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Fenwick Securities Law Update

– September 19, 2024 –

Welcome to the latest edition of Fenwick's Securities Law Update. This issue contains updates and important reminders on:

- **The SEC charging seven public companies with violating the whistleblower protection rule** by requiring employees to waive possible whistleblower monetary awards in employment, separation, and other agreements
- **The SEC's charges against biotechnology company Zymergen Inc.,** for allegedly misleading IPO investors about the company's market potential and sales prospects
- **The SEC's decision to approve a Nasdaq proposal to modify its independent director and committee phase-in periods**, which presents a host of considerations for affected companies
- **The California legislature's amendments to climate disclosure laws**, which may slightly delay the timeline for disclosing certain greenhouse gas emissions
- **Reminders about Form 10-Q disclosures** and upcoming compliance deadlines

Important Reminders

- **Considerations for upcoming Form 10-Q disclosure:**
    - **Risk related to inflation.** The Federal Reserve is expected to cut interest rates in mid-September. Companies may want to review their Quantitative and Qualitative Disclosures about Market Risk and Risk Factors in their upcoming Form 10-Q and consider whether any updates are necessary.
    - **Risk related to Chevron and related decisions.** As previously noted, we have observed that life sciences companies are adding risk factor language in response to the U.S. Supreme Court overturning the Chevron Doctrine and related decisions. Companies in life sciences or other highly regulated industries should consider whether it is appropriate to include such disclosure. Please see our alert for an example of such risk factor language.
    - **Ongoing risk related to CrowdStrike outage.** Companies impacted by CrowdStrike's defective software update should consider updating their risk factors and forward-looking statements about systems downtime and/or reliance on third parties to operate critical business systems. Remember to revise relevant hypothetical language about outages or systems downtime to indicate that such risks have already occurred. Finally, impacted companies

should also consider discussing material impacts (if any) in the management's discussion and analysis section of their next Form 10-Q. In addition, software and technology companies that similarly update systems, including automated updates, should ensure their risk factors cover risks associated with errant updates, and that their boards have oversight visibility on how those risks are mitigated where it may be deemed mission critical to the company.

- **Risk related to AI.** As a reminder, the EU AI Act entered into force on August 1. Companies should review and update any relevant language in their AI risk factor to reflect this development. Note that the SEC and the plaintiffs' bar also continue to focus on AI washing.

- **Risks related to U.S.-China trade tensions.** In advance of the upcoming presidential election, some businesses are reportedly increasing their imports from China so they can stockpile inventory of certain components manufactured in China. See Businesses Are Already Girding for Next Phase of the U.S.-China Trade War (*The New York Times*, August 2024). While reviewing their Form 10-Q, companies should consider whether any of their supply chain disclosure should be updated to reflect new risks, such as the risk of holding excess inventory, or any other developments.

- **Companies may also want to consider whether their risk factors adequately disclose** any risk related to the U.S. government potentially prohibiting or otherwise restricting procurement of key materials/components manufactured outside the United States or by companies domiciled outside the United States.

- **Risks related to export controls.** On September 5, the U.S. Department of Commerce's Bureau of Industry and Security (BIS) published an interim final rule implementing new export controls on several semiconductor, quantum computing, and additive manufacturing items, that began September 6. Companies should consider whether this new rule will have a material impact on their business.

- **Presidential election.** Companies should continue to monitor developments in connection with the upcoming presidential election and assess whether those may have material impacts on their business.

- **REMINDER: New filing deadlines for Schedule 13G become effective on September 30.** Note that amended 13G filings must be filed by 10 p.m. EST on Thursday, November 14 to report material changes since the filer's last 13G filing. Please see our client alert for more information.

- **REMINDER: Effective October 1, the SEC will increase the registration fee rate** from $147.60 per million dollars to $153.10 per million dollars. Companies should use the new rate when calculating the fees for any registration statement filing on or after October 1.

- **REMINDER: The following new insider trading disclosures will be required** in companies' upcoming Forms 10-K (FY 2024) and/or proxy statements:

Disclosure Requirement	First Required Filing for 12/31 FYE Companies	XBRL Tagging?	Action Items
Insider Trading Policy Exhibit - Items 408(b)(2) and 601(b)(19)	Form 10-K (FY 2024)	No	• Since insider trading policies will now be public, consider assessing whether any updates to the policy are necessary. • Consider benchmarking against insider trading policies exhibits from early filers.
Disclosure of Insider Trading Policies and Procedures - Item 408(b)(1)	Next Proxy Statement and Form 10-K (FY 2024)	Yes	• Consider reviewing disclosures from early filers. • Start documenting the company's procedures for handling trading activities under its insider trading policy. • Review the SEC's taxonomy guidance for XBRL tagging.
Tabular and Narrative Disclosure of Certain Options Awarded Close in Time to the Release of Material Nonpublic Information - Item 402(x)	Next Proxy Statement and Form 10-K (FY 2024)	Yes	• Consider reviewing disclosures from early filers. • Consider adopting an equity grant policy that provides for equity grants to be made on pre-established dates, or timing grants to be made outside of the period preceding filings that trigger specific disclosure. • Evaluate whether any other compensation practices need to be changed in light of the new disclosure requirements. • Review the SEC's taxonomy guidance for XBRL tagging.

Please see our client alert for more information.

- **REMINDER: Form SD is due on September 26 for resource extraction issuers** (i.e., companies that engage in the commercial development of oil, natural gas, or minerals) with a December 31 fiscal year end.

- **REMINDER: In August, a Texas federal district court struck down the FTC's noncompete ban**, blocking it from taking effect nationwide. Note that state law will continue to govern the enforceability of noncompetes. Please see our client alert for more information.

Rules and Regulations

- **On August 27, the SEC approved Nasdaq's proposal to modify its independent director & committee phase-in periods.** The SEC issued an order to approve Nasdaq's proposed changes to Rules 5605, 5615, and 5810 to clarify and modify the phase-in schedules to the independent director and committee requirements for companies in various circumstances. Please see a high-level overview below:
    - **IPOs**: Nasdaq amended Rule 5615(b)(1) to clarify and modify the phase-in schedules to the independent director and committee requirements for initial public offerings, including:
        - Adding the text of the phase-in provisions of SEC Rule 10A-3 regarding the number of independent audit committee members required post-IPO instead of just referencing the rule
        - Permitting companies to comply with the requirement to have one independent director on the compensation and nominations committees by appointing such director by the earlier of the date the IPO closes or five business days from the listing date (to accommodate the practice of some companies of holding a meeting to appoint additional independent directors a few days after the listing date)
        - Aligning the phase-in compliance schedule for the three-member requirement for the audit committee with Rule 10A-3 (i.e., at least one member by the listing date, at least two members within 90 days, and at least three members within one year)
- **Note**: The SEC emphasized that this amendment does not modify the requirements of Rule 10A-3 with respect to audit committees. "Thus, if a newly listed company that is eligible for a phase-in period with respect to the size requirement chooses to have initially only one member on its audit committee, that member would need to be independent and also have to meet the Exchange's financial sophistication requirement."
    - **Other circumstances**: Nasdaq amended rules 5615(b) and (c) to clarify and/or modify certain phase-in periods for companies emerging from bankruptcy, transferring from national securities exchanges, listing securities previously registered under Section 12(g), listing in connection with a carve-out or spin-off transaction, or ceasing to qualify as a foreign private issuer or controlled company.
    - **Noncompliance during the phase-in period**: Nasdaq amended rules 5605 and 5810 to codify its existing positions that:
        - A company relying on any phase-in period is not eligible for a cure period immediately following the expiration of the phase-in period unless it complied with the applicable board and committee composition requirements during the phase-in period, but then fell out of compliance.
        - If a company demonstrated compliance with the applicable requirement, but subsequently fell out of compliance before the end of the phase-in period, the cure period is calculated based on the event that caused the non-compliance rather than the end of the phase-in period.
    - **Cure period for compensation committee requirements**: Nasdaq amended Rule 5810 to describe cure period procedures if a company fails to meet the compensation committee composition requirement due to one vacancy

or one committee member ceasing to be independent due to circumstances beyond the member's reasonable control. In this situation, Nasdaq will notify the company and inform it that the company has until the earlier of its next annual meeting or one year from the occurrence of the event that caused the failure to comply with this requirement to cure the deficiency (with a minimum of 180 days if the annual meeting is held sooner).

Many of the amendments proposed by Nasdaq are similar to rules that were previously approved for the NYSE.

- **California legislature approves amendments to climate disclosure laws.** On August 31, the California Assembly and Senate passed SB 219, which provides for the following notable changes to the climate disclosure laws, among others:

  - The amendments would not impact the timeline for the disclosure of Scopes 1 and 2 Greenhouse Gas (GHG) emissions under SB 253, beginning in 2026, but may slightly delay the timeline for disclosure of Scope 3 GHG emissions (although the first disclosure will continue to be due in 2027).

  - The California Air Resources Board (CARB) would have until July 1, 2025, to adopt regulations for Scopes 1, 2, and 3 GHG emissions reporting.

  - GHG emission reports would be allowed to be consolidated at the parent company level.

  Gov. Gavin Newsom has until September 30 to sign or veto SB 219. We expect that he will sign the bill into law, though he may continue to advocate for delays in the reporting deadlines. Please see our client alert for more information.

- **California AI bill sent to Newsom for signing.** As currently drafted, the bill would among other things:

  - Require AI developers to comply with various precautionary measures before making AI models publicly available, including the capability to promptly enact a full shutdown to prevent imminent harm

  - Require AI developers to annually retain a third-party auditor to perform an independent audit of compliance, beginning January 1, 2026

  - Require AI developers to submit a statement of compliance to the state attorney general

  - Establish whistleblower protections

  - Authorize the state attorney general to pursue civil penalties

  Newsom has until September 30 to sign that bill as well, though he has not yet indicated whether he intends to do so. See AI Public Safety Risk Legislation Sent to California Governor (*Bloomberg Law*, August 2024) and AI Regulation Is Coming. Fortune 500 Companies Are Bracing for Impact. (The Wall Street Journal, August 2024).

- **Rule 16b-3 exemption likely extends to a former director or officer's post-termination transaction.** Historically, neither the SEC nor the federal courts have definitively stated whether Rule 16b-3 exempts a transaction between an issuer and a director or officer if the transaction is approved while the individual is still serving in that capacity but takes place after their service has ended (for example, tax withholding upon the exercise of an option previously approved). However, a recent decision by the Southern District of New York suggests that Rule 16b-3 is satisfied if the

requisite approval occurs prior to the insider's termination of service and the terms of the approved transaction are fixed and irrevocable at that time. See Rule 16b-3 Extends to a Former Insider's Post-Termination Transaction (section16.net, August 2024) for more information.

- **Nasdaq and NYSE are seeking SEC approval to allow the listing of an options tool that tracks the price of bitcoin.** See Nasdaq Seeks SEC's Green Light To Launch Bitcoin Options (*Law360*, August 2024).

- **SEC approves new quality control standard, QC 1000 - A Firm's System of Quality Control.** QC 1000 is an integrated, risk-based standard that mandates quality objectives and key processes for all accounting firms' QC systems. The new standard and related amendments will take effect on December 15, 2025. See Adopting Release No. 34-100968.

SEC Public Commentary and Guidance

- **SEC commentary on financial matters.** The Center for Audit Quality (CAQ) met with staff from the SEC's Division of Corporation Finance and the Office of the Chief Accountant regarding financial reporting matters. Below are some key takeaways:

  - **Non-GAAP debt covenants in earnings releases.** The staff has been recently commenting on measures that are calculated in accordance with a company's debt covenant indicating that a company should limit its discussion of these measures to the liquidity section of a 10-K/10-Q filing and that these measures should not be discussed in earnings releases. Disclosure of such covenants in earnings release is fine if it's presented in connection with the company's financial condition and liquidity.

  - However, if these disclosures present the covenant measure as an indicator of performance (e.g., highlighting it in the earnings release, comparing it to prior period results, and analyzing it like measures of the company's performance), then it does not comply with the non-GAAP rules. See Non-GAAP C&DI 102.09.

  - **Non-GAAP rules apply to measure of a segment's profit or loss.** The staff noted the Commission's non-GAAP rules may apply to measures of a segment's profit or loss (ASU 2023-7, *Segment Reporting*) disclosed in addition to the single required measure of a segment's profit or loss. Registrants with specific questions or plans to early adopt ASU 2023-07 and present additional measures of a segment's profit or loss should contact the staff.

  See SEC Regulations Committee Highlights (CAQ, June 2024) and Earnings Releases: Be Careful When Discussing Non-GAAP Debt Covenants (*theCorporateCounsel.net*, September 2024).

- **SEC scrutiny of disclosure about the application of clawback policies**. The SEC has begun issuing comment letters on clawback policies. In particular, the SEC appears to be digging into how companies are applying their clawback policies. For example, Aeon Biopharma received the following comment:

> "We note that in 2023 your executive officers received bonuses based on the achievement of key performance indicators as determined by your board of directors. We also note the statement that you performed a recovery analysis and determined there was no incentive-based compensation tied to financial performance for any of our executive officers during the relevant recovery period. Please briefly explain to us why

> the application of the recovery policy resulted in this conclusion. See Item 402(w)(2) of Regulation S-K."

In the event of an accounting restatement, the compensation committee will need to quickly oversee a recovery analysis to determine whether a clawback is necessary. Companies may want to establish an internal clawback implementation plan to outline specific actions the company will need to take in connection with such analysis and to assign responsibility to the specific teams. If no recovery is required, the company should still disclose its process and why recovery is not required.

See Dodd-Frank Clawbacks: Early Comment Letters Show Staff Scrutiny (*CompensationStandards.com*, September 2024) and How Boards Should Implement the SEC's Clawback Rule (*Governance Intelligence*, August 2024).

- **SEC comment letter trends**. An analysis of SEC comment letters by PwC identified the 10 most common areas addressed by the SEC staff in Form 10-K and 10-Q filings from July 1, 2023, to June 30, 2024:

  1. Non-GAAP Measures
  2. MD&A
  3. Segment reporting
  4. Business combinations
  5. Revenue recognition
  6. Inventory and cost of sales
  7. Goodwill and other intangibles
  8. Debt, quasi-debt, warrants, and equity
  9. Fair market value
  10. Disclosure controls and internal control over financial reporting

  Please see here for industry-specific SEC comment letter trends, including healthcare and technology.

Relevant Litigation and Enforcement Actions

- **On September 9, the SEC settled charges against seven public companies for violations of the whistleblower protection rule.** According to the SEC's orders, among other things, these companies violated Rule 21F-17(a) by requiring employees to waive their right to possible whistleblower monetary awards in employment, separation, and other agreements. The SEC argues that these provisions indirectly impede potential whistleblowers from reporting potential securities law violations.

  Companies should review their employment and separation agreements along with related policies for provisions requiring employees to waive their right to whistleblower awards or requiring notice of whistleblower communications to agencies. Recent SEC and DOJ whistleblower programs and this enforcement sweep reinforce the need to consider and adopt best practices for company whistleblower programs.

- **On September 13, SEC charged Zymergen Inc**., a biotechnology company, with misleading IPO investors about the company's market potential and sales prospects. The SEC order included the following claims against the company:

  - Zymergen claimed that it had a $1 billion market opportunity for its product, but the estimate was based on flawed and unreasonable assumptions that included product markets that were ill-suited for the product's technical characteristics and unsupported premium pricing.

  - Zymergen provided misleading revenue forecasts to research analysts that exceeded internal estimates.

  - During the company's first earnings call, Zymergen misled investors by misrepresenting the status of its customer pipeline while omitting significant technical and commercial problems facing the product.

  Zymergen agreed to pay a $30 million civil penalty to resolve the SEC's charges.

- **On September 10, SEC charged Keurig with making inaccurate statements regarding recyclability of K-Cups.** According to the SEC's order, in annual reports for fiscal years 2019 and 2020, Keurig stated that its testing with recycling facilities "validate[d] that [K-Cup pods] can be effectively recycled." The company failed to disclose that two of the largest U.S. recycling companies had expressed significant concerns about the commercial feasibility of recycling of K-Cups at that time and indicated that they would not accept them for recycling. The SEC notes that environmental concerns were a significant factor for consumers considering Keurig products. To settle the SEC's charges, Keurig agreed to pay a $1.5 million civil penalty.

  As a reminder, the SEC continues to focus on greenwashing. Companies should carefully any environmental disclosure in their public filings for accuracy.

- **Circuit split over the SEC's reversal of proxy firm advisory rule.** In July 2020, the SEC under then-Chair Jay Clayton amended the federal proxy rules to regulate proxy advisory firms. However, in July 2022, the SEC under Chair Gary Gensler adopted amendments that would eliminate the core components of the new proxy advisory firm requirements.

  On September 10, the U.S. Court of Appeals for the Sixth Circuit upheld the SEC's reversal of the 2020 proxy firm advisory rule, creating a circuit split with the Fifth Circuit, which recently ruled against the SEC in the same matter. The circuit split increases the chances that U.S. Supreme Court may review the matter. See SEC Proxy Firm Rule Repeal Survives Sixth Circuit Challenge (*Bloomberg Law*, September 2024).

- **Plaintiffs' bar scrutinizing AI disclosures.** The plaintiffs' bar appears to be tracking companies' public statements about AI prospects, such as the incorporation of AI. If those prospects are delayed or fail to materialize, plaintiffs are then asserting in lawsuits that the company's statements were materially misleading. See Software Development Platform Hit with AI-Related Securities Suit (*The D&O Diary*, September 2024) and Robotic Automation Company Hit With AI-Related Securities Suit (*The D&O Diary*, June 2024).

  The SEC has also continued to prioritize AI washing. In a recent video about AI washing, SEC Chair Gary Gensler reminded companies that "any claims about prospects should have a reasonable basis and investors should be told that basis."

- **Texas recently opened business courts** as part of the state's ongoing effort to make Texas a corporate-friendly alternative to Delaware. The Texas business courts will have concurrent jurisdiction with Texas' district courts in two categories:

  1. Cases with more than $5 million in controversy that involve items such as corporate governance, derivative actions and securities actions, and smaller such cases in which a publicly traded company is a party

  2. Cases such as contract disputes and actions from violations of the Texas Finance Code or Business and Commerce Code where the amount in controversy exceeds $10 million.

  See What Attorneys Need To Know About New Texas Biz Court (*Law360*, August 2024), Texas Could Be Next Delaware, Attys Say As Biz Court Opens (*Law360*, September 2024), and Musk's Legal Fights Boost Longshot Texas Bid to Become Court Hub (*Bloomberg Law*, August 2024).

- ***Jarkesy* decision used to challenge the SEC's ability to seek industry bars through follow-on administrative proceedings.** The SEC often files follow-on administrative proceedings seeking to bar investment advisers and brokers from working in the securities industry after they are found to have violated the law in court or settle their cases with the SEC. The lawsuit argues that industry bars involve a financial punishment similar to *Jarkesy* because the SEC is attempting to prevent a person from earning their livelihood without a jury trial. See 'Jarkesy 2.0': SEC Sees New Attack On In-House Courts (*Law360*, August 2024).

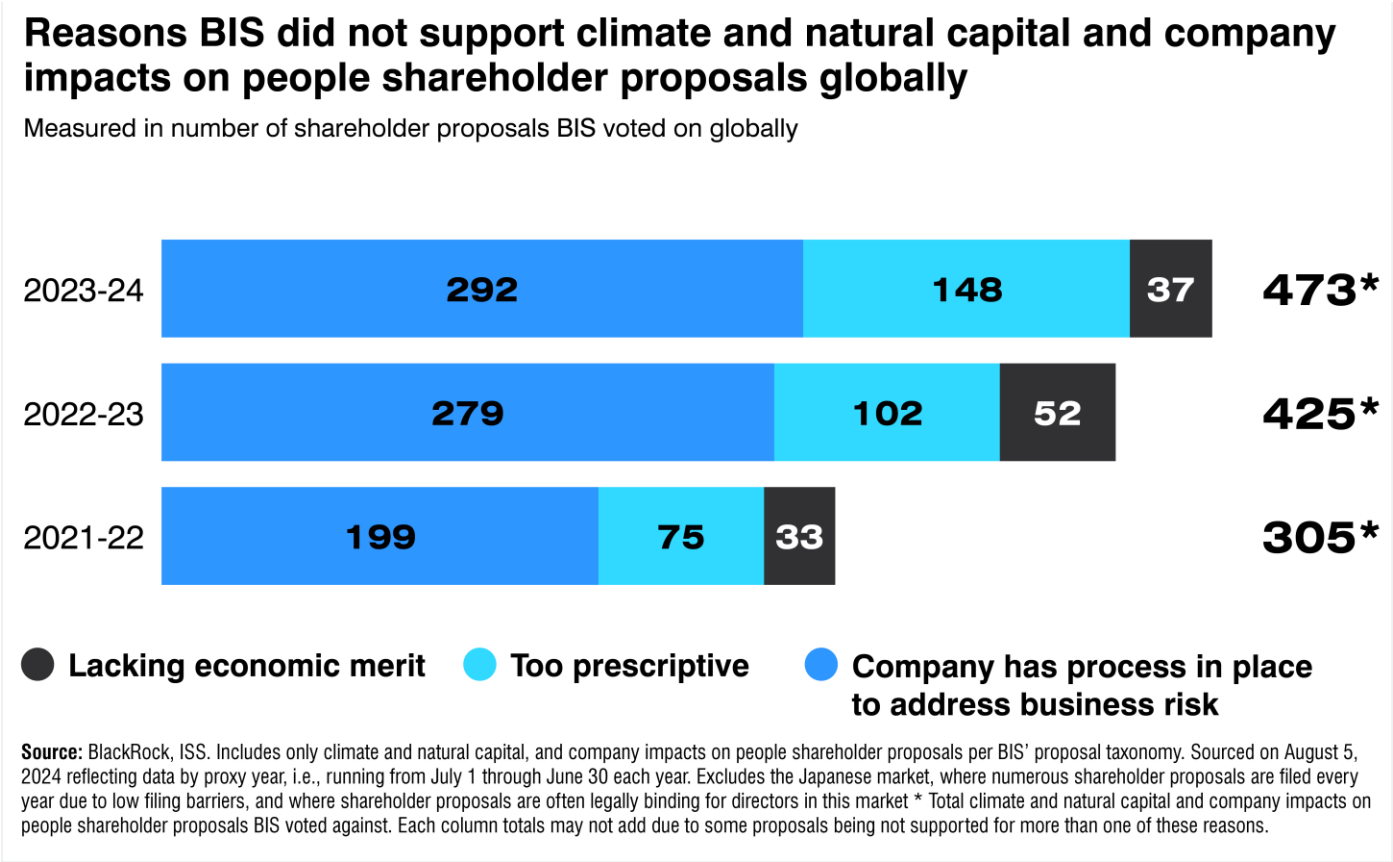
- **The SEC recently dissolved its Climate and ESG Enforcement Task Force.** Please see our alert for more information.

Proxy Season

- **BlackRock and Vanguard's support for environmental and social proposals decreases in 2024 proxy season.** During the 2024 proxy season, BlackRock supported only 20 out of a total of 493 climate proposals—less than 4%. In its 2024 Investment Stewardship Voting Spotlight, BlackRock stated:

  > "Consistent with last year, we found that most shareholder proposals on climate and natural capital issues (environmental), as well as company impacts on people (social), were overreaching, lacked economic merit, or sought outcomes that were unlikely to promote long-term shareholder value. A significant percentage were focused on business risks that companies already had processes in place to address, making them redundant. As a result, investor support – including BlackRock's – for such proposals remained low."

  Similarly, in its 2024 Investment Stewardship Report, Vanguard reports that it reviewed 400 environmental and social shareholder proposals but did not support any of the proposals. Vanguard explained that the lack of support for environmental and social proposals did not a reflect a change in their voting policies, but rather its assessment that these proposals "did not address financially material risks" and were overly prescriptive and often duplicative.



Source: BlackRock, 2024 Investment Stewardship Voting Spotlight

Notable Resources and News

- A Look at the 2024 Proxy Season (*Georgeson*, August 2024)
- The IPO Hopeful's Dilemma: Cram Into Fall or Wait for '25 (*Bloomberg Law*, August 2024)
- The IPO Market Gets Cold Feet (*The Wall Street Journal*, August 2024)
- Preparing Boards and Companies for Today's Enforcement Environment (*Governance Intelligence*, August 2024)
- Demand Review Committees and Privilege Considerations in Internal Investigations (*Directors & Boards*, August 2024)
- Personal Info in AI Models Threatens Split in US, EU Approach (*Bloomberg Law*, August 2024)
- SEC's Gensler Sees ESG Plans Thwarted as Biden's Term Nears End (*Bloomberg Law*, September 2024)
- Wall Street's T+1 Switch Is Proving Tougher Than Anticipated (*Bloomberg Law*, September 2024)

This update was created by Fenwick's corporate governance practice.

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As a leading technology and life sciences law firm, Fenwick advises companies on the full suite of corporate governance matters. We partner with our clients to anticipate and navigate issues arising in an evolving corporate governance landscape, including SEC reporting and governance requirements of relevant securities exchanges, board and committee structure, corporate purpose and sustainability, shareholder engagement, and executive compensation.