Katten

Capital Markets Compass

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Editorial Note



In the February edition of the Katten *Compass*, we discuss the SEC's recent amendments to Rule 10b5-1, which added new conditions to the availability of certain defenses to insider trading liability, as well as imposed new disclosure requirements that public companies should keep in mind as they institute and monitor compliance with their 10b5-1 plans. We also discuss the Delaware Chancery Court's recent decision in *Delman*, and the potential impact of the ruling on the SPAC market going forward, review a record Regulation FD penalty assessed by the SEC, and close with a roundup of other recent developments in the securities and capital markets world. Please note the invite to our "Crypto with Katten" Symposium in London next month at the end of the issue. And if you'll be at the Roth Capital conference in March, please do reach out so we can connect in person!

Timothy J. Kirby, Jennifer L. Howard and Michelle Mount

In This Issue

SEC Adopts Amendments to Rule 10b5-1 Plan Requirements

Adds Increased Disclosure Requirements Regarding Insider Trading Policies

By Mark D. Wood, Lawrence D. Levin, Timothy J. Kirby and Michelle Mount

On December 14, the Securities and Exchange Commission (SEC) unanimously adopted amendments to Rule 10b5-1 and related regulations governing "10b5-1 Plans." 10b5-1 Plans enable (1) public company insiders to sell their company's stock or (2) issuers to repurchase their shares, each at times when they otherwise might be prevented from doing so because they possess material non-public information (MNPI).

The adopted amendments:

- Add new conditions to the availability of the Rule 10b5-1(c)(1) affirmative defense from insider trading liability, such as mandatory cooling-off periods, new restrictions on the use of 10b5-1 Plans and required representations by those using 10b5-1 Plans.
- Impose new disclosure requirements regarding officer and director trading plans, insider trading policies and timing of certain stock awards; and
- Amend Forms 4 and 5 to require identification of Rule 10b5-1 transactions and earlier reporting of stock gifts.

Rule 10b5-1 plans that are in effect on the effective date of the new rules will be entitled to the benefit of grandfathering and, accordingly, will not need to be amended to comply with the new rules. However, if a grandfathered plan is modified or amended in a manner that changes the amount, price or timing of transactions under the plan, under the rule amendments, the existing plan will effectively be deemed to be terminated and replaced with a new plan, with further trading under the plan having to comply with the new rules.

The final rules were published in the Federal Register on December 29, establishing an effective date of February 27, 2023. Section 16 reporting persons will be required to comply with the amendments to Forms 4 and 5 for beneficial ownership reports filed on or after April 1, 2023. Issuers will be required to comply with the new disclosure requirements in Exchange Act periodic reports on Forms 10-Q, 10-K and 20-F and in any proxy or information statements commencing with the first filing that covers a full fiscal period that begins on or after April 1, 2023. The final amendments defer by six months the date of compliance with the additional disclosure requirements for smaller reporting companies. The full text of the adopting release may be found here.

The History

In the SEC's open meeting on December 14, SEC Chair Gary Gensler noted that many market participants have weighed in with proposals to update regulations regarding insider trading over the last two decades, including notably:

- On September 14, 2020, former SEC Chair Jay Clayton recommended mandatory cooling-off periods after the adoption, amendment or termination of a 10b5-1 Plan in his letter to a former Chair of the House Financial Service Committee;[1]
- SEC Chair Gary Gensler, on June 24, 2021, stated in a speech that Rule 10b5-1 Plans "have led to real cracks in our insider trading regime" and directed SEC staff to consider and recommend restrictions on the use of such plans;
- On June 24, 2021, bipartisan legislation was re-introduced in the US Senate directing the SEC to study whether Rule 10b5-1 should be amended;[2]
- On August 26, 2021, the Investor as Owner Subcommittee of the SEC's Investor Advisory Committee (IAC) released draft recommendations regarding amendments to rules governing 10b5-1 Plans, which the IAC formally approved at its meeting held on September 9, 2021;
- On January 13, 2021, the SEC proposed amendments to the rules governing 10b5-1 Plans (the Proposed Rule) that were mostly in line with the IAC's recommendations (as discussed in a prior edition of *Capital Markets Compass*); and
- On December 14, 2022, the SEC adopted its final rule on Insider Trading Arrangements and Related Disclosures (the Final Rule).

Key Differences Between the Proposed Rule and the Final Rule

In the Final Rule's adopting release, the SEC noted that since issuing the Proposed Rule, they had received and considered over 160 comment letters on the Proposed Rule leading to notable modifications from the Proposed Rule. The changes include:

- ***A shorter cooling-off period for directors and officers***. The cooling-off period in the Final Rule is shorter in comparison to the 120-day cooling-off period in the Proposed Rule.

- ***Carve-outs for issuers***. In the Final Rule, only insiders are restricted from using multiple overlapping 10b5-1 Plans, whereas the Proposed Rule considered imposing this restriction on issuers as well.
- ***Broader definition of multiple overlapping 10b5-1 Plans***. In the Final Rule, the reference to the "same class of securities" in the Proposed Rule has been removed from the description of what qualify as multiple overlapping 10b5-1 Plans. As a result, the prohibition on multiple overlapping 10b5-1 Plans will also apply if the two plans relate to different classes of an issuer's securities.

- ***More tailored disclosure requirements around options award grants***. Both the Proposed Rule and the Final Rule require tabular disclosures of information on awards of options, stock appreciation rights (SARs), and/or similar option-like instruments granted to corporate insiders during specified windows before and immediately after the release of MNPI. However, in the Final Rule, these windows are shorter, potentially resulting in fewer required disclosures.

Final Rules and Amendments

Rule 10b5-1 was adopted to provide more clarity regarding the meaning of "manipulative or deceptive device[s] or contrivance[s]" prohibited by Section 10(b) and Rule 10b-5 with respect to trading on the basis of MNPI. In that Rule, the SEC provided that a trade is made on the basis of MNPI if the person making the purchase or sale was "aware" of the MNPI when the trade was made (i.e., the person does not necessarily need to "use" the MNPI in making the trading decision). However, subsection (c)(1) of Rule 10b5-1 established an affirmative defense to insider trading liability, which the Commission intended "to cover situations in which a person can demonstrate that the MNPI did not factor into the trading decision," with 10b5-1 Plans adopted under that subsection providing appropriate flexibility for those who would like to plan a trade in advance.

Since the SEC's establishment of that affirmative defense, market participants and regulators have raised concerns that traders have inappropriately attempted to benefit from the liability protection of 10b5-1 Plans. In the Final Rule, the SEC cited academic studies which found that trades made under Rule 10b5-1 Plans that were executed in close proximity to upcoming earnings announcements have been abnormally profitable.[3] The Final Rule also mentions studies that found that trades made by corporate insiders under a 10b5-1 Plan are frequently more profitable than trades made by corporate insiders outside of a 10b5-1 Plan.[4] Further reference was made to certain analyses of the use of multiple overlapping 10b5-1 Plans in combination with canceling trades and adopting new plans that found that insiders may in some cases be using such tactics to "game the system."[5]

The newly adopted amendments are designed to address these concerns and prevent corporate insiders from the perceived opportunist trading on the basis of MNPI through the use of 10b5-1 Plans.

1. New Cooling-off Periods

Previously under Rule 10b5-1(c)(1), a corporate insider was not required to wait between adopting a new 10b5-1 Plan and making the first trade under such 10b5-1 Plan (although such waiting periods have frequently been included in Rule 10b5-1 Plans, often as required by issuer adopted insider trading plans, as a best practice). In the Final Rule, the SEC has now mandated the imposition of a waiting (or "cooling-off") period between the adoption of a 10b5-1 Plan and when trades may begin.

The Final Rule imposes varying cooling-off periods for specific corporate actors:

- ***Directors and officers***. Trading under 10b5-1 Plans adopted by directors and officers may commence only upon the later of: (1) 90 days following plan's adoption or modification; or (2) two business days following the disclosure in a periodic report of the issuer's financial results for the fiscal quarter in which the plan was adopted or modified (but not to exceed 120 days following plan adoption or modification).

- ***Persons other than issuers, directors or officers***. Before any persons (other than issuers or directors and officers) can commence trading under a 10b5-1 Plan, they must wait 30 days following adoption or modification of that 10b5-1 Plan.
- ***Issuers***. No cooling-off period is required with respect to issuers that adopt 10b5-1 Plans. As noted in the Final Rule, the SEC believes that further consideration on this topic is warranted and the SEC will continue to consider whether regulatory action is needed.

- Certain modifications trigger additional cooling-off periods. Note that, if an existing 10b5-1 Plan is modified in a manner that changes the amount, price, or directed timing of the purchase or sale of the securities, then an additional cooling-off period is required. The number of days for the cooling-off period in the event of such a modification would be that period appropriate for the director, officer or other corporate insider as discussed above. Further, certain changes related to the broker-dealer or agent administering a 10b5-1 Plan (i.e., canceling the agent's contract) may also fall under the definition of such a modification that require an additional cooling off period. The Final Rule is also consistent with the SEC's prior guidance on the effect of plan modifications, in that a modification that does not change the sales or purchase prices or price ranges, the amount of securities to be sold or purchased, or the timing of transactions under a Rule 10b5-1 Plan (such as an adjustment for stock splits or a change in account information) will not trigger a new cooling-off period.[6]

2. Limitations on Overlapping Plans and "One-And-Done" Plans

In the adopting release for the Final Rule, the SEC discussed its concern that a person previously could adopt multiple plans and set up trades timed to occur around dates on which they expect the issuer to release MNPI (such as earnings releases) and selectively cancel or terminate plans on the basis of MNPI.[7] The SEC also noted recent research indicating that 10b5-1 Plans that are designed to only cover a single trade often have the effect of loss avoidance and are often adopted before stock price declines.[8]

Accordingly, the Final Rule provides that the affirmative defense under Rule 10b5-1(c)(1) will not be available for any trades by persons, other than the issuer, that has established multiple overlapping trading arrangements. This condition precludes separate, overlapping arrangements even where each relates to a different class of securities of the same issuer. However, plans with separate brokers will be deemed to constitute a single plan where, taken together, the plans otherwise satisfy the conditions of Rule 10b5-1(c)(1). Further, this condition would not restrict a person from maintaining separate trading arrangements at the same time, so long as trades under the later-commencing plan do not commence until the completion or expiration of the earlier plan (plus any effective cooling-off period, to the extent the earlier plan was terminated). An overlapping plan that provides for only "sell- to-cover" transactions to satisfy tax withholding obligations in respect of vesting of equity awards also generally will not violate this condition.

In addition, other than for the issuer, the affirmative defense under Rule 10b5-1(c)(1) will only be available for one plan designed to effect a single trade (sometimes referred to as a "one-and-done" plan) in any 12-month period.

3. New Representations Required by Plan Participants

The Final Rule also requires:

- Directors and officers to certify at the time of the adoption of a new or modified 10b5-1 Plan, that: (1) they are not aware of MNPI about the issuer or its securities; and (2) they are adopting the 10b5-1 Plan in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 10b-5.
- All persons entering into a 10b5-1 Plan to also certify they are acting in good faith when entering into such 10b5-1 Plan (in addition to the current requirement that a Rule 10b5-1 trading arrangement actually be entered into in good faith). According to the adopting release, the new requirements serve to clarify that the affirmative defense will not be

available to a trader that cancels or modifies a plan in an effort to benefit their trading results, such as by using their influence to affect the timing of the announcement of MNPI, or otherwise attempting to evade the prohibitions of the rule.

4. Enhanced Disclosure of Rule 10b5-1 Plans and Insider Trading Policies

The newly adopted amendments seek to provide greater transparency regarding the use of 10b5-1 Plans by requiring additional disclosures around trading arrangements, which must be tagged in Inline XBRL.

- **Disclosure of trading arrangements**. The Final Rule requires an issuer to disclose in a Form 10-Q or Form 10-K, as applicable, whether, any director or officer has adopted, modified or terminated any 10b5-1 Plan during the registrant's last fiscal quarter, as set forth in new Item 408(a) of Regulation S-K. The disclosure must include a description of the material terms of any such 10b5-1 Plan, but the issuer does not need to include information relating to the particular trading prices at which the 10b5-1 Plan has authorized buying or selling.
- **Disclosure of insider trading policies and procedures**. The Final Rule requires annual disclosure of a registrant's insider trading policies and procedures, including disclosure regarding whether registrants have adopted such policies and procedures, and if the registrant has not adopted such insider trading policies and procedures, it must explain why that is the case, as set forth in new Item 408(b) of Regulation S-K. These disclosures will be in annual reports on Forms 10-K and 20-F and also in proxy and information statements on Schedules 14A and 14C. However, as is the case with certain other information required to be included in both annual reports and proxy statements, an issuer will be permitted to incorporate by reference the information required by Item 408(b) from a definitive proxy or information statement involving the election of directors, so long as the proxy or information statement is subsequently filed within 120 days of the end of the issuer's fiscal year. An issuer will also be required to file a copy of its insider trading policies and procedures as an exhibit to its annual report on Form 10-K or 20-F, as applicable.
- **Option awards**. The Final Rule requires an issuer to provide a discussion of its policies and practices regarding the timing of the awards of stock options, SARs and similar instruments in relation to the potential possession of MNPI by recipients, including how the board determines when to grant such awards and if the potential possession of MNPI by the recipient has been considered. Issuers must report information regarding options granted in the period beginning four business days before a triggering event and ending one business day after a triggering event. The triggering events include the filing of a periodic report (e.g., Form 10-Q or Form 10-K) or the filing or furnishing of a current report on Form 8-K that contains MNPI (except for an Item 5.02(e) Form 8-K that only discloses a material new option award grant).

- **Amendments to Form 4 and 5**. Form 4 and 5 filers must indicate via a new checkbox if a reported transaction was intended to satisfy the affirmative defense conditions of Rule 10b5-1(c).

Note that certain of the new 10b5-1 related disclosures included in Form 10-K or Form 20-F will now also be subject to the certifications required by Section 302 of the Sarbanes-Oxley Act of 2002, which require CEOs and CFOs to certify, among other things, that based on their knowledge, the form they have signed does not contain untrue statements of material facts or omit to state material facts necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the periods covered by the reports. As a result these executives may have additional liability under Rule 13a-14, which provides the SEC with a cause of action against CEOs and CFOs that make false certifications.

5. Reporting of 10b5-1 Plan Transactions and Gifts Pursuant to Section 16

Consistent with the additional disclosure requirements for issuers as discussed above, Form 4 and 5 filers (as required by Section 16(a) of the Securities Exchange Act of 1934) will be required to indicate via a new checkbox if a reported transaction was intended to satisfy the affirmative defense conditions of Rule 10b5-1(c).

Additionally, in its proposing release the SEC noted that the delayed reporting of gifts on Form 5 may allow Section 16 reporting persons to engage in what it perceives as problematic practices involving gifts of equity securities, such as making stock gifts while in possession of MNPI or backdating stock gifts in order to maximize the tax benefits associated with such gifts. The SEC sought to address these practices by requiring that all "bona fide" gifts of stock by Section 16 directors and officers be reported on Form 4 by the end of the second business day following the date of any such gift.

Next Steps for Public Companies and Best Practices

While many companies already impose certain restrictions with respect to use of 10b5-1 Plans, the final rules significantly expand requirements for such plans, in addition to imposing the new disclosure obligations.

In light of these amendments, public companies may want to consider taking the following actions:

- Review and amend existing trading policies, including pre-clearance requirements, to the extent necessary to ensure (1) the policies impose the appropriate requirements on 10b5-1 Plans permitted thereunder, such as the required cooling-off periods, limitations on overlapping plans and restrictions on the number of single-trade plans, and (2) the appropriate individuals responsible for insider trading policy compliance (compliance teams) receive all of the information regarding insiders' 10b5-Plans necessary for the companies to satisfy their own disclosure obligations and assist insiders with Section 16 filings, all taking into account the new filing requirement for such polices;
- Educate directors, officers and corporate insiders on the changes to the trading policies and the applicable
- standards of compliance;
- Ensure that their compliance teams are able to readily access information as to how 10b5-1 Plans are being
- used by insiders, including as to orders for trading modifications and cancelations;
- Adopt disclosure controls relating to the reporting of gifts on Form 4; and
- Update the board on additional disclosure requirements with respect to granting of stock options and other similar compensation, and adopt (or modify existing) equity award policies and procedures to address the timing of grants in relation to SEC filings and other events.

More generally, companies should assess the likely impacts of the changes on their insider trading policies on their directors and officers, and work to find solutions that comply with the new rules while still allowing corporate insiders to achieve liquidity goals.

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1 Letter from Jay Clayton, former Chair of the SEC, to Representative Brad Sherman, former Chairman of the House Financial Services Committee (Sept. 14, 2020); *See also* SEC Chairman Urges Corporate Insiders to Avoid Quick Stock Sales, Paul Kiernan, WSJ (Nov. 17, 2020).

2 Promoting Transparent Standards for Corporate Insiders Act; Cong. 117th 1st Session.

3 David Larcker et al., Gaming the System: Three "Red Flags" of Potential 10b5-1 Abuse, STAN. CLOSER LOOK SERIES (Jan. 2021).

4 Alan D. Jagolinzer, SEC Rule 10b5-1 and Insiders' Strategic Trade, 55 MGMT. SCI. 224 (2009); M. Todd Henderson et al., Offensive Disclosure: How Voluntary Disclosure Can Increase Returns from Insider Trading, 103 GEO. L.J. 1275 (2015); Taylan Mavruk & H. Nejat Seyhun, Do SEC's 10b5-1 Safe Harbor Rules Need to Be Rewritten?, 2016 COLUM. BUS. L. REV. 133 (2016); Artur Hugon & Yen-Jung Lee, SEC Rule 10b51 Plans and Strategic Trade Around Earnings Announcements, (2016).

5 John P. Anderson, Anticipating a Sea Change for Insider Trading Law: From Trading Plan Crisis to Rational Reform, 2015 UTAH L. REV. 339 (2015).

6 *Selective Disclosure and Insider Trading*, Release No. 33-7881 (Aug. 15, 2000) [65 FR 51716 (Aug. 24, 2000)]. The initial Rule 10b5-1 adopting release in August 24, 2000, qualified the third affirmative defense to insider trading liability with footnote 111, "[A] person acting in good faith may modify a prior contract, instruction, or plan before becoming aware of material nonpublic information. In that case, a purchase or sale that complies with the modified contract, instruction, or plan will be considered pursuant to a new contract, instruction, or plan."

7 *See, supra* note 3 and 5.

8 *See, supra* note 3.

Editor's Note: This client advisory, originally published on December 27, 2022, has been updated to include the effective date of the Final Rule.

Delaware Chancery Court Issues *Delman* Decision Potentially Increasing Scrutiny of the Actions of SPAC Sponsors and Boards

By Mark D. Wood, Richard H. Zelichov and Michelle Mount

On January 4, the Delaware Chancery Court issued a second decision suggesting that SPAC sponsors and directors proceed with care in connection with de-SPAC transactions (and potentially future SPAC formation). As a result of the recent decision in *Delman v. Gigacquisitions3, LLC, et al*. and the prior opinion in *In re Multiplan Corp. Stockholders Litig*., sponsors and directors of SPACs should consider if their policies and procedures around proxy statement disclosures, diligence, board discussions, financial valuations, capital raising and de-SPAC transactions could be potentially subject to criticism after the fact if litigation arises.

The opinion in *Delman v. Gigacquisitions3, LLC, et al*., Case No. 2021-0679 (*Delman*), came approximately one year after the first such opinion in *In re Multiplan Corp. Stockholders Litig*., Case No. 2021-0300 (*Multiplan*), and was decided by the same vice-chancellor as Multiplan. The basic facts alleged in *Multiplan* were similar to *Delman*. Both SPACs had sponsors who paid less for their shares of stock in the SPAC than the public stockholders and who forfeited their shares of stock if there was no de-SPAC transaction, allegedly lacked independent directors, closed a de-SPAC transaction without obtaining a fairness opinion from an independent financial advisor, failed to disclose allegedly material facts about the target company, ascribed valuations to the target company that were tied to aggressive growth projections, and saw the price of their shares drop significantly after the merger.

Background in *Delman*

GigCapital3, Inc. (Gig3 or the SPAC) was formed as a SPAC with GigAcquisitions3, LLC as its sponsor (Sponsor) in February 2020 and completed its IPO in May 2020. Avi Katz was the founding managing partner, Chief Executive Officer and Executive Chairman of GigCapital Global; he also held a controlling interest in the Sponsor; and he was the managing member of the Sponsor as well. Katz was Gig3's Executive Chairman, Secretary, President, and CEO. As is typical in the formation of SPACs, the Sponsor held a 20 percent equity interest in the SPAC, which it obtained for a cash payment of $25,000. Through the Sponsor Katz selected Gig3's initial directors and officers, which consisted of Katz, his spouse, and his associates at GigCapital Global.

After its IPO, the SPAC identified Lightning eMotors, Inc. (Lightning), an electric vehicle manufacturer focused on zero-emission medium duty vocational vehicles and shuttle bases, as its merger target. Katz and his spouse allegedly led the negotiations with the target. In connection with the de-SPAC transaction, two of Gig3's IPO underwriters were hired to serve as Gig3's financial advisers. As is typically the case, the payment of the majority of the underwriting compensation to the underwriters ($8 million) was contingent upon the completion of a de-SPAC transaction. In addition, the underwriters had collectively purchased 243,479 private placement units during the IPO that would be worthless if Gig3 did not complete a merger. Gig3's board did not obtain a fairness opinion in connection with the transaction.

In the proxy provided to the SPAC's shareholders by which they determined whether to redeem their shares or not, the value per share that the target stockholders were to receive was described as Gig3 stock valued at $10 per share. The proxy also contained projections prepared by Lightning that forecasted dramatic growth, including revenues rising from $9 million in 2020 to more than $2 billion in 2025 and profits growing from zero in 2020 to over $500 million in 2025. In connection with the redemption election and vote, approximately 29 percent of the public stockholders elected to redeem their shares, and 98 percent of the votes were cast in favor of the merger. The disparity between the redemption election and the votes against the merger result from the typical decoupling of economic and voting interests in the SPAC structure. Stockholders who elect to redeem their shares still own warrants in the company and can vote in favor of the transaction. These stockholders are actually incentivized to vote in favor of the transaction because deal approval provides them with both a return of the cash they invested plus interest and warrants in the merged entity. In contrast, if the stockholders do not approve the deal, the stockholders who elected to redeem must wait for the SPAC to search for another target (and wait for such deal to be approved and close) or until the end of the term of the SPAC to get back the money that they invested (and, if the SPAC's term ends without a deal, the warrants expire worthless).

The merger closed on May 6, 2021. Shortly thereafter, the company reduced its 2021 revenue guidance, and in August 2021, a lawsuit was filed against the SPAC's directors and officers, alleging breach of fiduciary duty claims. The complaint alleges that the Sponsor served as a controlling stockholder of the SPAC and that the Sponsor and members of the board were conflicted. It also alleged that the proxy contained false and misleading statements concerning the value per share of the SPAC and the target's projections. As a result, the defendants moved to dismiss.

Holdings in *Delman*

(1) The Court Held Disclosing Board Conflicts Is Not Sufficient for Estoppel in a Conflicted de-SPAC Transaction

While the facts alleged were not as extreme as in *Multiplan*, in *Delman* the court held that the Sponsor was a controlling

stockholder through its minority ownership interest, selection of the members of the board, close ties to and influence over each of the directors, and "unrivaled authority over the [SPAC's] business affairs." It held that the Sponsor's interests differed from the public stockholders because it had not paid the same amount as the public stockholders for its initial shares and had an interest in minimizing redemptions. The court also held that the directors who were not employees of the Sponsor were conflicted because they had multiple positions within the enterprise of the Sponsor, even though these directors were paid in cash and not in shares of stock of the SPAC. With respect to both of these issues, the court further held that the disclosure of these conflicts in the proxy did not amount to estoppel because "Delaware corporate law 'does not allow for a waiver of the directors' duty of loyalty.'" The court thus held that the entire fairness standard of review applied to the transaction. Delaware courts rarely, if ever, grant motions to dismiss where a transaction is subject to entire fairness review. Thus, the holding that entire fairness review applies makes it very difficult for SPAC sponsors and directors to win a motion to dismiss and potentially avoid burdensome discovery.

(2) The Court Held the Current Method of SPAC-share Valuation Is Misleading

The court also held that the proxy by which stockholders in the SPAC decided whether to exercise their redemption rights was misleading for two reasons. First, the court held that the net cash per share that the SPAC was investing in the target was not $10 per share because of various costs and dilution by sponsor shares of stock in the SPAC and other equity interests. In so doing, the court relied upon an analysis set forth by Professor Michael Klausner, who was also acting as co-counsel for the plaintiff in *Delman*. The analysis was described in two academic papers published in 2022 (Klausner Valuation Methodology) though the court did not adopt any specific valuation methodology.[1] Second, the court held that the target projections in the proxy were too "lofty" and "not counterbalanced by impartial information" such that the SPAC stockholders knew the risks of the new company in which they would be investing if they did not redeem their shares. The court thus held that the proxy was misleading.

(3) The Court Held Corwin Cleansing Is Not Available for Transactions With Decoupled Shareholder Votes

Under *Corwin v. KKR Financial Holdings LLC*, conflicted transactions are still subject to business judgment review, the standard by which courts do not second guess and defer to the directors' decisions, as long as the transactions are approved by a stockholder vote of fully informed stockholders. A stockholder vote is afforded deference under Delaware law because stockholders are presumed to be "impartial decision-makers" with an "actual economic stake in the outcome" of the merger.[2] However, the *Delman* court found that *Corwin* cleansing was not available to the de-SPAC transaction. First, as discussed above, it held that the proxy was materially misleading and as a result the stockholder vote was not fully informed. Second, it held that the shareholder vote in a de-SPAC does not reflect its investors' collective economic preference because stockholders' voting interests are decoupled from their economic interests. The court noted, "[t]he vote could have held greater importance if stockholders' voting and economic interests had been 'recoupled' by requiring redeeming stockholders to vote against the deal." Thus, it seems that even if the court held that the proxy was not misleading, *Corwin* cleansing would not work, the transaction would not be subject to business judgment review, and entire fairness would still apply.

The court's ultimate conclusion was to deny the defendants' motion to dismiss. It is presently unknown whether the defendants in *Delman* will attempt to appeal the court's decision. There was no appeal of the similar decision in the *Multiplan* case, which then settled for $33.75 million.

Next Steps and Recommended Best Practices

As a result of the decisions in *Delman* and *Multiplan*, sponsors and directors of SPACs should consider if additional procedural structures and substantive protections in connection with a de-SPAC are warranted. These protections may include the following:

- Enhanced disclosure of the potential conflicts of interest that exist between the SPAC Board, the Sponsor, the target company, the financial advisors, the underwriters, and any other parties that have a meaningful role in the valuation or approval of the de-SPAC transaction.
- A description of the cash value per share calculated in accordance with the principles underlying the Klausner Valuation Methodology discussed in *Delman*, or additional metrics detailing the total amount of dilution and the amount of cash on hand after the completion of the de-SPAC transaction.
- More careful disclosure concerning target projections, including underlying assumptions and risks to such projections.
- Meaningful discussions between the board members about the various options for the potential target, the target's potential value, and the risks to that valuation.
- A comprehensive diligence process conducted on the target and its projections, and appropriate documentation of the diligence process.
- A fairness opinion from an independent investment bank whose compensation is not contingent on the closing of the de-SPAC merger.
- For newly formed SPACs, consideration as to whether to appoint directors free from business and personal conflicts and how directors' independence may be affected by the form of their compensation, whether in cash or equity interests in the SPAC or the sponsor.

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[1] Michael Klausner, Michael Ohlrogge & Harold Halbhuber, "Net Cash Per Share: The Key to Disclosing SPAC Dilution," 40 Yale J. Reg. 18 (2022); Michael Klausner, Michael Ohlrogge & Emily Ruan, "A Sober Look at SPACs," 39 Yale J. Reg. 228 (2022).

[2] *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 313-314 (Del. 2015).

Editor's Note: This client advisory was originally published on January 31, 2023.

Record Penalty for Alleged Regulation FD Violations and Best Practices Going Forward

By Timothy J. Kirby and Brandon A. Bucio

On December 5, 2022, a large telecommunications company (the Company) and the US Securities and Exchange Commission (SEC) agreed to settle long-standing charges that executives allegedly had selectively disclosed material nonpublic information (MNPI) to financial analysts in 2016, a violation of Regulation Fair Disclosure (Regulation FD). To settle the charges, the Company agreed to pay a record $6.25 million penalty, and three Company investor relations executives, who were charged with aiding and abetting the violations, each agreed to individual $25,000 fines.

Regulation FD

Regulation FD prohibits public companies from selectively disclosing MNPI. It applies to statements made by, or attributable to, a company – including statements by members of the board of directors, senior management or those acting under their direction. Generally speaking, Regulation FD requires that whenever a public company, or any person acting on its behalf, discloses MNPI to certain "enumerated" persons, such as securities analysts or institutional investors, that company must also either (i) simultaneously (for intentional disclosures) or (b) promptly (for non-intentional disclosures) disclose that same information to the general public. Violations of Regulation FD can result in SEC enforcement actions being brought against companies and individuals, which may result in monetary penalties or other forms of relief. The full text of Regulation FD is available here.

- ***What constitutes "material information" under Regulation FD?*** Information may be considered "material" under Regulation FD if there is a "substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision, or if that information "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[i] Materiality assessments under Regulation FD must therefore take into account quantitative and qualitative factors, including the expected market reaction to information.

- ***What constitutes "nonpublic information" under Regulation FD?*** Under Regulation FD, information may be deemed "nonpublic" if it has not been disseminated in a manner that would make it available to all investors generally. Conversely, for information to be made public, "it must be disseminated in a manner calculated to reach the securities marketplace in general through recognized channels of distribution, and public investors must be afforded a reasonable waiting period to react to the information."[ii] Dissemination through "recognized channels of distribution" may include (i) disclosing the information in a press release, (ii) filing a Form 8-K that includes such information, (iii) publication of the information on a company website (if such website is one of the company's "recognized channels of distribution" or (iv) via social media (similar to disclosure on a company website if such social media platform is viewed as one of the company's "recognized channels of distribution").[iii]
- ***What constitutes an "enumerated person" under Regulation FD?*** It is important to note that Regulation FD is not a blanket prohibition on MNPI disclosures; rather, the rule only proscribes disclosures to (i) securities market professionals, such as brokers, dealers, investment advisers, institutional investment managers, and sell-side and buy-side analysts and (ii) shareholders, if it is reasonably foreseeable that they would trade on the basis of the information.

Regulation FD Oversight and Compliance

Senior management and public company director fiduciary duties include oversight of company policies protecting against breaches of federal securities laws and regulations. Part of such oversight responsibility includes overseeing a company's and its employees' compliance with Regulation FD. To strengthen compliance functions, many public companies adopt Regulation FD protocols, which provide specific guidance on timing, content, and methods of disclosure of any information that may constitute MNPI to prevent inadvertent securities violations. Such protocols typically establish (i) procedures for earnings releases and contact with securities analysts; (ii) guidelines for monitoring postings on a company's website and any social media outlets; (iii) rules requiring prior approvals of speeches and interviews of senior management or members of the board of directors; and (iv) processes for dealing with unintentional selective disclosures.

Recent Regulation FD Enforcement Action and Record Settlement

Although stand-alone Regulation FD enforcement actions are relatively rare, the SEC has brought several enforcement actions focusing on selective communications to analysts and shareholders surrounding earning estimates – and in particular, what could be considered "implied disclosures" and signaling with respect to such estimates – rather than outright disclosures of MNPI.

On March 5, 2021, the SEC charged the Company and three members of its Investor Relations department with violating Regulation FD by allegedly selectively disclosing to sell-side analysts internal sales data showing a larger-than-expected decline in smartphone sales, with an alleged goal of lowering the analyst's revenue estimates ahead of earnings. The original complaint is available here. Specifically, according to the SEC's complaint:

- In March 2016, the Company saw that a steeper-than-expected decline in its first-quarter smartphone sales would cause revenues to fall short of analyst expectations. The Company had missed consensus revenue estimates in two of the three preceding quarters.
- To avoid missing consensus estimates, the Company's Chief Financial Officer, according to the SEC, directed the Investor Relations department to "work the analysts who still have equipment revenue too high."
- Following such directive, three members of the Investor Relations team made private, one-on-one phone calls to approximately twenty sell-side analysts, disclosing internal smartphone sales data and their impact on internal revenue metrics.
- The Company's Regulation FD training materials noted smartphone revenues and data was generally considered "material" information.
- The director of the Company's Investor Relations department had his team track (a) each analyst's original first-quarter projection, (b) who was assigned to call each analyst and (c) any adjustments analysts made to their projections after the calls, with weekly internal meetings to discuss the effects of the outreach.
- Following the calls, each of the analysts reduced their revenue forecasts, resulting in the consensus estimate falling to just below the level the Company ended up reporting.

The Company contested the enforcement action, arguing that information about a slowdown in smartphone upgrades had already been publicly disclosed by the Company's Chief Financial Officer at an investor conference and claimed that employees who called the analysts just "wanted to make sure they had seen the Chief Financial Officer's earlier remarks." The Company also argued that information regarding an expected revenue drop was a publicly-known trend in smartphone sales caused by an industry-wide phase-out of subsidies for smartphone upgrades, and in any case, was immaterial, as it had less than a 5 percent impact on the Company's total revenue, which lawyers for the Company argued was a general threshold for whether a misstatement is considered material to investors. Finally, the Company further contended that the information disclosed was not material because, previously, missed consensus estimates had not considerably moved the stock price.

The Settlement

On December 5, 2022, the Company and the three members of the Investor Relations team who were charged with aiding and abetting the Regulation FD violations agreed to settle the case and pay fines without admitting or denying any of the alleged violations. The SEC noted in the press release announcing the settlement that the penalty agreed to by the Company was the largest ever recorded in a Regulation FD enforcement action, and the Director of the SEC's Enforcement Division specifically noted: "The actions allegedly taken by Company executives to avoid falling short of analysts' projections are precisely the type of conduct Regulation FD was designed to prevent… Compliance with Regulation FD ensures that issuers publicly disclose material information to the entire market and not just to select analysts."

Key Takeaways

Chairman Gensler's regime remains hyper-focused on reigning in what his administration has deemed aggressive market practices, including compliance with respect to obligations under Regulation FD. Although most public companies have specific disclosure policies and guidelines in place, and management may even receive periodic training regarding Regulation FD compliance, many public companies tend to rely mostly on self-policing to monitor and ensure internal Regulation FD policies are enforced which can potentially result in inadvertent foot-faults. Regular training, policy reviews and on-going guidance regarding prohibited communications and disclosures should be viewed as proactive and necessary steps towards avoiding Regulation FD violations.

Specifically, with respect to the context of the Company's enforcement action, it is important to note that one-on-one calls with analysts and shareholders should merit particular caution when it comes to Regulation FD scrutiny – the Company had argued that the SEC did "not cite a single witness involved in any of [the] analyst calls who believe[d] that material nonpublic information was conveyed to them" – and yet the SEC still brought a case alleging that violations had occurred. Materiality for purposes of securities law is judged on an objective, "reasonable shareholder" standard – and the Company's case may be viewed as a reminder that even if both the provider and the recipient of MNPI believe that the information conveyed was not material to *them*, lack of materiality with respect to the individual is not dispositive or potentially cleansing of what would otherwise amount to a Regulation FD breach – materiality of information must in this context be viewed through a broader any "reasonable shareholder" lens.

The SEC also rejected the Company's arguments that the calls did no more than repeat publicly-known information, noting the context and timing of the calls (i.e., right before earnings were released) in of itself was enough to convey MNPI to the analysts, even if during the calls the employees merely pointed to publicly available information. The Company's settlement reemphasizes that companies and employees must remain vigilant regarding indirect guidance and signaling with respect to earning estimates, and that companies should consider documenting both what is communicated during private calls and give consideration ahead of any such calls regarding whether any topics intended to be discussed may constitute MNPI.

If you have any questions regarding this article or would like your Katten team to provide a refresher on best practices regarding Regulation FD or training support, please do not hesitate to reach out.

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[i] *See* TSC Industries, Inc. v. Northway Inc., 426 U.S. 438 (1976).

[ii] In re Faberge, Inc., 45 S.E.C. 249, 255 (1973). *See also* Regulation FD Adopting Release, supra note 41, at Section II.B ("Information is nonpublic if it has not been disseminated in a manner making it available to investors generally.").

[iii] Note that in June 2012, then Netflix, Inc. Chief Executive Officer Reed Hastings was investigated by the SEC after making a post on his personal Facebook page disclosing certain metrics regarding streaming hours on the Netflix platform (and the stock moved up after his post). The SEC ultimately did not bring an enforcement action against Netflix or Hastings, but did reiterate that existing regulations provide company officials are only permitted to use social media to provide important information to the public in a Regulation FD-compliant manner if: (i) the outlets are viewed as "recognized channels of distribution" for communicating with the company's investors and (ii) the company first takes "steps sufficient to alert investors and the market to the channels it will use for the dissemination of material, nonpublic information." *See* the SEC's press release "SEC Says Social Media OK for Company Announcements if Investors Are Alerted" available here for further information.

Capital Markets Update in Brief

By Jennifer L. Howard, Neal Patel, Kate Ulrich Saracene and Shira Selengut

- On February 10, the SEC issued 15 new Compliance and Disclosure Interpretations (CDIs) on implementing the "pay versus performance" (PvP) disclosure rules that were adopted on August 25, 2022 (PvP Rules). The PvP Rules added new Item 402(v) to Regulation S-K, requiring public companies to disclose the relationship between the executive compensation actually paid to the named executive officers (NEOs) and the financial performance of the company in their proxy or information statements, to the extent required to include executive compensation disclosure.

  The key requirement of the PvP Rules is the inclusion of a PvP table illustrating compensation actually paid to the NEOs (compared to the total or average compensation paid to such NEOs as reported in the Summary Compensation Table), company and peer total shareholder return (TSR), and company financial performance for the five most recently completed fiscal years. The PvP Rules also require tabular disclosure of three to seven of the most important performance measures used to determine compensation for the current fiscal year.

  Among other aspects of the PvP Rules, the CDIs provide guidance on:

  (i) the "company-selected measure" used to link compensation actually paid to the NEOs to company performance;

  (ii) the peer group that may be used for the TSR comparison;

  (iii) the "net income" metric that must be disclosed in the PvP table; and

  (iv) questions that have arisen in respect of calculating compensation actually paid to the NEOs and related footnotes.

  A more detailed analysis of the CDIs by Katten's Employee Benefits and Executive Compensation attorneys is forthcoming.

- On January 31, the Securities and Exchange Commission (SEC) published the latest update to the Division of Corporation Finance's Financial Reporting Manual (FRM). The FRM is a resource for issuers on all topics relating to the presentation of financial statements and financial information. In addition to removing certain outdated information, the latest update reflects amendments to Rules 3-10 and 3-16 and the addition of new Rules 13-01 and 13-02 (relating to guarantors, issuers of guaranteed securities and issuers of collateralized securities) of Regulation S-X, all of which became effective in January 2021, and updates the revenue threshold for qualification for issuers to qualify as an "emerging growth company," which is based on an inflation-related adjustment announced in September 2022.

- On January 30, the SEC proposed amendments to its ethics rules that govern trading restrictions for SEC employees and their spouses and children. Currently, SEC employees are required to preclear securities transactions and comply with certain minimum holding periods and are prohibited from, among other things, transacting in securities of companies the SEC is investigating, engaging in short selling, transacting in derivatives, purchasing shares in an IPO until seven calendar days after the IPO is completed, or purchasing or carrying securities on margin. The amendments would also ban employees from investing in financial industry sector funds and would authorize the SEC to collect data on employees' transactions in certain "covered" securities.

The comment period for the proposed rules will remain open until the later of (i) 30 days after the proposal is published in the Federal Register and (ii) March 31, 2023.

- On January 27, the SEC published new Compliance and Disclosure Interpretations regarding the SEC's recently adopted clawback rules, which will become effective in November 2023. For a summary of the new clawback rules, please see Katten's coverage in the December 2022 issue of the *Compass*. The CD&Is cover the following topics:
  - One of the new disclosure requirements in the new clawback rules is the requirement to include a set of new checkboxes on the cover page of Forms 10-K, 20-F and 40-F, indicating whether the financial statements included in the report reflect the correction of an error to previously issued financial statements, and another checkbox indicating whether any of the error corrections required a recovery analysis under the company's clawback policy. The SEC indicated in the CD&I that while the checkboxes and other disclosure requirements will be included in the publicly available forms beginning in January 2023, the SEC does not expect issuers to provide such disclosure until they are required to have a recovery policy under the applicable listing standard.
  - The CD&Is clarify that Form 20-F and Form 40-F filers should also be prepared to include disclosure for each current and former executive officer for members of their administrative, supervisory, or management bodies, for whom the issuer otherwise provides individualized compensation disclosure in the filing.
  - The CD&Is clarify that for plans that take into account incentive-based compensation, an issuer will be expected to clawback the amount contributed to the notional account based on erroneously awarded incentive-based compensation and any earnings accrued to date on that notional amount.
- On January 25, the SEC proposed a rule intended to further minimize conflicts of interest in securitization transactions. The rule would prohibit an underwriter, placement agent, initial purchaser, or sponsor of an asset-backed security (ABS), including affiliates or subsidiaries of those entities, from engaging, directly or indirectly, in any transaction that would involve or result in any material conflict of interest between the securitization participant and an investor in such ABS.

  The comment period for the proposed rule will remain open until the later of (i) 30 days after the proposal is published in the Federal Register and (ii) March 27, 2023.

- On January 4, the SEC published its semiannual regulatory agenda and plans for upcoming rulemaking. The agenda separates items into a "Proposed Rule" and "Final Rule" stage, and identifies the estimated completion time for each item. Notable entries include:

Topic	Brief Description	Estimated Timing for Next Action	Further Reading
Proposed Rule Stage			
Rule 144 Holding Period	Proposal to revise the Rule 144 holding period determination for securities acquired upon the conversion or exchange of market-adjustable securities of issuers whose securities are not publicly listed.	Comment period ended March 22, 2021. SEC expects to revise the original proposal by October 2023.	SEC Press Release Proposed Rule Katten Summary
Regulation D and Form D Improvements	Proposed amendments to Regulation D, including updates to the accredited investor definition, and Form D.	SEC expects to propose rules by April 2023.	
Corporate Board Diversity	Proposal to enhance disclosure about the diversity of board members and nominees.	SEC expects to propose rules by October 2023.	
Final Rule Stage			
Cybersecurity Risk Governance	Proposal to enhance and standardize disclosure regarding cybersecurity risk management, strategy, governance and incident reporting by public companies.	Comment period ended May 9, 2022. SEC expects to adopt rules by April 2023.	SEC Press Release Proposed Rule Katten coverage in the *Compass*
Climate Change Disclosure	Proposal to enhance disclosure regarding climate-related risks and opportunities.	Comment period ended June 17, 2022. SEC expects to adopt rules by April 2023.	SEC Press Release Proposed Rule Katten coverage in the *Compass*
Special Purpose Acquisition Companies	Proposal to implement specialized disclosure requirements with respect to compensation paid to sponsors, conflicts of interest, dilution, and the fairness of SPAC business combination transactions.	Comment period ended June 13, 2022. SEC expects to adopt rules by April 2023.	SEC Press Release Proposed Rule Katten coverage in the *Compass*
Investment Company Names	Proposal to amend Rule 35d-1 under the Investment Company Act of 1940 (names rule) to include specific requirements related to ESG language in fund names.	Comment period ended August 16, 2022. SEC expects to adopt rules by October 2023.	SEC Press Release Proposed Rule Katten client advisory

Save the Date

2023 Crypto with Katten London Symposium

March 1

Katten will present its first Crypto with Katten London Symposium at 1:00 p.m. (GMT) on Wednesday, March 1. Hosted in London and accessible virtually, the symposium will feature panels hosted by Katten lawyers as well as outside industry leaders. Topics will include current and proposed crypto regulation in the UK, United States and Europe; accessing, taxing and trading markets; asset management; and a panel discussion with renowned crypto professionals.

Register for the 2023 Crypto with Katten London Symposium.

35th Annual ROTH Conference

March 12-14

Katten's Capital Markets team is attending and sponsoring the 35th Annual Roth Conference March 12-14 at The Ritz Carlton, Laguna Niguel in Dana Point, California. The event will feature 1-on-1 / small group meetings, company presentations, analyst-selected fireside chats, and thematic industry panels.

Attendees will hear from and meet with executive management from approximately 400 private and public companies in various growth sectors, including: Business Services, Consumer / Health & Wellness, Healthcare, Resources: Oil & Gas / Metals & Mining, Technology, Media & AgTech and Sustainability/ESG.

Learn more about the 35th Annual Roth Conference.

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.

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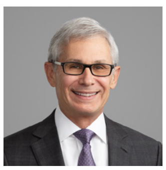

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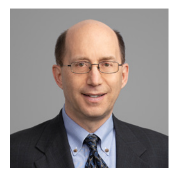

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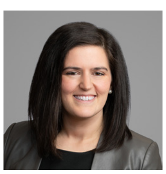

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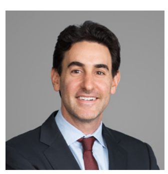

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