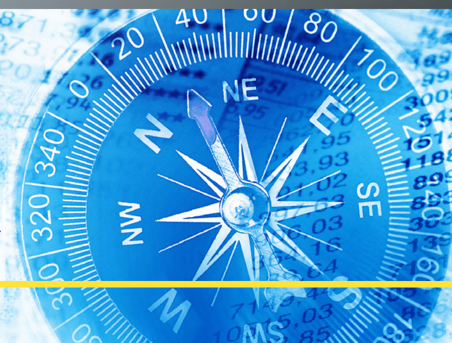
Katten
Capital Markets Compass



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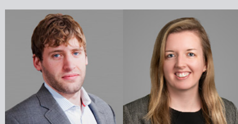
Editorial Note



We are pleased to share with you the first edition of Katten's *Capital Markets Compass* - a newsletter we are creating to help our clients keep pace with the latest developments in the capital markets, public company and corporate governance worlds. This first issue covers topics ranging from newly released board of director diversity requirements promulgated by Nasdaq to the first enforcement action taken against a SPAC by the Gary Gensler-led SEC. If you have any questions about the *Compass* or, any of the articles in this issue (or would like a particular topic to be covered in our next issue), please reach out to your Katten contact or to any of the Capital Markets partners listed on the last page of the newsletter. Thank you and we hope you are well.

Timothy J. Kirby and Jennifer L. Howard

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The SPAC Report

Stable Road Enforcement Action Post Mortem: Lessons for the SPAC Market After Momentus Begins Trading

By Timothy J. Kirby

Highlights

Stable Road And Momentus Close Business Combination. On August 11, Stable Road Acquisition Corp., a special purpose acquisition company (SPAC), announced that its shareholders had approved its business combination with Momentus, Inc., an aspiring provider of "space infrastructure"[i] services, a month after settling charges with the SEC that alleged false and misleading disclosures were made to investors during the lead up to the merger. The combined company's shares began trading on Nasdaq on August 13 under the "MNTS" ticker.

First SPAC Enforcement Action under Gary Gensler Focused on Diligence Failures. The landmark enforcement action, which was brought before the business combination was allowed to proceed to a vote, charged Stable Road, its sponsor, SRC-NI Holdings, LLC, Stable Road's CEO, Momentus and Momentus' former CEO with violating antifraud provisions of the federal securities laws.[ii] The charges focused on statements and claims made by Momentus and its former CEO to Stable Road regarding the commercial viability of its technology, statements and claims Stable Road repeated to investors, and Stable Road's allegedly inadequate due diligence efforts to confirm the veracity of such statements and claims.[iii] The SEC also found that Stable Road did not adequately or properly inform investors of several ongoing national security investigations concerning Momentus' former CEO, a Russian citizen, despite the potential of such investigations to prevent Momentus from securing key government licenses essential to its operations.[iv] Significantly, it was the SEC's view

that, although Momentus had deliberately mislead Stable Road several times during the de-SPAC process, Stable Road's own diligence failures and inadequate vetting is what ultimately lead to fraudulent information being disseminated to investors, both in private presentations to Private Investment in Public Equity (PIPE) investors and to public shareholders through the filing of inaccurate registration statements and proxy solicitation materials. In other words, the SEC was going to hold the SPAC and sponsor teams accountable, even if the inaccurate or misleading disclosure did not originate with them.

Civil Penalties. The SEC assessed over $8 million in fines against Momentus, Stable Road and Stable Road's CEO (who had signed off on the public filings and investor presentations which contained the relevant disclosure).[v] Momentus' former CEO has reportedly fled the country without settling the charges against him.

Founder Shares Forfeiture. Stable Road's sponsor agreed to forfeit 250,000 (or approximately 6 percent) of its "founder shares" or sponsor "promote." Founder shares are purchased by the SPAC's sponsor pre-IPO for nominal consideration (typically a total of $25,000), and customarily represent 20 percent of the SPAC's outstanding float after going public, fully vesting upon consummation of the business combination. Founder shares represent a key source of value for sponsors and are viewed by the market as the reward sponsors receive for finding a target and consummating a successful merger.

PIPE Investors Allowed to Back Out. Following the enforcement action about 40 percent of the funding commitments previously provided by PIPE investors was withdrawn. As part of the settlement agreement, the SEC mandated that PIPE investors be offered the opportunity to terminate previously executed subscription agreements, given the disclosure provided to them when making their investment decisions. Committed financing from PIPE investors is regularly used in de-SPAC transactions to provide funding certainty, back-filling any gap between the purchase price for the acquisition target and the funds initially raised in the SPAC's IPO, as well as topping-off any funding shortfalls resulting from shareholders who choose to redeem their shares at the shareholder vote rather than hold shares in the newly combined company. Although Stable Road ultimately consummated a de-SPAC merger with Momentus, allowing PIPE investors to withdraw their commitments represented a significant new weapon in the SEC's enforcement arsenal, with the potential to derail entire transactions by calling into question a sponsor's ability to successfully close deals without supplemental financing.[vi]

Lessons For The SPAC Market After Stable Road

SPACs and Sponsors Must Take Ownership of Target Business Disclosure (Even If The Target Is Being Less Than Truthful). SPACs and sponsors must take care to redouble their efforts to ensure any due diligence process regarding a potential business combination target is both rigorous and well documented. Although Stable Road engaged several consulting firms to assist in evaluating Momentus' technology, the SEC found the firms were not provided a reasonable amount of time to complete their work (they were engaged only a month before the initial merger agreement was signed), resulting in a diligence process which the SEC suggested, if properly performed, may have uncovered the apparent red flags before disclosures and solicitations reached investors.

The SEC has made clear that policing misconduct in the SPAC market is high on their regulatory agenda, and Stable Road likely represents only the first shot across the bow in terms of heightened enforcement activity. SPACs and their sponsors would be well served to strategically conduct due diligence of potential merger targets in light of Stable Road's message that they too will be on the hook in the event disclosures made to investors about a target business prove deficient and are challenged, even if that disclosure originally originated solely from the target. Best practices include the involvement of third party advisors, the SPAC's board of directors, sponsor representatives and other key stakeholders such as PIPE placement agents, legal counsels and other experts early on in the diligence process, including the creation of a robust, thoroughly documented and iterative record of the diligence efforts taken when evaluating a potential target, which in the event of litigation may be presented to a court to demonstrate an appropriate and thorough process was conducted. In short, a deceptive source resulting in bad disclosure does not excuse SPACs and their sponsors who do not conduct a thorough diligence exercise in the eyes of the SEC. Chair Gensler succinctly noted: "[t]he fact that Momentus lied to Stable Road does not absolve Stable Road of its failure to undertake adequate due diligence to protect shareholders."

Perception of Misaligned Structural Incentives In Focus. By including the forfeiture of founder shares as part of the settlement package, the SEC may be responding to certain perceived concerns that SPAC structures, in some cases may have the effect of incentivizing sponsors to consummate a de-SPAC transaction, despite concerns about the acquisition target, solely to maintain the value of their founder shares. SPACs are customarily provided an 18-to-24-month window (with some recent SPACs shortened to 15 months or less, with three month extension

periods requiring sponsors to pay-in more at-risk capital into the trust account) to find a suitable acquisition target and complete a successful combination.[vii] If no deal is reached by the end of this pre-determined lifespan (which is also subject to extension if shareholders approve), funds raised in the SPAC's IPO and held in trust are returned to shareholders, the SPAC is dissolved, and most importantly for sponsors, their founder shares are rendered worthless.

The SEC found that Stable Road's rushed diligence process as it neared the end of its life-span, as well as a late stage pivot to a general search for any acquisition target, regardless of industry or geography (Stable Road had initially told investors it was focusing exclusively on targets in the cannabis industry), all signaled that Stable Road and its sponsors were more incentivized to get a deal done, any deal done, than to find a quality acquisition candidate. With SPACs currently under the regulatory microscope, optics matter, and market participants must take care to ensure their actions in pursuit of a business combination do not become suggestive of an overzealous sponsor, over-eager to get a deal done, and thereby risk drawing comparisons to Stable Road, which Gensler characterized as a textbook "illustrat[ion of the] risks inherent to SPAC transactions, as those who stand to earn significant profits from a SPAC merger may conduct inadequate due diligence and mislead investors."

(i) Momentus is developing a "transfer vehicle" that would be deployed to outer space and be able to reposition satellites into different orbits.

(ii) Momentus was charged with violating the scienter-based (i.e. willful) securities law antifraud provisions, while the charges against Stable Road were negligence-based. Stable Road and its CEO were also charged with violating certain reporting and proxy solicitation provisions.

(iii) Momentus claimed that it had successfully tested its technology in a 2019 test mission, even though by Momentus' own standards the mission appeared to have been a failure. The false claims of a successful test were used to support financial projections provided to shareholders and PIPE investors to garner support for the de-SPAC transaction.

(iv) The national security concerns included an open investigation by the Committee on Foreign Investment in the United States and the Commerce Department's previous denial of an export license.

(v) Momentus, Stable Road and its CEO (who is also a managing member of Stable Road's sponsor) were assessed civil penalties of $7 million, $1 million, and $40,000, respectively.

(vi) In addition to the penalties discussed above, Momentus also agreed to undertakings requiring enhancements to its disclosure controls, including the creation of an independent board committee and retention of an internal compliance consultant for a period of two years.

(vii) Stable Road's charter allowed for an 18-month search.

Katten Capital Markets Attorneys Speak Out After Releasing Joint-Statement Alongside Over 60 Leading Law Firms

Statement Follows Former SEC Commissioner's Lawsuit Against Largest-Ever SPAC Claiming SPAC Operating As Unregistered Investment Company

By Timothy J. Kirby and Richard D. Marshall

On August 19, hedge fund magnate Bill Ackman released a letter to shareholders announcing plans to potentially unwind the SPAC he launched last year, Pershing Square Tontine Holdings, Ltd. (Tontine), in response to a shareholder derivative lawsuit that claimed Tontine was operating as an unregistered investment company in violation of the Investment Company Act of 1940, as amended (the Investment Company Act). Ackman's $4 billion investment vehicle was launched in June 2020 and remains the largest-ever SPAC raise by dollar size, but had trouble finding an acquisition target to match its substantial war chest.[i] Subsequent to the action against Tontine, several other similar suits were filed against additional SPAC vehicles, each making similar claims. In response to the lawsuits and in an unprecedented development, Katten and more than 60 other leading law firms released a joint statement condemning their merits.

Timothy J. Kirby, a partner in Katten's Capital Markets Group and Richard D. Marshall, a partner in Katten's Financial Markets and Funds practice, spoke with *The American Lawyer* regarding the suits, with Kirby noting: "A SPAC's primary goal is not to invest in securities [which is the focus of entities regulated under the Investment Company Act], but to buy an operating company. As SPACs went more mainstream, there has been more of an emphasis on transparency. You can go back and forth whether as a vehicle it is preferable to a traditional IPO, but the plaintiffs are trying to push through [this] Investment Company Act [claim]. That doesn't apply."

The lawsuit against Tontine, which was filed by former SEC commissioner Robert Jackson[ii] and Yale Law School professor John Morley, claims Tontine is operating as an illegal investment company in violation of the Investment Company Act because, as is typical in the SPAC industry, it had invested its initial public offering (IPO) proceeds (which per SPAC regulations are kept in trust until an acquisition target is found) in short-term treasury bonds and money market funds, which invest in high-quality, short term debt securities. The Investment Company Act defines an "investment company" as a company that "holds itself out as being **primarily** engaged, or proposes to engage **primarily**, in the business of investing, reinvesting or trading in securities"[iii] and the plaintiffs suggest in the suit: "An investment company is an entity whose primary business is investing in securities. And investing in securities is basically the only thing that [Tontine] has ever done."

Although Katten and other leading law firms argued in their joint statement that such claims are without merit, the lawsuits are notable because the requirements of the Investment Company Act and the process of registering as an "investment company" are generally incompatible with the structure and operations of a SPAC vehicle, including certain fundamental elements such as the awarding of warrants to sponsors and directors, which under the Investment Company Act could be deemed

"unlawful compensation." Further, operating as an unregistered investment company potentially renders any contracts such entity had entered into null and void - a dire consequence, which if realized, could call into question the legitimacy of everything from a SPAC's basic constitutional documents, to any agreements between the SPAC and its sponsor, and perhaps most significantly, any agreements the SPAC had entered into with an acquisition candidate related to a proposed business combination.

Regardless of the merits of the underlying claim,[iv] its potential chilling effects on SPAC market investors and potential deal partners wary of legal challenges is readily evident – including with respect to Ackman himself.[v] – In response to the lawsuit, Ackman announced he was shifting his focus to a new investment structure called a special-purpose acquisition rights company, or SPARC, which differs from a SPAC in that it does not take investor money upfront, but gives shareholders the right to buy into a deal when it is presented, and would not be subject to any time-based limitations on finding an acquisition target. Although Ackman noted Tontine is still searching for an acquisition candidate, he claimed that, if the SEC and New York Stock Exchange (NYSE) approve his new SPARC structure, which would require amending NYSE listing rules, he would dissolve Tontine and return investor funds (as well as provide them with a warrant to purchase shares in his new SPARC vehicle).

(i) Notably, Pershing Square's bid to acquire a 10% stake in Universal Music Group was derailed by the SEC, which cited NYSE rules requiring a SPAC merger target to have "a fair market value equal to at least 80% of [its] net assets held in trust" - Ackman's bid for Universal utilized only ~74% of the SPAC's trust funds (with the rest rolling over for future acquisitions). See New York Stock Exchange Listed Company Manual Rule 102.06 and https://www.bloomberg.com/opinion/articles/2021-06-04/bill-ackman-s-spac-will-be-three-spacs?sref=1kJVNqnU#footnote-3.

(ii) Ackman said of Jackson's involvement: "Notably, one of the professors who is leading the suit, Robert Jackson, served as an SEC Commissioner between January 2018 and February 2020. During his more than two-year term as Commissioner, the SEC reviewed and declared effective more than 100 SPAC IPO registration statements, and oversaw dozens of de-SPAC merger transactions. If Mr. Jackson is so sure that SPACs are in fact illegal investment companies, why didn't he take steps to shut them down while he was an SEC Commissioner?" https://www.businesswire.com/news/home/20210819005824/en/.

(iii) See Section 3(a)(1) of the Investment Company Act.

(iv) Significantly, Tontine plaintiffs noted that part of their motivation in bringing the suit was general "reform" of the SPAC industry.

(v) Ackman noted: "While we believe the lawsuit is meritless, the nature of the suit and our legal system make it unlikely that it can be resolved in the short term. Even if the case were dismissed expeditiously, the plaintiff can then appeal. As a result, the mere existence of the litigation may deter potential merger partners from working with [Tontine] on a transaction until the lawsuit is finally resolved. Because the basic issues raised here apply to every SPAC, a successful claim would imply that every SPAC may also be an illegal investment company. As a result, the lawsuit may have a chilling effect on the ability of other SPACs to consummate merger transactions or to engage in IPOs until the litigation is resolved in [Tontine's] favor, as the consequences of being deemed an illegal investment company are extremely onerous."

SEC Sample Letter to Companies Regarding Climate Change Disclosures

By Elizabeth C. McNichol and Farzad F. Damania

Recently, Katten public company clients, like many other public companies, have been receiving comment letters relating to climate change disclosure. Such comment letters are along the lines of an illustrative comment letter released by the Securities and Exchange Commission's (SEC) Division of Corporation Finance (Division) in September 2021 containing sample comments that the Division may issue to registrants regarding their climate-related disclosure or the absence of such disclosure. The Division notes that a number of existing rules related to description of business, legal proceedings, risk factors and management's discussion and analysis of financial condition may all require disclosure regarding climate-change related risks and opportunities. The sample letter comments are grouped into three topics:

General: This comment relates to discrepancies in the scope of climate-change disclosure in a registrant's corporate social responsibility report compared to its SEC filings. If the disclosure in its corporate social responsibility report is more expansive than in its SEC filings, the registrant may be required to explain why it did not provide the same level of disclosure in its SEC filings.

Risk Factors: The Division included two comments related to risk factors, which ask the registrant to disclose climate-change risks related to: policy and regulatory changes that impose operational and compliance burdens; market trends that alter business opportunities; credit risks; technological changes; and material litigation.

MD&A: The Division included six comments related to management's discussion and analysis (MD&A). The comments touch on a wide range of topics, including: identifying material pending or existing climate change legislation and any material effect on the business; identifying any material past and/or future capital expenditures for climate-related projects; discussing the indirect consequences of climate-related regulation on business trends (e.g. decreased demand for goods or services that produce significant greenhouse gas emission); and disclosures about the purchase or sale of carbon credits or offsets.

We encourage SEC registrants, to the extent they have not already received these SEC comments, to review the existing climate change disclosure in their periodic filings or in the context of a securities offering, and to prepare to address potential SEC comments related to climate change disclosure. We also encourage public companies to review climate change disclosure in other non-SEC filed company materials (such as its corporate social responsibility report) to ensure that statements made in such materials regarding climate change are consistent with statements made in the company's SEC reports.

The Division of Corporate Finance's illustrative comment letter is one component of the SEC's increased focus on climate change disclosure and enforcement under Chairman Gary Gensler. Such efforts also include the SEC's launch of the Climate and ESG Task Force within the Division of Enforcement in March. The Climate and ESG Task Force is charged with developing initiatives to proactively identify Environmental, Social, and Governance (ESG)-related misconduct. That same month, the SEC also called on the investment community to provide input on the adequacy and effectiveness of the SEC's rules applicable to climate change disclosures.

In June 2020, the SEC announced its 2021 regulatory agenda, and listed disclosure related to climate risk as a notable SEC rulemaking area. In prepared remarks delivered in July, Gensler noted that 75 percent of the comment letters responding to the March 15 request for comment supported mandatory climate change disclosure rules. Gensler previewed that in response to investor demand for enhanced climate change disclosure, he has instructed the SEC to prepare a mandatory climate risk disclosure rule proposal by the end of 2021.

We continue to track the SEC's efforts with respect to climate change disclosure and enforcement. Please contact us if you have any questions regarding the SEC's illustrative comment letter or any other climate change disclosure developments.

SEC Approves NASDAQ's Board Diversity Disclosure Requirements

by Vlad M. Bulkin and Jennifer L. Howard

On August 6, the Securities and Exchange Commission (SEC) approved Nasdaq listing rules implementing new board diversity disclosure requirements that will apply to most Nasdaq-listed companies (Nasdaq Board Diversity Rules). The Nasdaq Board Diversity Rules will generally require Nasdaq-listed companies to:

- have, or publicly disclose why they do not have, at least two diverse directors (including at least one self-identified female director and at least one director who self-identifies as an "underrepresented minority" or LGBTQ+, each as defined below); and
- publicly disclose board diversity statistics using a standardized format on an annual basis.

As described in more detail below, the Nasdaq Board Diversity Rules have deferred compliance dates and transition periods. The Nasdaq Board Diversity Rules also provide flexibility and compliance alternatives for certain companies, including companies with five or fewer directors, foreign issuers and smaller reporting companies. While the Nasdaq Board Diversity Rules specifically carve out registered closed-end funds and special purpose acquisition companies (SPACs), the rules are applicable to business development companies (BDCs).

Background

The Nasdaq Board Diversity Rules follow various initiatives that aim to address corporate diversity. For example, California has adopted legislation that requires publicly traded companies headquartered in California to have board members from underrepresented communities, as well as to have a minimum number of female directors depending on board size. According to a *Los Angeles Times* article, as of September 29, women now hold more than 25 percent of board seats nationwide, which represents a 50 percent increase since the California legislation passed. See "State Law Board Diversity Rules" below for more detail.

Proxy advisory firms, institutional investors and investment banks also have developed policies that generally support increased board diversity. For example, Goldman Sachs has announced that it will only underwrite initial public offerings in the US and Europe if a company has multiple diverse candidates for board seats.

Nasdaq filed its original proposal with the SEC on December 1, 2020, and subsequently amended the proposal on February 26, 2021 to add compliance flexibility for smaller boards and allow for a lengthier compliance period for newly listed companies. The SEC approved the Nasdaq Board Diversity Rules as proposed.

Rule 5605(f): Diverse Board Representation

New Rule 5605(f) requires Nasdaq-listed companies to have, or publicly disclose why they do not have, at least two diverse directors, including:

- at least one self-identified female director; and
- at least one director who self-identifies as an "underrepresented minority" or as LGBTQ+.

For this purpose, the Nasdaq Board Diversity Rules include the following definitions:

- "Female" means an individual who self-identifies as a woman, without regard to the individual's designated sex at birth.
- "LGBTQ+" means an individual who self-identifies as any of the following: lesbian, gay, bisexual, transgender, or as a member of the queer community.
- "Underrepresented Minority" means an individual who self-identifies as one or more of the following: Black or African American, Hispanic or Latinx, Asian, Native American or Alaska Native, Native Hawaiian or Pacific Islander, or "two or more races or ethnicities" (meaning a person who self-identifies with more than one of the following categories: White (not of Hispanic or Latinx origin), Black or African American, Hispanic or Latinx, Asian, Native American or Alaska Native, Native Hawaiian or Pacific Islander).

Notably, Nasdaq provided some compliance flexibility for certain types of issuers:

- Companies with five or fewer directors will only be required to have one diverse director (or publicly disclose the absence of a diverse director), and are permitted to add a single diverse director to a five-person board without automatically becoming subject to the general requirement to have at least two diverse directors (so long as the company did not have any diverse directors before it expanded its board).
- Smaller reporting companies, as defined in SEC rules, can satisfy Rule 5605(f) with two female directors, or with one female director and one director who is an underrepresented minority or LGBTQ+.
- Foreign private issuers, as defined in SEC rules, can satisfy Rule 5605(f) with two female directors, or with one female director and one director who is an underrepresented individual based on national, racial, ethnic, indigenous, cultural, religious or linguistic identity in the country of the company's principal executive offices, or LGBTQ+.

Disclosure Requirements

A company that elects to meet the diverse board requirements outlined above is not required to disclose compliance. If a company elects not to meet the diverse board requirements outlined above, it can instead: (1) disclose the specific requirements of the Nasdaq Board Diversity Rules that are applicable; and (2) explain the reasons why it does not comply with those requirements. This disclosure must be provided in any proxy statement or information statement that the company files, or can alternatively be provided on the company's website so long as the company posts the disclosure concurrently with its annual proxy statement or information statement filing.

Compliance Period Phase-In

The compliance period for Rule 5605(f) is phased and varies depending upon which tier of Nasdaq a company is listed, as follows:

Currently Listed Companies		
Nasdaq Tier	*Initial Compliance: One Diverse Director*	*Full Compliance: Two Diverse Directors*
Nasdaq Global/Global Select Market	Later of (i) August 7, 2023 or (ii) the filing date of the company's proxy statement for its 2023 annual meeting	Later of (i) August 7, 2025 or (ii) the filing date of the company's proxy statement for its 2025 annual meeting
Nasdaq Capital Market	Later of (i) August 7, 2023 or (ii) the filing date of the company's proxy statement for its 2023 annual meeting	Later of (i) August 7, 2026 or (ii) the filing date of the company's proxy statement for its 2026 annual meeting
Newly Listed Companies		
Nasdaq Tier	*Initial Compliance: One Diverse Director*	*Full Compliance: Two Diverse Directors*
Nasdaq Global/Global Select Market	Later of (i) one year from listing or (ii) the filing date of the Company's proxy statement for its first annual meeting following listing	Later of (i) two years from listing or (ii) the filing date of the Company's proxy statement for its second annual meeting following listing
Nasdaq Capital Market	N/A	Later of (i) two years from listing or (ii) the filing date of the Company's proxy statement for its second annual meeting following listing

The transition period outlined above for newly listed companies applies to any company that lists on Nasdaq and that was not previously subject to a substantially similar requirement of another national securities exchange, including through an initial public offering, direct listing, transfer from the over-the-counter market or another exchange, in connection with a spin-off or carve-out from a company listed on Nasdaq or another exchange, or through a merger with a SPAC.

Cure Period

A company that falls out of compliance with Rule 5605(f) will be required to achieve compliance by the later of (1) its next annual meeting; or (2) 180 days from the event causing the deficiency. However, if the compliance failure arises from a board vacancy, the company will be required to achieve compliance by the later of (1) one year from the date of vacancy; or (2) the filing date of its proxy statement for its annual meeting in the calendar year following the year of the vacancy.

Rule 5606: Board Diversity Disclosure

In addition to the disclosure requirements in Rule 5605(f) described above, new Rule 5606(a) requires Nasdaq-listed companies to publicly disclose board diversity statistics on an annual basis in a standardized format, as follows:

Board Diversity Matrix (As of [DATE])				
Total Number of Directors				
	Male	Female	Non-Binary	Gender Undisclosed
Part I: Gender Identity				
Directors				
Part II: Demographic Background				
African American or Black				
Alaskan Native or American Indian				
Asian				
Hispanic or Latinx				
Native Hawaiian or Pacific Islander				
White				
Two or More Races or Ethnicities				
LGBTQ+				
Did Not Disclose Demographic Background				

Foreign issuers will be permitted to provide a modified matrix that includes information about the issuer's home jurisdiction and is tailored to the applicable requirements of the Nasdaq Board Diversity Rules.

Board Diversity Matrix Compliance Date

A company is required to provide its initial board diversity matrix by the later of (1) August 8, 2022; or (2) the filing date of its proxy statement for its 2022 annual meeting. Following the first year of applicability, companies will be required to include in the matrix information for the current year and the immediately preceding year.

Exempt Entities

Entities exempt from compliance with the Nasdaq Board Diversity Rules include: SPACs (prior to a business combination); asset-backed issuers and other passive issuers; cooperatives; limited partnerships; management investment companies; and issuers whose only securities listed on Nasdaq are non-voting preferred securities, debt securities, derivative securities, and certain other securities listed under Nasdaq's Rule 5700 Series (which include, but are not limited to: non-convertible debt securities, exchange-traded fund (ETF) shares, equity and commodity index-linked securities, paired class shares and index warrants).

Nasdaq exempts "management investment companies" from certain of its corporate governance listing rules, including the Nasdaq Board Diversity Rules, based on the premise that funds "registered under the Investment Company Act of 1940 (Investment Company Act) are already subject to a pervasive system of federal regulation in certain areas of corporate governance." The current Nasdaq definition of "management investment companies" excludes BDCs because BDCs are not registered under the Investment Company Act, even though BDCs are generally subject to all of the same corporate governance regulation under the Investment Company Act as registered investment companies. Due to this distinction, Nasdaq-listed BDCs will be required to comply with the Nasdaq Board Diversity Rules, unlike their registered open- and closed-end fund counterparts.

Board Recruiting Services

The SEC also approved the implementation of board recruiting services that will provide certain Nasdaq-listed companies with access to a network of board-ready diverse candidates for consideration and evaluation.

State Law Board Diversity Rules

The Nasdaq Board Diversity Rules follow several state law initiatives that aim to address board diversity, with most measures to date focusing on gender diversity and disclosure requirements.

California

California was the first state to legislate on the topic of board diversity. In September 2018, California passed SB 826, which requires each public company with corporate headquarters in California to have at least one female director by the end of 2019. By the end of 2021, the minimum increases. Companies with six or more directors will be required to have three females and companies with five directors will be required to have two females. Companies with four or fewer directors are still required to have one female. The law also requires reports to be published on the website of the California Secretary of State reflecting the level of compliance with the new minimums, and imposes fines for companies that do not comply. We note that many California companies still have not achieved full compliance and will need to appoint additional female directors before the end of the year.

In September 2020, California enacted a second board diversity law, AB 979, which mandates board representation from underrepresented communities (including Black, African American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian or Alaska Native, or those who self-identify as gay, lesbian, bisexual or transgender). By the end of 2022, a company with more than four but fewer than nine directors will be required to have a minimum of two directors from underrepresented communities, and a company with nine or more directors will be required to have a minimum of three directors from underrepresented communities. This law includes similar reporting requirements and imposes fines for noncompliance. According to a *Los Angeles Times* article, despite this legislation and other similar state measures outlined below, people who self-identify as a member of an underrepresented community or as LGBTQ+ still hold only 18.4 percent of board seats in the top 1,000 companies nationwide.

Unlike the Nasdaq Board Diversity Rules, California's legislation scheme does not allow companies to choose whether to comply with the diversity requirements or disclose reasons for non-compliance. Instead, companies must comply. The California mandate has resulted in various legal challenges. Most have arisen under the Fourteenth Amendment's equal protection clause, alleging that the statutes require California companies to discriminate based on sex and race in selecting their board members. Some plaintiffs have alleged that by including required quotas, these diversity statutes seek to force shareholders to perpetuate discrimination. Some of the lawsuits have been dismissed and a few remain pending in California and federal courts.

Washington

In June 2020, Washington State passed a law similar in structure to the Nasdaq Board Diversity Rules. The law requires public companies incorporated in Washington to, by January 1, 2022, either (i) have a "gender-diverse board" or (ii) provide shareholders with a "board diversity discussion and analysis" as to why not. The law considers a board to be "gender-diverse" if, for at least 270 days of the fiscal year preceding the company's annual shareholder meeting, the board is composed of at least 25 percent of individuals who self-identify as female. If a public company's board is not sufficiently diverse by January 1, 2022, it can alternatively disclose in its annual proxy statement to shareholders or post on its website a "board diversity discussion and analysis" that includes information regarding the company's approach to developing and maintaining board diversity. The law also contains exemptions for, among other entities, emerging growth companies and companies that are not required to have annual meetings.

New York

In June 2020, New York passed the "Women on Corporate Boards Study Law," which calls for a study on the proportion of female directors on the boards of companies headquartered and authorized to do business in the state. To provide data for the study, each New York company is now required to include in its annual report filing with the state the number of directors on its board and how many of those directors are women. The New York Department of State will publish the findings of the study on its website on February 1, 2022 and follow up comparative reports will be filed every four years thereafter.

Maryland

In October 2019, Maryland passed HB 1116 requiring all business entities headquartered in Maryland to include in its annual report filing with the state the number of directors on its board and how many of those directors are women. Notably, the disclosure requirement specifically applies to all entities with revenues in excess of $5 million, whether or not they are publicly traded.

Illinois

Effective August 2019 pursuant to H.B. 3394, Illinois requires public companies headquartered in the state to provide certain diversity disclosures in their annual reports, including: the self-

identified gender of each board member; whether or not board members self-identify as members of a minority group and if so, which group; a description of the company's process to identify and evaluate board and executive officer nominees that demonstrates how diversity is considered; and a description of the company's policies and practices for promoting diversity, equity and inclusion.

Colorado

In 2017, Colorado passed House Joint Resolution 17-1017 that urges, but does not mandate, "equitable and diverse gender representation on corporate boards." The resolution encourages public companies in Colorado with nine or more directors to have at least three females; with five to eight directors to have at least two females; and with fewer than five directors to have at least one female representative on the board. There are no disclosure requirements associated with the Colorado resolution.

Pending Legislation

State legislatures in Hawaii, Massachusetts, Michigan and New Jersey are considering mandatory gender diversity legislation that largely mirrors California's approach. The proposed bills vary slightly by state with respect to the minimum number of female directors required and the timeline to achieve compliance.

State legislatures in Ohio and Pennsylvania are considering non-binding resolutions to encourage companies to improve gender diversity, and both resolutions leave the possibility for an annual reporting requirement open.

Conclusion

In preparation to comply with the Nasdaq Board Diversity Rules, Nasdaq-listed companies to which these rules apply should consider:

- identifying diverse candidates for vacant and/or additional board seats;
- developing disclosure controls and procedures and other compliance policies surrounding the collection and disclosure of board diversity information in advance of the 2022 proxy season (e.g. updating director and officer questionnaires to obtain the relevant information); and
- updating nominating and corporate governance committee charters and policies to specifically include diversity as defined under Nasdaq's Board Diversity Rules as a factor to consider in identifying and evaluating director candidates.

Additionally, all companies headquartered in any state that has adopted or is considering its own board diversity requirements will need to review the requirements of the applicable measure and ensure (or prepare for) compliance on the state law level.

The full text of the SEC approval order is available here, and the full text of the Nasdaq Board Diversity Rules is available here (see Sections 5605 and 5606).

Editor's note: This client alert, initially published on August 16, 2021, has been updated to include additional developments in state law.

Enforcement Trends

Gensler-Led SEC Demonstrates Continued Support for Whistleblowers

By Timothy J. Kirby

On August 5, the Securities and Exchange Commission (SEC) announced interim procedures effectively nullifying amendments to the SEC's whistleblower program adopted less than a year ago under former SEC Chairman Jay Clayton.[i] The controversial amendments gave the SEC discretion to reduce the size of monetary awards for whistleblowers in certain instances and deny awards entirely if a whistleblower was also due to receive an award under a competing non-SEC whistleblower program. In support of the reversal, SEC Chairman Gary Gensler cited concerns raised by the whistleblower community and Democratic SEC Commissioners that the amendments had the potential to "discourage whistleblowers from coming forward."[ii]

The SEC's whistleblower program was created in 2010 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act and directs the SEC to provide monetary awards to individuals who supply information leading to SEC enforcement actions. Under the program, a whistleblower may receive up to 30 percent of the fines levied by the SEC in enforcement actions that stem from his or her tip. Chairman Gensler's actions come on the heels of a record quarter for whistleblower awards, with over $178 million doled out to tipsters during the second quarter of 2021, topping the previous record of $176 million from the fourth quarter of 2020.

Recent enforcement activity suggests the Gensler-led SEC is willing to take an expansive view of what kinds of tips merit an award in order to encourage whistleblowers to come forward. On May 19, the SEC announced it was upholding an award for a whistleblower whose tip eventually lead to the unveiling of unrelated improprieties, even though the original information provided by the tipster did not in of itself lead to enforcement action.[iii] Significantly, the Gensler-led SEC has also demonstrated a willingness to overlook administrative foot-faults in order to reward whistleblowers who have provided valuable information, recently invoking rarely used discretionary authority under Section 36(a) of the Exchange Act to uphold a $23 million award[iv] for two tipsters who had filed their award application 18 days after the 90-day submission deadline had passed, a scenario in which previous regimes were unwilling to waive the procedural defect and had revoked awards.[v]

Since 2012, the SEC's whistleblower program has paid out approximately $937 million to tipsters. The pace of recent activity suggests total whistleblower awards may soon surpass $1 billion. In addition to maintaining and continually strengthening internal reporting and compliance mechanisms to prevent fraud and securities law violations, reporting companies are advised to regularly review their internal reporting structures to ensure any whistleblower tips provided are properly reviewed, escalated and acted upon. Thorough investigations and a robust response are essential in creating a defensible position in the event regulators or law enforcement become involved.

(i) See the SEC's release announcing the interim procedures here: https://business.cch.com/srd/The_Securities_and_Exchange_Commission.pdf. The speed with which the Democratic-appointed SEC Chairman Gary Gensler is walking back rules enacted by his Republican-appointed predecessor is notable and was criticized by SEC commissioners Hester Peirce and Elad Roisman, both appointed under the Trump administration, who released a joint statement criticizing Gensler's actions: "This course of action is unwise and continues a troubling and counterproductive precedent…Abandonment of duly-adopted rules without notice and request for comment raises the prospect that the rules that the Commission adopts in compliance with the Administrative Procedure Act may be interim at best, and transitory at worst." See https://business.cch.com/srd/Today_the_Commissionissuedastatementannouncing.pdf.

(ii) See https://www.sec.gov/news/public-statement/gensler-sec-whistleblower-program-2021-08-02. Chairman Gensler was a vocal proponent of the whistleblower program during his nomination process. See https://z6t5r8d4.rocketcdn.me/wp-content/uploads/2021/03/Senator-Grassley-questions-3.17.214.pdf.

(iii) The SEC acknowledged there was "not a strong nexus between the Claimant's information" and the eventual charges but noted that although the "charges involved misconduct in geographical regions that were not the subject of the Claimant's information," an award would nonetheless be granted that "appropriately recognizes Claimant's level of contribution to the Covered Action and Related Action." See https://www.sec.gov/rules/other/2021/34-91933.pdf.

(iv) The SEC noted that "[s]trict application of the deadline would result in undue hardship to [the claimant], particularly in light of [the claimant's] significant contributions to the successful enforcement of the Covered Action and certain unique obstacles faced by" the whistleblower. See https://www.sec.gov/rules/other/2021/34-92086.pdf.

(v) See https://www.sec.gov/rules/other/2020/34-89002.pdf.

Reminder:

iXBRL Requirements Have Gone Into Effect for All Operating Company Filers

by Elizabeth C. McNichol

All operating company filers (other than certain Foreign Private Issuers) that were not previously required to comply with Inline eXtensible Business Reporting Language (iXBRL) tagging requirements are now required to use iXBRL format and tag certain cover page information in iXBRL for their first 10-Q filing for fiscal periods ending on or after June 15. Following the first 10-Q required to include iXBRL tagging, all registration statements and Forms 10-K and 8-K must also include iXBRL tagging. Foreign Private Issuers do not have quarterly filing requirements. Therefore, Form 20-F and 40-F filers that report their financial statements in IFRS will be required to comply with iXBRL tagging beginning with their first annual report for a fiscal period ending on or after June 15.

The Securities and Exchange Commission (SEC) adopted final rules requiring operating company financial information to be in iXBRL format on June 28, 2018. On April 8, 2020, the SEC also adopted final rules requiring registered closed-end fund (CEF) and business development company (BDC) filers to comply with iXBRL tagging requirements. BDCs and CEFs that are eligible to file short-form N-2 registration statements must comply with the iXBRL requirements for financial statements, the registration statement cover page, and certain prospectus information by August 1, 2022. All other BDCs and CEFs must comply by February 1, 2023.

For more information on iXBRL requirements, please see the SEC's adopting release available at this link and its Compliance and Disclosure Interpretations regarding iXBRL, available at this link.

Other Recent Developments

On September 29, the SEC proposed a new rule that would require an institutional investment manager to report annually on Form N-PX how it voted proxies relating to executive compensation matters. The proposal also includes amendments to Form N-PX that would enhance the information that registered closed-end investment companies, mutual funds and exchange-traded funds are required to report annually on Form N-PX. The proposal is available at this link.

On October 4, the SEC approved Nasdaq's proposal to impose additional listing requirements for companies principally based in "Restrictive Markets," which are jurisdictions that do not provide the US Public Company Accounting Oversight Board (PCAOB) with access to conduct inspections of public accounting firms that audit Nasdaq -listed companies (such as China). For a company in a Restrictive Market that chooses to list on Nasdaq through a traditional IPO or a merger with a SPAC, the additional condition for listing will be a minimum amount or market value of the Company's securities in public hands. The proposal is available at this link.

Save the Date

Crypto for FCM Customer Accounts

October 20

Financial Markets and Regulation chair **Gary DeWaal** will participate in the "Crypto for FCM Customer Accounts" at 1:00 p.m. (ET) on Wednesday, October 20. Speakers will discuss the Commodity Futures Trading Commission's (CFTC) Market Participants Division's (MPD) guidance regarding the deposit of virtual (crypto) currencies by customers and holding of these currencies by futures commission merchants (FCMs) to margin customer transactions in crypto currency futures.

Learn more about the "Crypto for FCM Customer Accounts" webinar.

2021 Legal & Legislative Issues Conference

October 21-22

Katten Financial Markets and Funds partners **Carl Kennedy** and **Dan Davis** will moderate panels at the 2021 Legal & Legislative Issues Conference on October 21–22. Kennedy will moderate the "Derivatives" panel at 4:55 p.m. on Thursday, October 21. Davis will moderate the "Securities General Counsels" panel at 9:10 a.m. on Friday, October 22.

Registration details are available.

2022 Proxy Season Update

December 2

Join Katten, Ernst & Young LLP and Meridian Compensation Partners for a webinar featuring a timely discussion of key legal, governance and financial reporting developments and trends impacting public companies in the 2022 annual reporting and proxy season. CLE available.

Panelists include **Lawrence Levin**, national co-head of Katten's Capital Markets practice, and **Alyse Sagalchik**, partner in Katten's Capital Markets practice.

RSVP for the 2022 Proxy Season Update.

In Case You Missed It

2021 Computershare Virtual Client Conference

Lawrence Levin, national co-head of Katten's Capital Markets practice, served as a panelist in the "Annual Meetings: Attitudes, Images and Changing Global Expectations" session on October 6.

Learn more about the event.

2021 HFS Executive Summit: Together Towards a Digital Tomorrow

Gary DeWaal, Financial Markets and Regulation special counsel and chair, participated in the "2021 HFS Executive Summit: Together Towards a Digital Tomorrow" webinar on September 23.

MFA Digital Assets 2021

Gary DeWaal, Financial Markets and Regulation special counsel and chair, and Financial Markets and Funds partner **Dan Davis**, participated in the "MFA Digital Assets 2021" virtual conference on September 21.

Learn more about the event.

The Deal Economy: Predictions and Perspectives

Kimberly Smith, global chair of Katten's Corporate practice, moderated a panel titled, "The State of Middle Market Deal Flow" at the Metropolitan Club New York on September 21.

Watch event videos.

Are Crypto Lending, DeFi and Stablecoins the New "Lions and Tigers and Bears, Oh My!": A Review of Recent Crypto Legal and Regulatory Developments

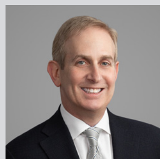
Financial Markets and Regulation attorneys **Daniel Davis**, **Gary DeWaal**, **Phillip Koh**, **Sheehan Band**, **Alexander Kim** and **Elizabeth Organ** presented a webinar featuring speakers Joe Borg, Director, Alabama Securities Commission; Dorothy DeWitt, Director, Division of Market Oversight, Commodity Futures Trading Commission (CFTC); and Donna Redel, Blockchain-Digital Assets Professor, Fordham Law, on September 14.

See video, materials and find more information about the event.

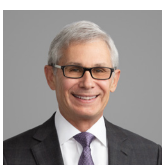
Katten's Capital Markets Practice

Capital markets activity is subject to complex disclosure and regulatory requirements from multiple agencies. Pragmatic guidance on public and private financing transactions requires a multipronged perspective. Katten's work on thousands of securities matters keeps clients' capital-raising deals on track and governance practices sound. For more information, click here.

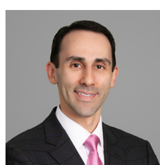
Lawrence D. Levin
Partner
Co-head of National Capital Markets Practice
lawrence.levin@katten.com



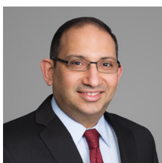
Mark D. Wood
Partner
Co-head of National Capital Markets Practice
mark.wood@katten.com



Matthew S. Brown
Partner
matthew.brown@katten.com

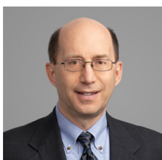


Vlad M. Bulkin
Partner
vlad.bulkin@katten.com



Farzad F. Damania
Partner
farzad.damania@katten.com

Timothy J. Kirby
Partner
tim.kirby@katten.com



Jeffrey R. Patt
Partner
jeffrey.patt@katten.com

Mark J. Reyes
Partner
mark.reyes@katten.com

Alyse A. Sagalchik
Partner
alyse.sagalchik@katten.com

Jonathan D. Weiner
Partner
jonathan.weiner@katten.com

Katten

For more information, contact:

Lawrence D. Levin | Partner | Co-head of National Capital Markets Practice | Katten Muchin Rosenman LLP
+1.312.902.5654 | lawrence.levin@katten.com | 525 West Monroe Street | Chicago, IL 60661-3693

Mark D. Wood | Partner | Co-head of National Capital Markets Practice | Katten Muchin Rosenman LLP
+1.312.902.5493 | mark.wood@katten.com | 525 West Monroe Street | Chicago, IL 60661-3693

CENTURY CITY | CHARLOTTE | CHICAGO | DALLAS | LONDON | LOS ANGELES | NEW YORK | ORANGE COUNTY | SHANGHAI | WASHINGTON, DC

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