in true arm's-length bargaining with JBS, alleging in particular that Pilgrim's Pride permitted its management team and its financial advisor to lead the negotiations despite their lack of independence from JBS and ultimately agreed to pay a purchase price that was higher than what internal analyses supported and other bidders were willing to pay.

The defendants did not dispute that the acquisition, as a transaction between a company and its controlling stockholder, ordinarily would be reviewable under the entire fairness standard of review. As the deal had not been conditioned on approval by a special committee of independent directors and a majority of the stockholders unaffiliated with JBS, the *MFW* framework for restoring the presumptions of the business judgment rule had not been met.[2] However, JBS moved to dismiss the complaint for lack of personal jurisdiction, maintaining that the complaint did not establish any ties between JBS and the State of Delaware other than JBS's status as controller of Pilgrim's Pride. The defendant directors also moved to dismiss, arguing that the special committee had negotiated and approved the deal in its entirety while the defendant directors' only involvement was approving the acquisition to avoid violating the indenture covenant.

Implied Consent to Personal Jurisdiction

The Chancery Court rejected JBS's motion to dismiss for lack of personal jurisdiction, holding that because Pilgrim's Pride was controlled by JBS, the Pilgrim's Pride board's adoption of a Delaware forum-selection bylaw with the involvement of JBS's board representatives constituted implied consent by JBS to personal jurisdiction in Delaware. In support of its ruling, the Court cited decisions by the federal district court in Delaware and the Delaware Superior Court that held that when parties specify an exclusive forum for disputes, they implicitly agree to the existence of personal jurisdiction in that forum.[3] The Court extended that principle to the controlling stockholder in the case at hand, in which the controlled board adopted the bylaw on the same day that it approved the acquisition. Given the reasonable inference that the board adopted the bylaw specifically to funnel any stockholder claims relating to the acquisition to the Delaware Court of Chancery, and that JBS was the obvious stockholder defendant in any action claiming a breach of fiduciary duties, JBS was held to have consented implicitly to personal jurisdiction in Delaware when its representatives on the Pilgrim's Pride board voted to adopt the bylaw.[4]

Key Takeaways

The Chancery Court emphasized that its decision was limited to the facts of the case and that it was not making a blanket ruling that ownership of stock (even 100 percent ownership, let alone a mere controlling stake) in a Delaware corporation confers personal jurisdiction.[5] Nevertheless, the facts of the case are common enough to serve as a warning to non-resident controlling stockholders who cause their subsidiaries to undertake an M&A transaction. Adopting a Delaware forum-selection bylaw has become common practice in M&A deals with Delaware governing law when the target company does not already have such a bylaw in place. In any situation in which a controlled subsidiary adopts a forum-selection bylaw, the controlling stockholder (assuming it at least controls a majority of the subsidiary board) should be on notice that it could be held to have submitted to personal jurisdiction in Delaware.

On the basis of the rationale described in *Pilgrim's Pride*, personal jurisdiction could extend to non-resident controlling stockholders even in deals that are not self-dealing transactions. Even in an arm's-length transaction, if the target company board, a majority of whose members are appointed by the controlling stockholder, adopts a forum-selection bylaw on the same day that it approves the transaction, the non-resident controlling stockholder of the target company should be aware that it could be held to have consented to personal jurisdiction in Delaware.

Personal Liability for Approval of a Transaction

The Chancery Court further rejected the director defendants' motion to dismiss the suit on the grounds that they were uninvolved in the deal. The director defendants argued that the full board only approved the transaction for purposes of compliance with the company's indenture while the special committee did all the relevant work, and that their involvement was not enough to support personal liability.

The Court agreed that under Delaware law, a director can avoid liability for an interested transaction by totally abstaining from any participation in the transaction.[6] Here, however, two of the director defendants did more than simply vote on the resolution to approve the transaction, but actively participated in the negotiations.[7] With respect to the other three directors, the Court acknowledged that approval of a board resolution is a "slim reed" on which to base personal liability.[8] However, the Court noted that the directors could have used the threat of violating the indenture covenant to halt the transaction. Their failure to do so constituted sufficient involvement in the transaction at the pleading stage to deny the director defendants' motion to dismiss.[9]

Key Takeaways

The *Pilgrim's Pride* decision on personal liability for directors based on mere approval of the transaction, at this point, is relevant only for purposes of dismissing a claim at the pleading stage. The decision is also somewhat ambiguous as to whether it applies only in the context of a self-dealing transaction or any time the board takes action, and whether it applies any time the board approves a transaction or only if the approval represented some failure to exercise leverage, as was the case here. Therefore, it is too soon to conclude that mere approval of a transaction can expose directors to damages. Nevertheless, directors who have properly recused themselves from participating in a conflict transaction should be aware that the mere act of approving the transaction, even for contractual-compliance purposes, can provide a basis for litigation in Delaware, if not liability.

Standard of Review

Although both parties assumed that the operative standard of review would be entire fairness, Vice Chancellor Laster suggested of his own accord that there could be another way, aside from the *MFW* framework, in certain controller transactions to lower the standard of review to the business judgment rule. Citing to an article by Lucian Bebchuk and Assaf Hamdani,[10] the Court proposed in dicta that if a transaction is approved by directors who are not only independent, but who are nominated and can be removed by the minority stockholders—whom the article describes as "enhanced-independence directors"—the transaction should qualify for the more lenient business judgment rule standard of review. The Court noted Bebchuk and Hamdani's observation that while the *MFW* structure works well for major transactions like squeeze-out mergers, its significant requirements are harder to meet in other types of controller transactions such as the Moy Park acquisition, where a more flexible framework might be appropriate. The paper argues that approval by enhanced-independence directors should suffice because the concern of undue influence by the controller over the decision-making of otherwise independent directors is mitigated if the minority stockholders control the directors' selection, election and removal.

Here, the three members of the special committee who negotiated and approved the transaction for Pilgrim's Pride were appointed to the board in a stockholder vote in which JBS was required to vote its shares in the same proportion as the shares held by the minority stockholders were voted. The Court held that as a practical matter, this voting structure would qualify the special-committee members as enhanced-independence directors. Nevertheless, the Court agreed with the plaintiff stockholders that the proposed framework opened too many questions of first impression for the Court to resolve on the current record and did not consider the approach any further.

Key Takeaways

While the Chancery Court did not rule on the application of the enhanced-independence framework, its decision in *Pilgrim's Pride* signals to the deal community the Court's readiness to take up the issue.

The enhanced-independence framework likely would be embraced in the private equity realm, where portfolio companies frequently are owned by a sponsor that would qualify as a controller under Delaware law, yet the minority stockholders at times have contractual rights to appoint directors to the board. The framework also would apply in situations beyond the typical squeeze-out merger (where the aggrieved stockholders are the minority stockholders of the target company), such as in the transaction at issue in *Pilgrim's Pride*, in which the plaintiff stockholders owned equity in the buyer entity.

Various questions concerning the application of the enhanced-independence framework would have to be resolved in a future decision on the subject, including whether:

- Approval by enhanced-independence directors warrants restoring the presumptions of the business judgment rule or simply relaxing the standard of review to the intermediate standard of enhanced scrutiny.[11]
- A special committee comprised only of enhanced-independence directors would have to be formed to negotiate and approve the transaction in order to lower the standard of review to business judgment, or whether ordinary independent directors also could participate in the process (and, if so, whether the enhanced-independence directors must at least comprise a majority of the special committee).
- The standard of review should be lowered if the transaction is approved by enhanced-independence directors even if the transaction was not initially conditioned by the controller on such enhanced-independence directors' approval.
- The enhanced-independence framework should be available in squeeze-out mergers, where the *MFW* procedural protections are required to lower the standard of review to business judgment.

Notes

1. In re Pilgrim's Pride Corp. Deriv. Litig., 2019 WL 1224556 (Del. Ch. Mar. 15, 2019).
2. *See* Kahn v. M & F Worldwide Corp., 88 A.3d 635, 644 (Del. 2014), affirming that the business judgment rule can be the operative standard of review for a transaction that would otherwise be reviewable under entire fairness if the controller conditions the transaction on the approval of both (i) a special committee of independent directors and (ii) a majority of the minority stockholders.
3. *Pilgrim's Pride*, 2019 WL 1224556, at *12.
4. *Id.* at *13.
5. *Id.* at *15.
6. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 710–11 (Del. 1983).
7. *Pilgrim's Pride*, 2019 WL 1224556, at *17.
8. *Id.* at *2.
9. *Id.* at *18.
10. Independent Directors and Controlling Shareholders, 165 U. Pa. L. Rev. 1271 (2017); *see Pilgrim's Pride*, 2019 WL 1224556, at *8.
11. *Pilgrim's Pride*, 2019 WL 1224556, at *9, n.4.

CLIENT MEMOS

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

Akin, Gump, Strauss, Hauer & Feld LLP
Washington, DC (202-887-4000)

New York Court Dismisses Public Company's Defamation Lawsuit against Short Sellers (April 1, 2019)

A discussion of a defamation suit brought by an India media company against multiple short sellers who had questioned the accuracy of the company's reported financials in a series of investor reports, tweets, and public statements. The New York court dismissed the claims, finding the challenged statements were constitutionally protected opinion and not actionable.

Cadwalder, Wickersham & Taft LLP
New York, NY (212-504-6000)

Delaware Court of Chancery Interprets Merger Agreement (April 4, 2019)

A discussion of a Delaware Chancery Court decision, *Vintage Rodeo Parent, LLC v. Rent-A-Center, Inc*., holding that Rent-A-Center properly terminated its merger agreement with Vintage after Vintage failed to submit a notice to extend the drop-dead date for its pending buyout of Rent-A-Center.

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

SEC Issues Guidance on New Rules for Confidential Treatment of Material Agreements (April 5, 2019)

A discussion of SEC guidance on how it will review redacted agreements under new procedures for filing redacted agreements with the SEC without the need to make a formal confidential treatment request as well as transition issues.

Recent Second Circuit Decision May Lead to an Increase in Offshore M&A Litigation Being Filed in the United States (April 25, 2019)

A discussion of a US Court of Appeals for the Second Circuit decision holding that the district court abused its discretion by failing to consider a forum selection clause in a foreign issuer's Depositary Agreement, notwithstanding the fact that the issuer is a Cayman Islands company and the gravamen of the lawsuit concerned an issue of Cayman law.

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

SEC Pares Pack Required Content for Exhibit Filings: Takeaways for TMT (April 2019)

A discussion of the SEC's adoption of amendments to Regulation S-K intended to modernize and simplify disclosure requirements applicable to SEC reporting companies, particularly two changes of note for companies in the technology, media and telecommunications industry.

Drinker Biddle & Reath LLP
Philadelphia, PA (215-988-2700)

SEC Issues Risk Alert Regarding Reg S-P, Privacy, Safeguarding, and Registrant Compliance (April 25, 2019)

A discussion of issuance by the SEC's Office of Compliance Inspections and Examinations of a "Risk Alert" regarding the compliance practices for privacy notices and safeguard policies for investment advisers and broker-dealers.

Goodwin Procter LLP
Boston, MA (617-570-1000)

Developments in the Use of "At-the-Market" Offering Programs by REITs (April 2019)

A discussion of unique aspects and recent developments in the use of at-the-market offering programs by public real estate investment trusts.

K&L Gates LLP
Pittsburgh, PA (412-355-6500)

Percidian and ActiveShares ETFs (April 1, 2019)

A discussion of the SEC's giving notice of its intent to grant exemptive relief to an adviser and its related open-end investment companies, which signals the dawn of a new era for traditional active management and exchange-traded funds.

Kirkland & Ellis LLP
Chicago, IL (312-862-2000)

Drafting Governing Law and Forum Selection Clauses (April 8, 2019)

A discussion of a number of recent cases highlighting the importance of properly drafting governing law and forum selection clauses to give maximum effect to the parties' preferences.

McDermott, Will & Emery, LLP
Chicago, IL (312-372-2000)

Observations from the Enforcement Directors at SEC's Annual Conference (April 17, 2019)

A discussion of remarks by SEC Enforcement Co-Directors addressing notable enforcement decisions, actions, and trends affecting public companies and regulated entities.

Morris, Nichols, Arsht & Tunnell LLP
Wilmington, DE (302-658-9200)

Delaware Corporation Law Section Approves Amendments to Delaware's Alternative Entity Acts (April 25, 2019)

A discussion of proposed amendments to the Delaware Limited Liability Company Act, the Delaware Revised Uniform Limited Partnership Act, and the Delaware Revised Uniform Partnership Act approved by the Delaware State Bar Association that will be considered by the Delaware legislature.

Norton, Rose Fulbright LLP
Washington, DC (202-662-0200)

US Reporting Companies Must Disclose Brexit Risks (April 2019)

A discussion of the impact of Brexit that US reporting companies should consider disclosing.

Pepper Hamilton LLP
Philadelphia, PA (215-981-4000)

Proposed Rule Would Allow Expanded Solicitations of Interest Prior to a Registered Public Offering (April 22, 2019)

A discussion of a proposed new SEC Rule 163B under the Securities Act of 1933 that would expand the availability to follow-on and other registered offerings and to all issuers of "test the waters" communications with qualified institutional buyers and institutional accredited investors to gauge market interest prior to filing a registration statement.

Quarles & Brady LLP
Milwaukee, WI (414-277-5000)

The SEC's Whistleblower Program after Digital Realty Trust Is Still Going Gangbusters (April 23, 2019)

A discussion of the SEC's whistleblower program following the 2018 Supreme Court decision holding that the anti-retaliation provisions of the

Dodd-Frank Act do not apply to one who solely reports potential violations internally.

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

SEC Scrutinizes Sale of Mortgage Interests among Affiliated Funds (April 2, 2019)

A discussion of a settled enforcement case in which the SEC alleged that an investment adviser arranged for the sale of mortgage interests from one client to another, but failed to run an adequate auction process for the loans.

SEC Proposes Extending Securities Offering Reforms to Closed-End Funds and Business Development Companies (April 15, 2019)

A discussion of SEC proposals intended to streamline the registration, communications, and offering practices for business development companies and registered closed-end investment companies.

Simpson, Thacher & Bartlett LLP
New York, NY (212-455-2000)

Auditor-Related Considerations for 20-F Filers Involved in Government Investigations (April 4, 2019)

A discussion of the importance of a company, subject to the reporting requirements of the SEC, including the requirement to file an annual report on Form 20-F, of obtaining an unqualified audit opinion and considerations for 20-F filers in dealing with the company's auditor.

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

NYSE Revises Exceptions to Shareholder Approval Rules (April 2, 2019)

A discussion of SEC approval of an amendment to the New York Stock Exchange requirement that listed companies obtain shareholder approval for certain share issuances, particularly the method for determining whether the price at which common stock is sold by a company exceeds the value of the common stock.

Shareholder Activism Trends in the 2019 Proxy Season (April 23, 2019)

A discussion of recent trends in the industry indicating that there are various ways for companies and boards to expect to engage with activist investors.

Stradley, Ronon, Stevens & Young, LLP
Philadelphia, PA (215-564-8000)

New Jersey Proposes Uniform Fiduciary Standard (April 16, 2019)

A discussion of a regulation proposed by the New Jersey Bureau of Securities to create a uniform fiduciary standard for broker-dealers and investment advisers that imposes fiduciary duties on broker-dealers and agents for certain types of recommendation and advice made to retail customers.

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

SEC Adopts New Rules and Procedures for Confidential Treatment of Material Contracts and Agreements (April 22, 2019)

A discussion of the SEC's adoption of amendments to modernize and simplify certain disclosure requirements under Regulation S-K; including new rules that allow registrants to file redacted material contracts and agreements without submitting a confidential treatment request.

Vinson & Elkins LLP
Houston, TX (512-542-8400)

Kokesh Costs SEC Nearly $1 Billion; DOJ and Congress React (April 10, 2019)

A discussion of the impact on the SEC of the 2017 Supreme Court *Kokesh* decision curtailing the

SEC's ability to seek disgorgement outside the five-year statute of limitations for civil penalties.

Wachtell, Lipton, Rosen & Katz New York, NY (212-403-1000)

Compensation Committee Guide (April 2019)

An overview of the key rules applicable to compensation committees of listed US companies and practices that compensation committees should consider in the current environment.

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

Mutual Fund Sponsors Beware (April 17, 2019)

A discussion of a SEC staff request that mutual funds file a delaying amendment to postpone the effective date of their registration statements if a fund is unable to submit responses to staff comments at least five business days before automatic effectiveness. The memorandum notes that complying with this request could leave a mutual fund without an effective registration statement.

INSIDE THE SEC

Highlights from SEC Speaks 2019

By Emily Shroder and Sherri Deckelboim

On April 8 and 9, 2019, senior officials of the US Securities and Exchange Commission (SEC) spoke at the annual Practising Law Institute "SEC Speaks" conference in Washington, DC, detailing the SEC's key developments during fiscal year 2018 and its priorities for fiscal year 2019. Recurring areas of focus were transparency, efficiency, and cybersecurity in speeches by the Chairman, Commissioners, Investor Advocate, and representatives of the Division of Corporation Finance.

Chairman Clayton Outlines the SEC's "MD & A"

Chairman Jay Clayton spoke about the SEC through the "eyes of management," providing an overview of SEC operations and results in a style similar to a company's "Management Discussion & Analysis" section of public filings. He noted the SEC's "three-part mission: (1) to protect investors; (2) to maintain fair, orderly, and efficient markets; and (3) to facilitate capital formation."

In discussing factors and trends affecting the SEC's results of operations, Chairman Clayton identified numerous topics, including the ability to invest in technology and address privacy concerns, the need to divert resources to respond to unforeseen events or congressional mandates, the potential effects of events such as Brexit and other events beyond the SEC's control that can have significant impacts on the capital markets, and the ability to assess and improve how the SEC looks at risk, both internally to the SEC and externally to the capital markets. Additionally, Chairman Clayton acknowledged that the ability to retain and recruit SEC Staff was hindered by the hiring freeze, with staffing levels at the SEC down by more than 400 positions as compared to fiscal year 2016; however, the SEC expects to add about 100 positions in fiscal year 2019 under its new budget.

Chairman Clayton highlighted the SEC's accomplishments from fiscal year 2018, commenting that the SEC's recent victory in *Lorenzo v. SEC* in the Supreme Court will have a significant impact on the SEC's ability to bring charges in situations involving the dissemination of misstatements, including in private markets.

With regard to the SEC's rulemaking agenda, Chairman Clayton noted how the streamlined Regulatory Flexibility Act included only the initiatives the SEC could "reasonably expect to complete" over the year, and in doing so, it increased the SEC's transparency and accountability, both to the public and to Congress. In fiscal year 2018, the SEC advanced 23 of the 26 rules on its agenda and advanced several other initiatives outside of the agenda to keep up with current events.

Chairman Clayton also stated that the SEC's enforcement efforts were highly successful during fiscal year 2018, returning $794 million to harmed investors. He spoke of the Staff and Commissioners' direct engagement with Main Street investors throughout the country during fiscal year 2018 using town halls, outreach tours, digital tools, and other methods.

In looking ahead to the remainder of fiscal year 2019, Chairman Clayton emphasized that the SEC will continue to improve its transparency and efficiency, and it is working hard to identify outdated rules that might not be functioning as intended in modern markets.

Emily Shroder *and* **Sherri Deckelboim** *are associates at Gibson, Dunn & Crutcher LLP in Washington, DC.*

Commissioner Jackson on Regulation Best Interest, Cybersecurity Disclosure Guidance, and Goals for 2019

Commissioner Robert J. Jackson, Jr. reported on the importance of the SEC's progress with regard to Regulation Best Interest, a proposed new rule under the Securities Exchange Act of 1934 (Exchange Act), to establish standards of conduct for broker-dealers. He noted that he has advocated for clarification of the standard of the obligations a broker owes to a client. Most importantly, he emphasized his view that the broker should "put the client's interests first." Commissioner Jackson argued that compensation practices that lead brokers to focus on conflicted activities should be limited or banned, an effort that should be bipartisan.

According to Commissioner Jackson, cybersecurity is the issue that he hears about most from boards and from counsel in the marketplace. He has been conducting a set of empirical studies about the degree to which data breaches are being disclosed properly in Form 8-Ks and other filings, and he expressed his desire for the SEC to develop more robust and clearer guidance for disclosure in this area. Commissioner Jackson's focus is on what information is not getting to market, and he stated that additional guidance would be useful in this area; however, he asserted that the degree of disclosure about a cybersecurity incident requires a judgment call by companies and counsel.

In addition, Commissioner Jackson reported on his many other goals for fiscal year 2019. He said that insider trading laws should be updated to better fit the market today, and the SEC should adopt more bright-line rules that are easier for companies and individuals to follow. He noted that the SEC has a working group looking at this topic, and he recently co-wrote a *New York Times* opinion piece about the issue. Commissioner Jackson also promoted reconsidering whether a four-day requirement for filing a Form 8-K is still appropriate or if the deadline should be shortened to two days, which was considered post-Sarbanes-Oxley and is required for Section 16 filings. He also stated that he wants to reconsider the degree to which compensation disclosures provide the information investors need. Such disclosures have not been addressed since 2006.

Commissioner Jackson also plans to evaluate how to balance the benefits of robo-advisors—that they can move investors toward a lower-cost model for investment in the economy—with their detrimental effects, including with regard to fiduciary duties. He qualified the benefits of robo-advisors by noting that algorithms are not foolproof ways to advise investors, and he also commented that many people still desire a face-to-face conversation when discussing their financial future.

Commissioner Peirce Identifies the SEC's "Secret Garden"

Commissioner Hester M. Peirce discussed how the SEC has its own "Secret Garden," meaning that Staff guidance through non-public no-action letters or Staff phone calls and meetings can create a body of "secret law" that is only accessible to a select few. She cautioned that this, along with the complexity of the securities laws, creates a "compliance minefield." While the ideal world would be "radical simplification" of the securities laws, her goal is to provide greater clarity, consistency, and workability. She acknowledged that not all questions can be handled at the SEC level while voicing dissatisfaction with non-public Staff guidance that she asserts has essentially become secret law not subject to judicial oversight. Though making many no-action letters public was a step in the right direction, Commissioner Peirce stated that she remains concerned about the fairness and transparency of this secret law that effectively binds market participants, and she questioned the impact that it will have on the SEC in maintaining the public trust in the long term.

Commissioner Roisman Encourages Smaller Entrants to the Capital Markets

Commissioner Elad L. Roisman discussed encouraging and facilitating entrance to the capital markets, especially for smaller companies. He identified how a necessary component of successful capital markets is Main Street investors' participation. Commissioner Roisman asserted his belief that the SEC should address barriers to small business capital formation, such as regulatory burdens, high costs related to litigation, and challenges with secondary market liquidity after a company goes public.

Commissioner Roisman highlighted how the SEC is responsible both for constantly engaging with those who participate in the public markets and for helping to facilitate capital formation. Some recent examples that he noted with regard to the SEC addressing that responsibility are:

- In December 2018, the SEC issued a request for comment on Form 10-Qs and earnings releases, asking how the SEC can reduce reporting burdens while maintaining investor protections. The request also questioned whether the existing reporting system may foster an overly short-term focus on the part of managers and other market participants.
- In early 2019, in an effort to encourage issuers to conduct registered public offerings and lower their cost of capital, the SEC proposed extending the availability of test-the-waters communications to all issuers, regardless of size.
- Also in early 2019, the SEC adopted amendments to implement the FAST Act. These amendments simplify disclosure requirements and will likely result in time and money savings for registrants without having a detrimental impact on the amount of material information provided to investors.

In the coming months, Commissioner Roisman would like the SEC to provide clear guidance on the topic of "'finders,' who introduce companies to prospective investors, typically for compensation." Questions exist as to whether these finders are acting in the role of broker-dealers under Section 15 of the Exchange Act, and, if so, whether the finders must register as broker-dealers and subsequently comply with applicable rules.

Investor Advocate Rick Fleming on Investor Protection

Investor Advocate Rick Fleming explained how the Division of Trading and Markets is constructing a transaction fee-and-rebate pilot program, as requested by the Investor Advisory Committee, the Equity Market Structure Advisory Committee, and various other market participants. The pilot program will test whether the fee cap of $30 million that has been adopted through Regulation National Market System

> has led to a system of fees and rebates that distort the incentives of market participants, presenting broker-dealers with a potential conflict of interest that could compromise their duty to pursue best execution on behalf of their clients.

Fleming also commented that recent amendments to Rule 15c2-11 implemented by the Division of Trading and Markets hopefully will deter fraud against retail investors by minimizing the trading of unlisted, over-the-counter securities of issuers with minimal or no relevant information publicly available. Likewise, refreshing the "penny stock" definition and the related sales practice rules provides an opportunity to improve investor protections in a historically risky area of the market. Additionally, updates to the antiquated rules regarding transfer agents could help to minimize abuses of investors.

Fleming noted that proxy advisors are a key tool for asset managers, providing for the efficient oversight of companies in the managers' portfolios. He warned that companies dislike this oversight and, as a result, are pushing for increased regulation of proxy advisors, "cloaking their arguments under the mantle of investor protection." Because investors themselves are not the parties asking for protection from the proxy advisors, Fleming maintained that imposing new regulations on proxy advisers should not be a high priority for the SEC.

Division of Corporation Finance Maintains a Broad Focus

The Division of Corporation Finance (Corporation Finance) hosted a panel and a workshop at the SEC Speaks, addressing its recent activities, including cryptocurrency, rulemaking efforts, risk management, shareholder proposals, proxy reform, dispute resolution provisions, and updates from the Office of Mergers and Acquisitions.

Cryptocurrency

Corporation Finance addressed its focus on digital assets for fiscal year 2019, reminding the audience of the strategic hub for innovation and financial technology called "FinHub" that Corporation Finance launched in late 2018. Corporation Finance recently published a framework on FinHub that uses the *Howey* test to analyze a digital asset and the determination of whether a digital asset is a security, an assessment that depends on the overall facts and circumstances, with no one factor being dispositive. Corporation Finance also recently issued a no-action letter to a market participant in connection with the proposed offer and sale of a digital asset. The letter to TurnKey Jet, Inc. said that Corporation Finance will not recommend enforcement action to the SEC if, in reliance on the concept that the tokens are not securities, the company offers and sells the tokens without registration under the Securities Act of 1933 or the Exchange Act. Corporation Finance noted that it will continue to examine this area.

Rulemaking Efforts

In terms of its rulemaking efforts, Corporation Finance outlined how it has been and will continue emphasizing capital formation by:

- Broadening the smaller reporting company definition;
- Examining the private placement exemptions and the accredited investor definition and pursuing a concept release to make those topics less binary;
- Issuing a concept release for the Rule 701 exemption and considering broadening the range of exemptions further as a result of the changing economy (*e.g.*, the gig economy); and
- Broadening Regulation A to cover reporting companies and assessing whether the permitted offering size should be increased.

Additionally, through the FAST Act, Corporation Finance simplified Regulation S-K, including the confidential treatment request process. Corporation Finance also reported that it is requesting comments on the earnings release and quarterly reports processes to assess whether those processes can be streamlined. Further, Corporation Finance announced that it is considering releasing a proposed rule request for comment about Rule 305 of Regulation S-X (*editor's note: this proposal was released on May 3, 2019 in Release No. 33-10635)*, and it is proposing extending the availability of test-the-waters communications to all issuers, rather than just emerging growth companies.

Risk Management

Corporation Finance highlighted that the Office of Risk and Strategy (ORS) was established last year, building on the former Disclosure Standards Office. The ORS addresses enterprise risk management and emphasizes a risk-based approach to regulatory practices, including for strategic, operational, and governance risks, the last of which largely are considered through a disclosure lens. According to Corporation Finance, the ORS is meant to complement the filings review program, which mostly is reactive, by being proactive through looking at broad-based disclosure risks in advance. Corporation Finance remarked that the ORS recently has focused its research on risks presented to registrants by Brexit and the switch from LIBOR (London Interbank Offered Rate) to alternative standards.

Shareholder Proposals

Corporation Finance indicated that the number of shareholder proposals submitted this year was consistent with prior years despite the federal government shutdown. With regard to the ordinary business exception under Rule 14a-8(i)(7), Corporation Finance commented that the Staff has received very helpful analyses from boards and continues to believe that developing these analyses is a useful exercise. In particular, the Staff finds these analyses helpful to determine what is "ordinary" to a particular company under Rule 14a-8(i)(7). With regard to micromanagement arguments, Corporation Finance reaffirmed that the Staff is focused on whether the proposal dictates how particular issues should be resolved, and the Staff has been granting relief where proposals dictate certain outcomes. Corporation Finance noted that executive compensation proposals are not immune from micromanagement arguments if the proposal addresses the minute details of particular forms of compensation.

Proxy Reform

According to Corporation Finance, improving the proxy process is a significant effort that it is pursuing in fiscal year 2019. Commissioner Roisman has asked the Staff to consider both short- and long-term options, including ways to update or clarify current guidance. Topics identified by Corporation Finance for consideration were:

- Raising the $2,000 or 1 percent ownership threshold for shareholder proposal submissions;
- Examining Rule 14a-2(b) proxy solicitation requirements for proxy advisory firms; and
- In general, continuing the dialogue about "proxy plumbing" to see if there are solutions for improving the proxy system, and if modern technology such as blockchain can be part of those solutions.

Dispute Resolution Provisions

Corporation Finance noted that it has been focusing on dispute resolution provisions, such as mandatory arbitration and exclusive forum clauses, and issuing comments regarding their impact on the rights of security holders and questions of enforceability. Corporation Finance acknowledged Chairman Clayton's position that if issues with these provisions arise in a federal context in an initial public offering, the questions will be raised to the Commissioners, not decided by the Staff. These issues also can arise in both a state and federal law context through shareholder proposals (*e.g.*, the 2019 proposal submitted to Johnson & Johnson by The Doris Behr 2012 Irrevocable Trust). While a state law issue can be addressed by the Staff, if a decision on state law does not fully resolve the questions presented, the Commission will address the issues of federal law.

Updates from the Office of Mergers and Acquisitions

Corporation Finance addressed key elements of the filing review program of the Office of Mergers and Acquisitions (OMA) in light of recent market trends. Corporation Finance noted that Item 5 of Schedule 14A, which requires the disclosure of any substantial financial interest (*e.g.*, a short position) that a participant may have in a proxy solicitation, is becoming increasingly relevant because deal activism is on the rise. It emphasized that this requirement was meant to be interpreted broadly. Corporation Finance also commented that the Staff has observed an uptick in illusory tender offers, or offers that are not truly genuine, under Section 14(e) and is reviewing these offers carefully. Additionally, in acknowledging that the FAST Act changed the confidential treatment procedures for reporting companies under Regulation S-K, Corporation Finance clarified that this treatment is not available for exhibits to Schedule 13D because its exhibit requirements, which are separate from those of Regulation S-K, were not amended. Finally, Corporation Finance noted that the OMA is actively working on updating its guidance on a broader scale, and it plans to release much of the guidance this year.

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