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CORPORATE POLICIES

ChatGPT Risks and the Need for Corporate Policies

By Jeffrey Neuburger

ChatGPT has quickly become the talk of business, media and the Internet. Reportedly, there were over 100 million monthly active users of the application just in January alone. While there are many stories of the creative, humorous, apologetic, and in some cases unsettling interactions with ChatGPT,[1] the potential business applications for ChatGPT and other emerging generative artificial intelligence applications (generally referred to in this article as GAI) are plentiful. Many businesses see GAI as a potential game-changer. But, like other new foundational technology developments, new issues and possible areas of risk are presented.

ChatGPT is being used by employees and consultants in business today. Thus, businesses are well advised to evaluate the issues and risks to determine what policies or technical guardrails, if any, should be imposed on GAI's use in the workplace.

What Are the Risks?

Confidentiality

While it may be tempting to use GAI to further develop or refine business strategies, software or other proprietary information, the input of confidential information into ChatGPT and other GAIs presents a number of risks:

- ChatGPT may train on the input that is provided,[2] and thus it is possible that portions of that inputted confidential information may be provided, in some form, to a subsequent user. Indeed, it was reported that at least one company advised employees not to input confidential code into the application for data security concerns.[3]
- Some confidential business information may be licensed from third parties and may be subject to confidentiality requirements or restrictions on use, and by putting such information into ChatGPT, a company may be in violation of those restrictions.
- Trade secret law requires one to maintain reasonable steps to protect the secrecy of information claimed to be a trade secret, and putting information into ChatGPT may weaken a company's position that such information is actually, as a matter of law, protectable as a trade secret.
- Privacy laws may restrict the submission of personal information of employees, clients, affiliates or consumers into any GAI.

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Regulatory Issues

To the extent a regulated business is using ChatGPT or other GAI in its business operations, thought should be given to whether some or all of that use is subject to regulatory requirements. For example, should or must some of the interactions be logged, recorded, archived in some manner? The analysis of this issue will possibly be informed by applicable law, contract, insurance-based requirements, as well as possibly a company's own internal policies.

Intellectual Property

GAI presents a number of interesting and new intellectual property issues:

- Does training of GAI via scraping the Web constitute an intellectual property infringement or Digital Millennium Copyright Act (DMCA)

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violation for the removal of CMI (copyright management information), and if so, can the user of that GAI be found to be liable in any way?

- What is the intellectual property (IP) status of the output of GAI? For example, if a software developer uses ChatGPT to create software, can that developer represent to its user that the developer owns all IP rights in that software? Can the developer indemnify the user for infringement issues? And what is the status of GAI-generated images, which often bear a recognizable similarity to one or more of their human-created sources?
- To the extent the use of GAI is infringing, is the fair use or implied license doctrine relevant?
- Can a GAI or the user of GAI be an "inventor" under patent law or an owner of a US copyright in GAI-generated material?

These intellectual property issues are, to varying degrees, all open questions, with litigants just beginning to bring suit and ask some of these questions. However, a few basic principles are clear:

- It is best practice to avoid claiming copyright in GAI-generated content (particularly in AI-generated artwork or images). ChatGPT's terms are instructive. The terms cover rights in content: "As between the parties and to the extent permitted by applicable law, you own all Input, and subject to your compliance with these Terms, OpenAI hereby assigns to you all its right, title and interest in and to Output." While such license to the output is a broad grant of OpenAI's rights in the Output, it is not definitive that ChatGPT has any rights in the Output to grant at all.
- Consideration should be given as to whether third-party software developers or content creators of any kind should be permitted to use ChatGPT or any GAI in their deliverables. This is an issue that should be addressed in development agreements with those third parties.
- Copyright Office policy, as currently stated in the *Compendium of U.S. Copyright Office Practices* (3d Ed. 2021), is that the Copyright Office "will not register works produced by a machine or mere mechanical process that operates randomly or automatically without any creative input or intervention from a human author. The crucial question is 'whether the 'work' is basically one of human authorship, with the computer [or other device] merely being an assisting instrument, or whether the traditional elements of authorship in the work…were actually conceived and executed not by man but by a machine.'"[4] Thus, based on this policy, GAI-generated content would not be subject to copyright protection.

Quality and Output Issues

There are a number of issues that are presented by the nature of GAI's output:

- ChatGPT and the other GAIs are still works-in-progress with limitations. As OpenAI has advised: "ChatGPT sometimes writes plausible-sounding but incorrect or nonsensical answers." Thus, while the current ChatGPT interface is ready to use "out of the box," the accuracy and truth of any output must be confirmed before finalizing or publishing any work product.
- GAI-generated analysis may reflect biased or discriminatory content on which it was trained.[5] Along with fact-checking the veracity of ChatGPT and other GAI output, users should be attuned to any discriminatory or biased statements or conclusions resulting in the algorithmic mining of such source materials. This could be a particular concern in the context of employment discrimination laws and laws regulating the use of artificial intelligence in employment decisions.
- Publishers and other content creators often procure "Errors and Omissions" insurance to cover exposure based on infringement and other risks. Often the underwriting of those policies involves a review of internal content creation practices. Will GAI-generated content

be within the scope of traditional errors and omissions policies?

- Section 230 of the Communications Decency Act (CDA) is highly controversial in its scope and application. To the extent GAI-generated content is used in an online business, it is unclear if and to what extent the CDA would apply with respect to that content. CDA § 230 prohibits a "provider or user of an interactive computer service" from being held responsible "as the publisher or speaker of any information provided by another information content provider." Are there any situations where GAI-generated content would not be considered "information provided by another information provider"? These types of third-party content issues are especially fraught, as the Supreme Court just heard argument on February 21, 2023 in a case examining the applicability of the CDA to algorithmic functions.
- Thought should be given to whether GAI-generated content should be identified as such when made public. This may be an issue if the content is generated in a real-time fashion, for example, in a bot conversation with a customer or employee. Organizations should also consider whether such disclosures are appropriate to clients, business partners, or the public.
- Are GAI interactions discoverable in litigation? Should a company's document retention policy specifically address GAI-generated content?

Artificial Intelligence Compliance Issues

There are a number of laws and regulations place and in various stages of enactment in the United States and abroad that address the use of artificial intelligence. For example, California's chatbot law[6] requires, among other things, that in certain consumer interactions, a company provide clear and conspicuous disclosure that the consumer is interacting with a bot. Moreover, New York City and several states have regulations impacting automated decisionmaking in the employment context and the Federal Trade Commission (FTC) and state attorneys general have enforcement powers against "unfair or deceptive" trade practices. Organizations must ensure that their use of GAI is compliant with such laws.

Thoughts on Policies

ChatGPT is being used today. Organizations cannot ignore it and the inevitability of the even wider use of these technologies in the near future. Every organization should be evaluating the issues GAI presents to determine to what degree they present material risk to the organization. Each entity must approach GAI from its own particular risk profile. Indeed, as outlined in the National Institute of Standards and Technology's (NIST) recently published *Artificial Intelligence Risk Management Framework 1.0*, risk tolerances can change over time as AI systems, policies, and norms evolve.[7]

Possible courses of action include the following:

- Messaging to the relevant community that the use of GAI is permitted, but outlining the power and risks of GAI and asking the community to be vigilant.
- Enacting policies that may do some or all of the following:
  - — Precluding certain uses of GAI. News reports suggest that some companies have already taken actions to restrict employee use of ChatGPT.
  - — Identifying permitted uses of GAI, and the cases in which prior approval is required
  - — Requiring internal tracking of the use of GAI and additional human review of selected GAI-generated content
  - — Addressing external disclosures of the use of GAI and GAI output
  - — Regulating the uses of GAI by external business partners and vendors.
  - — Addressing the possibility of embedding GAI applications on the company's website

We are likely just at the start of a cycle of innovation surrounding generative AI technology and

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its application for businesses and consumers, much like the early days of e-commerce or Web 2.0 or the current days of Web 3.0. Of course, this article highlights just some of the preliminary issues and concerns associated with GAI—there will likely be many more issues to unpack in the future as the technology evolves. To the extent an organization perceives GAI to present any of the risks highlighted above, or views GAI to present other issues for its business, putting appropriate policies in place now may be helpful.

Notes

1. A Feb. 16, 2023 post on the OpenAI Blog noted that the company has received copies of biased or offensive outputs from users, noting that in many cases the responses showed limitations of the system that will be addressed: "Many are rightly worried about biases in the design and impact of Artificial Intelligence (AI) systems. We are committed to robustly addressing this issue and being transparent about both our intentions and our progress." *See https://openai.com/blog/how-should-ai-systems-behave/*.
2. As per the ChatGPT terms: "To help OpenAI provide and maintain the Services, you agree and instruct that we may use Content to develop and improve the Services."
3. Organizations that are using ChatGPT's API and are concerned with such issues might consider using ChatGPT's opt-out procedure, as outlined in *https://help.openai.com/en/articles/5722486-how-your-data-is-used-to-improve-model-performance*.
4. *See also* Trade-Mark Cases, 100 U.S. 82, 94 (1879) (copyright law only protects "the fruits of intellectual labor" that "are founded in the creative powers of the mind."
5. *See generally, https://www.whitehouse.gov/ostp/ai-bill-of-rights/*: The White House, "Blueprint for an AI Bill of Rights" ("Algorithmic discrimination occurs when automated systems contribute to unjustified different treatment or impacts disfavoring people based on their race, color, ethnicity, sex…, religion, age, national origin, disability, veteran status, genetic information, or any other classification protected by law. Depending on the specific circumstances, such algorithmic discrimination may violate legal protections").
6. Bus. and Prof. Code § 17940.
7. The NIST framework recommends that organizations develop enhanced processes for governing, mapping, measuring, and managing AI risk and clearly define the roles and responsibilities for the personnel overseeing AI system usage and performance.

CORPORATE POLICIES

In the Aftermath of Recent Bank Closures, What Can My Company Do to Mitigate Future Risk?

By Pamela L. Marcogliese, Shira Oyserman, Jerome Ranawake, Brian D. Rance, and Sarah K. Solum

On the heels of the closures of Silicon Valley Bank and Signature Bank in March, many depositors are breathing a sigh of relief. By the end of that fraught weekend, the Federal Deposit Insurance Company (FDIC) announced that it would pay all deposits (even those in excess of the $250,000 deposit insurance limit). Prior to that announcement, companies whose cash balances were entirely or principally tied up in investment accounts at these two banks were left wondering what impact the closures of these banks would have on their operations and potential viability, including how they were going to meet near term payment deadlines, especially routine payroll obligations.[1] There are still many issues to work through for creditors and equity holders, but it is not too early to consider the lessons that companies can draw from these events and act on to mitigate future risk. We outline below some of the key takeaways.

Do I Need an Investment Policy?

Yes. Every company should adopt an investment policy and actively manage investment risk. An investment policy prescribes how management should invest the company's cash balances. For operating companies, investment policies accomplish at least two goals. First, the policies set forth the types of securities in which the company can invest and requires management to monitor the maturity profiles of such securities, any liquidity concerns and the performance of the investment portfolio.

Second, for operating companies, investment policies are designed to ensure that a company's cash resources are not deployed in a manner that would inadvertently cause the company to become an investment company under the Investment Company Act of 1940, as amended. This is important because a failure to register as an operating company, even if inadvertent, can have significant negative direct and indirect consequences, including the potential unenforceability of all of the company's contracts, Securities and Exchange Commission (SEC) enforcement action and litigation. An operating company that seeks to raise capital is typically required to obtain a legal opinion to the effect that the company is not required to register as an investment company under the Act.

In the wake of recent events, we recommend that companies adopt or expand the scope of their investment policies as described below.

What Responsibilities Should Be Covered in the Investment Policy?

Following recent events, we recommend that companies expand the scope of their investment policy to ensure the following items are actively monitored and managed:

- *Liquidity needs*. Analyzing the company's liquidity needs as the business evolves and

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devising a prudent cash management strategy that is responsive to those evolving needs. In particular, this includes considering whether cash deposits should be swept into liquid, short-term, high-quality securities held in properly documented custody accounts on a daily basis or above a certain dollar threshold in order to avoid the limitations of FDIC deposit insurance.

- *Cash flows*. Analyzing the company's cash flows and cash burn to identify which categories of expenses are short-term and recurring (for example, payroll, insurance, interest, rent) and which are longer-dated or may be amenable to a deferral on payment.
- *Cash balances and portfolio performance*. Periodically reviewing the company's cash balances and the performance of the company's investment portfolio overall.
- *Risks of financial instruments*. Understanding the nature of financial instruments the company is permitted to invest in and any associated risk exposure and verifying that the level and profile of risk is within the company's risk appetite and is supported by adequate capital and liquidity levels.
- *Risk limits.* Establishing relevant risk limits and monitoring compliance with such limits.
- *Concentration.* Avoiding any excessive concentration in the company's investment portfolio (for example, credit, maturity, counterparty) and monitoring the creditworthiness of the financial institutions that serve as counterparties (for example, by reference to long/short-term credit ratings and credit default swap spreads on its long-term debt).[2]
- *Letters of credit.* Considering whether the cash collateralization of letters of credit exposes the company to unnecessary risk exposure to a particular financial institution and, if so, whether alternative collateral arrangements are necessary.
- *Alternate capital.* Identifying potential alternate sources of capital and, if appropriate, arranging for backup sources of capital.

Who Should Be Responsible for Monitoring Investment Risk and Managing Compliance with the Investment Policy? Do I Need an Investment Committee?

Not all companies need an investment committee. An investment committee is typically composed of members of management and other key employees and its principal role is to focus on a company's cash flows, liquidity needs and the investment of any excess funds. Some companies with active balance sheets should have an investment committee, in part because it is a convenient way to ensure regular review of the company's cash balances and investment portfolio and hold appropriate personnel accountable for its financial management. But for many others, the formation of an investment committee will be unnecessary and burdensome.

For these companies, however, it is critical to identify which members of management (for example, the chief financial officer) and other key employees (for example, VP of finance, controller or treasurer) have the authority and direct responsibility for developing policies and overseeing those risks and ensuring that regular reports are made to the broader management team and, as described below, the board.

The investment oversight personnel or the investment committee should, at least quarterly (or more frequently if circumstances warrant, such as during periods of increased volatility), review the items above based on an updated financial analysis of the relevant balances and benchmarks. The investment oversight personnel or the investment committee should also report to the broader management team following each periodic review.

What Kind of Oversight Should the Board Have Over These Issues?

The board is responsible for oversight of the company's key risks and therefore should regularly review

the company's liquidity profile. We generally recommend that the company's liquidity be reviewed at the board level at least on a quarterly basis (or more frequently if necessary).

In particular, the board should review the risk appetite that guides the strategic direction for the management of financial risk (including asset quality and interest rate risk) and provide credible challenge to, and hold management accountable for, implementing sound principles that facilitate the identification, measurement, monitoring, and control of risk. The board should also ensure that the company has sufficient resources to adequately manage this risk, including personnel who have the authority to manage investment risk and the requisite experience (or support from credible external service providers) to do so effectively.

The board may decide to delegate the oversight of these risks to a committee, such as the audit committee or the risk committee, or may instead prefer to review these risks at the full board level. Even if oversight of the company's liquidity is delegated to a committee, the committee should report to the full board on a regular basis. Thorough recordkeeping of board and committee oversight is critical.

How Can the Legal Team Help?

The legal team is instrumental in helping to identify key risks, setting up and amending necessary policies and procedures for managing these risks and responding to any crisis, and ensuring that the relevant stakeholders are adequately coordinated.

- *Identify the "team."* Overseeing these issues will require a cross disciplinary approach. In addition to the investment oversight personnel or investment committee, key members of finance and legal will play an important role in ensuring that risks are identified and adequately addressed. In the event of a crisis, members from the public relations and investor relations teams will also be critical. Ensure that each of these individuals understands what their key responsibilities are in this regard.
- *Review or adopt an investment policy.* If your company already has an investment policy, review the policy to ensure the key tasks identified above are addressed. If your company does not have an investment policy, consider, together with other members of management, whether an investment policy or investment committee is appropriate for the company. In the event your company elects to establish an investment committee, ensure it is tasked with the key elements described above.
- *Review documentation.* When possible, ensure that all transactions are entered into under industry-standard documentation that includes appropriate termination and netting provisions.[3]
- *Pay close attention to default events and other liquidity-related triggers.* Collect all relevant agreements and identify the provisions that may be triggered if there is a liquidity event, paying particular attention to default provisions and provisions that trigger consequences in other agreements (and, in particular, the risk of cross-default to third-party agreements which can have a contagion effect).
- *Review set off rights.* If the company can both owe and be owed money by a particular counterparty or its affiliates at any given time, whenever possible ensure that appropriate set-off rights are in place.
- *Consider margin requirements.* If any derivatives or securities financing transactions require margin posting, review margining provisions in trading documentation to ensure they are favorable to the company.[4]
- *Consider global issues*. If any of the company's assets are custodied abroad (or if a counterparty has the right to custody securities with, or to otherwise transfer securities to, an affiliate outside of the United States), local law advice should be sought as to the risks that such custodied assets may not be returned in the event of the relevant custodian's bankruptcy and ways to mitigate them.

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- *Ensure this topic is regularly on the board agenda.* As part of preparing for board or committee meetings, ensure that the topic of investment risk is on the agenda in accordance with the timing considerations described above. To the extent a board committee is tasked with leading the board's efforts in monitoring investment risk, ensure that the committee's charter reflects this responsibility.
- *Review escalation processes*. If and when any issues arise, ensure that they are escalated to the broader management team and the board on a timely basis. Also ensure that there is a process for notifying the company's auditors at the appropriate time.
- *Review insurance policies.* Some custodians offer additional insurance protection for some or all of their products. Due diligence should be conducted on the scope and adequacy of such insurance, in particular its availability for claims relating to the financial products used by the company.
- *Prepare communications and disclosures.* Given the fallout from recent events, expect to receive ongoing inquiries from investors, customers, vendors, and other contractual counterparties as to the company's exposure to recent bank closures and related risks. Work with PR and IR to prepare accurate statements and ensure that spokespersons for the company use such statements consistently. In addition, public companies should review existing disclosures to determine the need for any changes or updates. In particular, carefully consider risk factors and MD&A to ensure accurate disclosure in light of the company's specific circumstances in the aftermath of the recent events. It is important to consider both the company's direct exposure, as well as the potential for indirect exposure through the company's customers and other contractual counterparties. The SEC can be expected to focus on these disclosures in connection with its review of the company's periodic filings.

These recent bank closures illustrate once again that potentially catastrophic events can unravel very rapidly. Careful planning and preparation can mitigate many of these issues. We recommend that companies take the time now to ensure that they are adequately protected for any future bank closures.

Notes

1. We refer you to our blog titled "Protecting Assets and Guarding Against Counterparty Risk" for more information on what companies can do to increase the likelihood that custodial assets will be returned in the event of a custodial insolvency and further protect against counterparty risk. *See https://blog.freshfields.us/post/102iaem/protecting-assets-and-guarding-against-counterparty-risk*.
2. Note that, in the context of trading relationships that offer the risk-mitigating benefits of netting across multiple transactions (such as derivatives/ repo transactions), concentration of such transactions with a particular counterparty may be beneficial insofar as it may increase the likelihood of effective netting.
3. Also, when entering into a financial transaction, consider whether it can be structured as a contract entitled to one of the safe harbors afforded by the Bankruptcy Code (in the case of a counterparty that would be a debtor thereunder) or the Federal Deposit Insurance Act (in the case of a counterparty that is an insured depository institution). These safe harbors preserve your right to cause the termination, liquidation or acceleration of any such safe harbored contract (and to realize upon related collateral security) when such right arises upon the bankruptcy or receivership of your counterparty, subject (in the case of an FDIC receivership) to the FDIC's right to effect the prompt transfer of such contracts to a solvent financial institution. The safe harbored contracts are: (a) securities contracts; (b) commodity contracts; (c) forward contracts; (d) repurchase agreements; and (e) swap agreements.
4. Company-favorable provisions include: (a) two-way posting of collateral, (b) daily valuation of both mark-to-market exposure and posted collateral, (c) no unsecured threshold, (d) small minimum transfer amounts,

(e) shortening transfer timing for delivery and return of collateral, (f) providing for effective alternative to transfer of securities by cash payments as an alternative (reduces settlement delays), (g) minimizing any initial margin (so-called Independent Amounts in derivatives documentation) or requiring initial margin posted by the company to be held at a third party custodian, and (h) eliminating the counterparty's ability to invest cash collateral in obligations owing by counterparty or any of its affiliates.

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UNIVERSAL PROXY

The Universal Proxy: An Early Look

By Keir Gumbs

Last year, the Securities and Exchange Commission's (SEC) universal proxy rule took effect. Prior to the rule's adoption, companies and dissident shareholders sent separate proxy cards listing only their own slate of nominees for board of directors. It was difficult for shareholders to mix and match management and dissident nominees unless they attended a company's annual meeting in person.

Under the universal proxy rule, companies and dissidents are now required to use a universal proxy card that lists all of the nominees from both sides. The rule is triggered when a dissident solicits 67 percent of a company's shareholders and complies with nomination procedures included in a company's bylaws. As a result of the rule, shareholders can select the nominees they favor regardless of who nominated them.

The First Few Months

At the time that universal proxy was first proposed, there was robust debate about how the rule would affect proxy contests. Some predicted that universal proxy would have no meaningful impact on the overall process or results. Others predicted a major increase in the number of proxy fights due to a (mis)perception that the rule would reduce costs, as well as expectations that shareholders groups would have more leverage than had been the case in the past.

We need not relitigate those debates now, but the early returns suggest a ripple, rather than a wave resulting from the rule. At a minimum, it appears that the predictions regarding a reduction in cost were not supported. Although dissidents can use the less expense notice and access method of distribution, they generally prefer to send full packages to get their materials in the hands of other investors. In addition, the bulk of proxy contest costs remain tied to outside advisers such as bankers and lawyers. From what we can tell, legal and banking fees continue to rise, notwithstanding the hopes of the most optimistic prognosticators.

To date there have only been a handful of proxy contests that have used the new universal proxy rule. Those contests have not been meaningfully different from contests waged in the past:

- *Argo Group International*—Argo and an activist group, Capital Returns Master (CRM), both used universal proxy, when CRM nominated two nominees for Argo's seven-member Board. CRM withdrew its nominees after ISS and Glass Lewis recommended in favor of Argo's nominees.
- *Apartment Investment and Management Co.* (AIV)—AIV and an activist group, Land & Buildings Investment Management (L&B), both used universal proxy, when L&B nominated two directors for three open seats on AIV's 10-member Board. Glass Lewis recommended in favor of AIV's three nominees, while ISS recommended in favor of one of L&B's nominees, resulting in one of the L&B nominees being successfully elected to the Board.
- *AIM Immunotech* (AIM)—An activist group calling itself the AIM Stockholder Full Value Committee attempted to use universal proxy at AIM. The activist's efforts were contested by AIM on the basis that they did not comply with its advance notice bylaw requirements.

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AIM successfully defended its approach in the Delaware Court of Chancery, which rejected the activist group's demands that AIM accept the activist's nomination to the Board.

- *Diffusion Pharmaceuticals*—Diffusion and the activist group, LifeSci Special Opportunities Master Fund Ltd (LifeSci), both used universal proxy, when LifeSci had nominated a full slate of directors to the Diffusion Board. After rounds of filings, LifeSci and Diffusion entered into a settlement prior to the relevant meeting, under which Diffusion agreed to appoint one of the LifeSci nominees to the Board if it did not complete a transaction as defined in the agreement prior to July 2023.
- *The Walt Disney Company*—The Trian Group invoked the universal proxy rule and launched a proxy contest against the Walt Disney Company in early 2023, but withdrew the contest following actions taken by the Walt Disney Company. This would have been the largest use of the universal proxy rule since the rule was adopted.

So, as of this writing there have been five universal proxy contests as we enter the heart of the proxy season. Not exactly a tsunami.

Universal Proxy: Implications for VIFs vs Proxies

One of the interesting developments from the universal proxy contests to date relates to how proxies and voting instruction forms (VIFs) are collected.

Shareholders fall into two categories: (1) record shareholders and (2) beneficial owners. A "record" or "registered" shareholder is a shareholder that holds an issuer's shares directly and is listed in the issuer's records. Alternatively, a shareholder may hold shares as a "beneficial owner" or a "street name holder," which means that it holds shares through a broker or a bank. In turn, this broker or bank is generally the record holder of those shares held on behalf of its beneficial owner clients. Consequently, it is typically the broker or bank that is entitled to vote the shares held on behalf of its beneficial owner clients.

In light of this structure, Rules 14b-1 and 14b-2 under the Securities Exchange Act of 1934 require a bank or broker to distribute to their beneficial owner clients any proxy soliciting materials received from an issuer or any other soliciting person. In addition, New York Stock Exchange Rules 451 and 452, as well as Financial Industry Regulatory Authority (FINRA) Rule 2251, require banks and brokers to distribute these materials and prescribe specific rules governing how banks and brokers do so.

A VIF is how a broker or bank collects voting instructions from its beneficial owner clients under these rules. As described by the SEC, a VIF "allows a beneficial owner to instruct his or her broker or other securities intermediary how to vote their shares at company meetings." The bank or broker collects VIFs and then casts a vote according to the aggregated VIF instructions. Voting instructions are collected through paper, or through telephone, Internet, or mobile device voting platforms.

Historically VIFs have closely followed the structure of proxy cards, although at times differences have developed due to differences between proxy cards and VIFs. For example, proxy cards are governed by state law, which generally provides companies with increasingly broad latitude in how these cards are structured and designed, subject principally to disclosures and a bias against disenfranchisement.

In contrast, VIFs are principally a communication mechanism between a beneficial owner and the bank or broker through which the beneficial owner holds shares. There are basically only a handful of rules that govern how VIFs operate. Rule 14a-2(a)(1) under the Exchange Act is the main rule that applies to VIFs and its prescriptions are limited. It exempts the distribution of proxy materials by banks, brokers, and other entities from the bulk of the proxy rules if they:

- Receive no compensation other than the reimbursement of expenses;
- Distribute the soliciting material furnished to them to the beneficial owners being solicited; and

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- Impartially instruct the person solicited as to how to transmit the proxy to the person who is originally soliciting it, or request voting instructions.

This last bullet point provides the regulatory underpinnings for VIFs. Other than Rule 14a-2, the primary rules governing the preparation and distribution of VIFs are NYSE Rules 451 and 452 and FINRA Rule 2251.

Recent SEC Guidance Could Open the Floodgates

Although it did not proceed to completion, the proxy contest launched by the Trian Group with respect to Disney led to new SEC guidance regarding VIFs that could meaningfully impact future proxy contests. Specifically, the Staff of the SEC's Division of Corporation Finance has taken the position that:

- a voting instruction form should mirror the proxy card to the furthest extent possible, including with respect to the instructions relating to signed, but unmarked cards, partially marked proxy cards and overmarked proxy cards, and
- a soliciting party can include the instructions of their choosing so long as the disclosure in the proxy statement, proxy card and voting instruction form are clear to investors.

The SEC took this position in response to a new approach to proxies and VIFs advocated for by the Trian Group. Specifically:

- *Unmarked but Signed Proxies and Voting Instructions*—Trian Group took the position that unmarked proxy cards and VIFs should be instructed as "FOR" their nominee to the Board and "WITHHOLD" on all of the nominees recommended by The Walt Disney Company.
- *Overmarked Voting Instructions*—Trian Group took the position that overmarked proxy cards and VIFs (where a shareholder votes "FOR" more directors than available seats) should be marked "FOR" their nominee to the Board, "FOR" the 10 unopposed management nominees and "WITHHOLD" on the one opposed management nominee.
- *Partially Marked Voting Instructions*—Voting instructions were to be executed exactly as cast, that is, whichever Director nominees get a "FOR" vote will be marked as a "FOR" and the remaining nominees will be marked as "WITHHOLD."

The key to this new approach is disclosure. From the SEC's perspective, these and similar changes are acceptable under the proxy rules as long as the soliciting party is clear regarding these outcomes.

Broadridge has made changes to its systems to accommodate the new guidance from the SEC and was prepared to follow these instructions and similar instructions from Disney. Ultimately the contest went away before these changes were tested in practice.

Implications of the New SEC Guidance

Although Broadridge was able to accommodate the changes in the Disney/Trian contest, the new position from the SEC is meaningfully different from how Broadridge and soliciting parties have addressed this issue in the past. Historically, for solicitations that did not involve the use of a universal proxy, Broadridge has followed the guidance from the New York Stock Exchange (NYSE) with respect to signed, but unmarked proxy cards and VIFs, that is, completing them in accordance with management's recommendation.

Similarly, for partially marked proxies and VIFs, Broadridge has historically submitted the instructions as cast, for example, if the beneficial owner only votes for one item on the proxy, that is how Broadridge has submitted the instructions. Under the new guidance however, a soliciting party could direct tabulators and proxy service providers to cast partially marked proxies and VIFs to vote for all of their candidates and none of the opposition candidates, even if the shareholder intended to abstain from the director election proposals. Similarly, a

shareholder that only intended to vote for a non-management nominee could have their vote cast for their selected nominees and the management nominees, even if that was not their desire.

The big change resulting from the new SEC guidance most directly impacts how Broadridge processes overmarked VIFs (for example, voting for 12 nominees when there are only 11 seats that are up for re-election). Historically Broadridge has pulled out overmarked VIFs and sent them to the relevant bank or broker for further instruction from the relevant investor. Now, instead of sending such forms for further instructions, the SEC guidance requires that firms rewrite overmarked VIFs to follow the instructions from the soliciting party regarding such votes. This means, as was the case in the Trian/Disney contest, that an overmarked card could be voted in favor of the soliciting party's candidates to the Board with Withhold votes for the other side's candidates.

One might wonder what this portends for proxy contests based on past practice. There, the news is good. As a starting matter, investors voting online can't overvote, and we are updating our systems to ensure that they can't undervote either. This means that the proposed changes should not impact voting by institutional investors, which typically represent 70 percent or more of shares entitled to vote and who largely vote online using the voting tools provided by ISS, Glass Lewis, and Broadridge. This also helps for online voting by retail investors, which typically represent 20-25 percent of shares entitled to vote a proxy. Excluding online voting, we are left principally with the 5–6 percent of shares that are voted using paper VIFs.

The pool gets even smaller. Of the 5–6 percent of shares that are voted through paper VIFs, a very small percentage—typically less than 0.05 percent of shares—include overmarks. Those are the VIFs that are most impacted by the new SEC guidance.

Looking Forward

This early into the proxy season, it would be a mistake to make grand predictions regarding the future of universal proxy. Nevertheless, the contests to date, as well as the new guidance from the SEC, suggest that the future of proxy solicitations may be meaningfully different from what they have been in the past.

The changes will not be limited to how proxies and VIFs are drafted. Recognizing the growing importance of retail investors in these contests, we've invested considerable time and resources into increasing the ability of retail investors to participate in proxy solicitations.

- *ProxyVote App*. Last year we implemented changes in our online voting app, ProxyVote, that allow shareholders to establish voting preferences regarding how they want to vote with respect to the election of directors, ratification of auditors and other matters. These changes are intended to make retail voting more similar to institutional voting, where institutional investors are allowed to establish advanced voting instructions with their proxy voting service provider. Unfortunately, due to legacy guidance from the SEC, retail investors must review these preferences and click "submit" before they are submitted for voting, a step that is not required for institutional investors.
- *Pass-Through Voting*. In addition to the changes to the ProxyVote app, last year we worked with a number of leading asset managers to create pass-through voting, which allows an institutional investor to solicit the views of its retail investors with respect to their voting policies, and in some cases, specific items being presented at a company's annual meeting of shareholders. Although we remain in the early stages of implementing pass-through voting solutions, we are optimistic that the tool will result in more investor engagement and allow asset managers to solicit more information from their investors as they make voting decisions on behalf of fund investors.
- *End-to-End Vote Confirmation*. Finally, there is end-to-end vote confirmation. Last year Broadridge was part of an industry working

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group that established new protocols resulting in nearly 2,400 companies having end-to-end vote confirmation available at their annual meetings of shareholders. In end-to-end vote confirmation, an investor is provided with information that confirms that their voting instructions or votes were included in the final tabulation. This is one of the main areas for improvement identified by the SEC in its 2010 proxy plumbing release and in the 2018 proxy plumbing roundtable. We are proud to say that we were able to confirm 99.95 percent of votes cast in the 2022 proxy season. As we look forward, we hope to build on the successes from last year to cover all annual meetings, as well as proxy contests.

Conclusion

With just a few months behind us, there already has been considerable change resulting from the universal proxy rule in the form of new SEC interpretive guidance. We will continue to monitor developments this season and beyond as we assess the impact of the universal proxy rule on the frequency and nature of proxy contests. Notwithstanding the ongoing evolution in proxy solicitations resulting from the universal proxy rule, we are excited and optimistic about the ways in which we can continue to enhance the proxy voting system to best serve investors and companies alike.

FORM 144

Another Unintended Consequence of Filing Form 144 Electronically

By Bob Lamm

You should be aware that, starting on April 13, 2023, Form 144 filings have been newly required to be submitted electronically. Aside from some of the challenges discussed in our earlier alert, companies should be aware of another unintended consequence of this requirement.

Specifically, given the difficulty of tracking paper filings, few people follow Form 144 filings; as a result, they get little or no publicity. Sales are therefore generally reported only as they actually occur and are reported on Form 4. However, once Form 144 filings are made electronically, the media and others will likely be able to track Form 144 filings more easily and to report anticipated insider sales, rather than reporting sales only as they occur.

It is not unusual for Form 144 filings to show the maximum number of shares to be sold under Rule 144 so that, if market conditions permit, an insider can dispose of as many shares as possible. The number of shares actually sold under Rule 144 can be lower than the number appearing on the Form 144 filing—and in some cases substantially lower, or none at all.

Due to the requirements of Rule 144, many brokers (and insiders) may continue the practice of reporting the maximum number of shares that may be sold. At a minimum, those insiders and their companies should be prepared to get questions on Form 144 filings and, more importantly, to answer those questions.

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WHITE COLLAR CRIME

DOJ Issues Voluntary Self-Disclosure Policy for Corporate Criminal Enforcement Applicable to US Attorneys' Offices Nationwide

By Aaron M. Zebley, Christopher Cestaro, Robert L. Boone, Michael J. Leotta, Edward C. O'Callaghan, Emily L. Stark, Masha Bresner, and Alexandra Stanley

On February 22, 2023, the Department of Justice (DOJ) issued a Voluntary Self-Disclosure Policy (VSDP) which, effective immediately, applies to all US Attorneys' Offices (USAOs) nationwide with respect to corporate criminal enforcement matters.[1] Distinct from the Criminal Division's Corporate Enforcement and Voluntary Self-Disclosure Policy (Criminal Division's Corporate Enforcement Policy),[2] which only applies to components of the DOJ's Criminal Division, the VSDP was approved by the Office of the Deputy Attorney General to immediately apply to all USAOs throughout the country and was developed by the Attorney General's Advisory Committee, a select group of US Attorneys that advises the Attorney General on matters of policy affecting the Offices of the US Attorneys.

The VSDP's stated goal is to "standardize how [voluntary self-disclosures] are defined and credited by USAOs nationwide, and to incentivize companies to maintain effective compliance programs capable of identifying misconduct, expeditiously and voluntarily disclose and remediate misconduct, and cooperate fully with the government in corporate criminal investigations."[3] The VSDP was developed pursuant to the direction in the September 2022 "Monaco Memo" that each DOJ component that prosecutes corporate crime develop and publish a voluntary self-disclosure policy.[4]

The concrete nature of the incentives set forth in this policy and their applicability to USAOs across the country should allow corporations to better weigh the pros and cons of self-reporting potential criminal violations—and may increase the appeal of such self-reporting in certain circumstances, although significant risks certainly remain.

The VSDP is the latest in a series of concerted efforts by the DOJ to encourage voluntary self-disclosures and underscores the DOJ's recent, public commitment to providing incentives for voluntary self-disclosure.[5] This commitment was most recently reiterated in February 16, 2023 remarks by Deputy Assistant Attorney General Lisa Miller, in which she emphasized, in reference to the updated Criminal Division's Corporate Enforcement Policy, that the "[c]arrots we offer [for voluntary self-disclosure] have never been juicier" and noted that the changes in that policy would "offer companies new and concrete incentives and powerfully make the business case for voluntary self-disclosure."[6]

However, the actual "carrots" announced in the VSDP—for instance, that the USAO "will not seek a guilty plea" where all of the VSDP's requirements are met and there are no aggravating circumstances—are less "juicy" than the "presumption of a declination" incentive that is included in the Criminal Division's Corporate Enforcement Policy,[7] and the VSDP introduces few new incentives. The most notable aspect of the policy is that the incentives included in the VSDP are now standardized across all USAOs.

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Unlike the Criminal Division's Corporate Enforcement Policy, the VSDP does not provide guidance on the requirements and expectations for obtaining cooperation credit or being determined to have timely and appropriately remediated other than noting that the USAO will rely on the operative provisions of the Justice Manual and DOJ policy and expressing the requirement that a company must pay all disgorgement, forfeiture, and restitution resulting from the misconduct at issue.

As its name suggests, the crux of the VSDP is encouraging voluntary self-disclosures by assuring disclosing companies that their disclosure will be treated similarly by all USAOs. Interestingly, the VSDP does contemplate joint prosecution by a USAO and another component of the DOJ. In such cases, and as allowable under an alternate voluntary self-disclosure policy, "the USAO may choose to apply any provision of an alternate [voluntary self-disclosure] policy in addition to, or in place of, any provision of this policy."[8] It, of course, remains to be seen whether and how, in practice, distinct voluntary self-disclosure policies will be applied.

As the Criminal Division's Corporate Enforcement Policy, under the VSDP, a disclosure must be truly voluntary (that is, made when there is no preexisting obligation to do so) and timely. This leaves open the possibility that entities in highly regulated industries will not qualify for the credit, if they already are under an obligation to report violations (such as broker-dealers that must report material securities-law violations under FINRA Rule 4530, for example).

As the Criminal Division's Corporate Enforcement Policy, the VSDP provides that a self-disclosure will only be deemed timely when the disclosure is made (1) before such misconduct is publicly reported or is otherwise made known to the DOJ; (2) before an imminent threat of such disclosure or a government investigation exists; and (3) within a reasonably prompt time after the company becomes aware of the misconduct.

If the Company has fully met the requirements of the VSDP, having voluntarily and timely disclosed to the DOJ or relevant USAO "all relevant facts concerning the misconduct that are known to the company at the time of the disclosure,"[9] and the company has fully cooperated and timely and appropriately remediated the criminal conduct, the VSDP provides that the USAO "may choose not to impose a criminal penalty, and in any event will not impose a criminal penalty that is greater than 50 percent below the low end of the US Sentencing Guidelines fine range."[10] Additionally:

- Absent aggravating factors:
  - The USAO will not seek a guilty plea.
- Where there are aggravating factors:
  - A guilty plea may be warranted despite a voluntary self-disclosure where there are aggravating factors, including where the misconduct poses a threat to national security, public health, or the environment; is "deeply pervasive" in the company; or involved a company's current executive management.[11]
  - In the event a guilty plea is warranted due to an aggravating factor but a company has "voluntarily self-disclosed, fully cooperated, and timely and appropriately remediated the criminal conduct,"[12] the USAO will recommend at least 50 percent and up to a 75 percent reduction off of the low end of the US Sentencing Guidelines fine range and will not require appointment of an independent compliance monitor if the company has demonstrated that it has an effective compliance program.[13]

The VSDP makes clear that the government is not backing off its drive to encourage voluntary self-disclosures. On the contrary, with the factors on how to assess a voluntary self-disclosure now standardized across USAOs, the government has taken an important step in removing uncertainty regarding potentially disparate evaluation of a voluntary self-disclosure.

Accordingly, the VSDP serves as a good reminder that companies must: (1) develop and maintain an effective compliance program to ensure that any potential misconduct is timely detected and that

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relevant internal stakeholders at the Company are immediately made aware of the potential misconduct; and (2) where potential criminal misconduct is suspected, immediately conduct an internal investigation to determine whether misconduct has occurred and assess its potential scope, or at least to gather enough facts to be able to make an informed decision as to voluntary self-disclosure taking into account the provisions of both the VSDP and the Criminal Division's Corporate Enforcement Policy. The government's carrots notwithstanding, voluntary self-disclosure may not be right in many instances, but it is important that companies not lose the potential benefits unintentionally and that informed, risk-weighted decisions can be made.

Notes

1. United States Attorneys' Offices Voluntary Self-Disclosure Policy, (Feb. 22, 2023) (hereinafter VSDP), available at *https://www.justice.gov/usao-sdny/press-release/file/1569411/download*.
2. DOJ, Criminal Division Corporate Enforcement and Voluntary Self-Disclosure Policy, Justice Manual § 9-47.120 (2023); *see also*, WilmerHale, "DOJ Announces Updates to Corporate Enforcement Policy," (Jan. 18, 2023), available at *https://www.wilmerhale.com/en/insights/client-alerts/20230118-dojannounces-updates-to-corporate-enforcement-policy*.
3. "Damian Williams and Breon Peace Announce New Voluntary Self-Disclosure Policy for United States Attorney's Offices," (Feb. 22, 2023), available at *https://www.justice.gov/usao-sdny/pr/damian-williamsand-breon-peace-announce-new-voluntary-self-disclosure-policy-united*.
4. Lisa O. Monaco, Deputy Attorney General, DOJ, Further Revisions to Corporate Criminal Enforcement Policies Following Discussions with Corporate Crime Advisory Group, at 7, (Sept. 15, 2022) (hereinafter Monaco memo), available at *https://www.justice.gov/opa/speech/file/1535301/download*.
5. *See, e.g.*, Lisa O. Monaco, Deputy Attorney General, DOJ, Memorandum on Corporate Crime Advisory Group and Initial Revisions to Corporate Criminal Enforcement Policies, (Oct. 28, 2021) (revising the DOJ's criminal enforcement policy, announcing the creation of the Corporate Crime Advisory Group to review the DOJ's approach to corporate enforcement, and modifying the standards used to determine whether a monitorship is appropriate); Lisa O. Monaco, Deputy Attorney General, Further Revisions to Corporate Criminal Enforcement Policies Following Discussions with Corporate Crime Advisory Group (Sept. 15, 2022) (establishing four priorities: (1) individual accountability, (2) corporate accountability, (3) independent compliance monitors, and (4) a commitment to transparency. To foster the commitment to transparency, the Monaco Memo directed each DOJ division to publish a written policy incentivizing self-disclosure and making voluntary self-disclosure a prerequisite for any resolution other than a guilty plea); "Assistant Attorney General Kenneth A. Polite, Jr. Delivers Remarks on Revisions to the Criminal Division's Corporate Enforcement Policy," (Jan. 17, 2023), available at *https://www.justice.gov/opa/speech/assistant-attorney-general-kenneth-polite-jr-delivers-remarks-georgetown-university-law*. *See also* WilmerHale, "The Corporate Crime Advisory Group Has Spoken: DOJ Revises Corporate Criminal Enforcement Policies" (Sept. 19, 2022), available at *https://www.wilmerhale.com/insights/client-alerts/20220919-the-corporate-crime-advisory-group-hasspoken-doj-revises-corporate-criminal-enforcement-policies*); WilmerHale, "DOJ Announces Updates to Corporate Enforcement Policy" (Jan. 18, 2023), available at *https://www.wilmerhale.com/en/insights/clientalerts/20230118-doj-announces-updates-to-corporate-enforcement-policy*.
6. "Deputy Assistant Attorney General Lisa H. Miller Delivers Remarks at the University of Southern California Gould School of Law on Corporate Enforcement and Compliance," (Feb. 16, 2023), available at *https://www.justice.gov/opa/speech/deputy-assistant-attorney-general-lisa-h-miller-delivers-remarksuniversity-southern*.
7. DOJ, Criminal Division Corporate Enforcement and Voluntary Self-Disclosure Policy, Justice Manual § 9-47.120 (2023).
8. VSDP at 2.
9. VSDP at 4. The VSDP recognizes that at the time of disclosure, "a company may not be in a position to know all relevant facts at the time of a [voluntary self-disclosure]

because the company disclosed reasonably promptly after becoming aware of the misconduct. Therefore, a company should make clear that its disclosure is based upon a preliminary investigation or assessment of information, but it should nonetheless provide a fulsome disclosure of the relevant facts known to it at the time." *Id.*

10. *Id.*, at 5.
11. *Id.* at 4.
12. *Id.* at 5.
13. The USAO will refer to the Monaco Memo when evaluating whether the company has implemented and tested an effective compliance program. *Id.* at 5.

Questions Remain as Supreme Court Declines to Decide Scope of Attorney-Client Privilege for "Dual-Purpose" Communications

By Katherine Cicardo Mannino and Brittany Holt Alexander

The US Supreme Court recently dismissed a *writ of certiorari* as improvidently granted in a case that has far-reaching implications for counsel of all industries.[1] The case under review was *In re Grand Jury*.[2] There, acknowledging that attorneys "often wear dual hats, serving as both a lawyer and a trusted business advisor," the Ninth Circuit sought to determine to what extent the attorney-client privilege applies to dual-purpose communications that implicate both business and legal concerns.

Details of the Case

A company and a law firm were each served with grand jury subpoenas requesting documents and communications related to a criminal investigation. The company and law firm each withheld certain documents as privileged. The district court ordered production of the withheld materials, and when the company and law firm refused, they were held in contempt. The company and law firm appealed.

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Some of the documents withheld based on attorney-client privilege were dual-purpose communications involving both legal and non-legal purposes. The Ninth Circuit held that the primary purpose test applies to these types of communications. Under that test, courts "look at whether the primary purpose of the communication is to give or receive legal advice, as opposed to business or tax advice." Implicit in this consideration is the notion that a dual-purpose communication has but one "primary," or predominate, purpose.

The court left open whether the DC Circuit's application of "a primary purpose" test might apply in some limited circumstances.[3] Under that test, a court would ask whether obtaining or providing legal advice was one of the significant purposes of the communication. The court found that this test would only change the outcome of a privilege analysis in "truly close cases, like where the legal purpose is just as significant as a non-legal purpose," and that this was not such a case.

The question presented to the Supreme Court for review was whether a communication involving both legal and non-legal advice is protected by attorney-client privilege when obtaining or providing legal advice was at least one of the significant

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purposes behind that communication. In granting the writ, the Supreme Court signaled that it intended to resolve whether the communications' purpose must be primarily legal or whether it is sufficient if one of the significant purposes is legal.

But, in a surprising move that came two weeks after the justices heard oral arguments, the Supreme Court ultimately did not resolve the question, stating instead that "[t]he writ of certiorari is dismissed as improvidently granted." This is a rare occurrence that happens only when the Court determines that it should not have accepted the case in the first place, usually either because there is no conflict warranting review or because dismissal is preferable to a fractured opinion where no consensus could be reached.

Lessons for Counsel

The Supreme Court's dismissal of the writ, and its resulting choice not to set a clear test for determining whether "dual-purpose" communications are covered by attorney-client privilege, leaves law firms and businesses in a state of uncertainty about how to protect such communications.

Accordingly, lawyers and clients must continue to exercise caution when communicating about both legal and non-legal issues, as the management of attorney-client communications will continue to be fact-specific and will vary based on jurisdiction. However, there are a few key takeaways for practitioners who want to maximize the potential privilege protections afforded to "dual-purpose" communications:

- First, attorneys and clients should familiarize themselves with the relevant privilege rulings and applicable privilege test(s) in the various jurisdictions in which they practice or conduct business.
- Second, to the extent a document or communication is intended for legal purposes, that purpose should be well and clearly documented. The reason for this is simple: It is sometimes very difficult to discern the parties' intent or purpose for a document or communication years after the fact. A clear and visible statement about the parties' intent on the face of the document is therefore recommended.
  - Finally, to the extent practicable, legal and non-legal advice should be segregated as much as possible—either in separate documents or communications, or in separate portions of a single document or communication. Such segregation makes the privileged nature of a purely legal communication more certain and predicable, while also allowing for ease of redacting clearly privileged information, if such redactions are appropriate and allowed.

Notes

1. *https://cdn.ca9.uscourts.gov/datastore/opinions/2022/01/27/21-55085.pdf.*
2. In re Grand Jury, 23 F.4th 1088 (9th Cir. 2021).
3. *https://www.cadc.uscourts.gov/internet/opinions.nsf/701A3512988256CD85257D04004F78AA/$file/14-5055-1499662.pdf.*

DOJ Brings First-Ever Indictment for Insider Trading Based on Use of a Rule 10b5-1 Plan

By Jonathan R. Barr, John J. Carney, Jimmy Fokas, Teresa Goody Guillén, Alexandra Karambelas, Lauren P. Lyster, and Michelle N. Tanney

On Wednesday, March 1, 2023, the Department of Justice (DOJ) announced its first-ever prosecution of an individual for insider trading based on an executive's use of 10b5-1 trading plans. Terren Peizer, the executive chairman of healthcare treatment company Ontrak Inc., was charged with one count of engaging in a securities fraud scheme and two counts of securities fraud for insider trading. The DOJ's press release noted that "[t]he investigation is part of a data-driven initiative led by the Fraud Section to identify executive abuses of 10b5-1 trading plans."[1]

A Rule 10b5-1 plan allows corporate insiders of publicly traded companies to establish a trading plan to purchase and sell stock in the company in the future. Rule 10b5-1(c)(1) provides an affirmative defense to insider trading liability when transactions were executed pursuant to the Rule 10b5-1 plan. Critically, the plan must have been adopted at a time when the person or entity was not aware of any material nonpublic information.

According to the indictment, Cigna, Ontrak's biggest customer at the time, notified Ontrack on or about May 18, 2021, that it planned to terminate its contract with Ontrak by the end of the year. On or about August 18, 2021, Cigna formally notified Ontrak that it would terminate the contract. On August 19, 2021, Ontrak filed a Form 8-K with the Securities and Exchange Commission (SEC) in which it disclosed that an unidentified customer was terminating its contract. Following the announcement, Ontrak's stock price declined by more than 44 percent. Due to Peizer's position as executive chairman and pursuant to communications with Ontrak employees, the DOJ alleged that Peizer was aware of these developments with Cigna.

The DOJ further alleged that Peizer entered into two 10b5-1 trading plans to avoid $12.069 million in losses by selling Cigna stock prior to the announcement of the termination of the Cigna contract. According to the indictment, in early May 2021, Peizer set up the first Rule 10b5-1 plan when he knew the contract was at serious risk of being terminated. The broker Peizer initially approached to set up the plan (Broker A) informed him that a "cooling-off" period[2] was required before he could trade stock, that is, that Peizer could not engage in trading while in possession of material nonpublic information.

Upon learning of Broker A's cooling-off policy, Peizer contacted another broker who did not require a cooling-off period (Broker B), although Broker B warned Peizer that a 30-day cooling-off period is industry practice. Peizer entered into a second 10b5-1 plan in August 2021, approximately one hour after Ontrak's chief negotiator informed him that Cigna confirmed that the contract would likely be terminated. Accordingly, to obtain approval for the second plan, Peizer allegedly falsely certified that he did not possess material nonpublic information, even though he knew of the high likelihood that Cigna would terminate its contract with Ontrak.

The SEC's Parallel Enforcement Action

The SEC also filed a complaint against Peizer in the Central District of California, alleging a violation

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of Rule 10b5-1.[3] This complaint follows efforts to amend Rule 10b5-1. Addressing the issue of insider trading through 10b5-1 plans in 2021, Gary Gensler, chairman of the SEC, announced that the SEC would consider amending the rule and remarked that "these plans have led to real cracks in our insider trading regime."[4] Gensler has continued to express concerns over trading through Rule 10b5-1 plans; "[W]e've heard from courts, commenters, and members of Congress that insiders have sought to benefit from the rule's liability protections while trading securities opportunistically on the basis of material nonpublic information."[5]

On December 14, 2022, the SEC adopted several amendments updating Rule 10b5-1. The rule now requires a cooling-off period for directors and officers, which is the later of (1) 90 days following plan adoption or modification, or (2) two business days following the disclosure in certain periodic reports of an issuer's financial results for the fiscal quarter in which the plan was adopted or modified. Officers and directors are also now required to certify at the time of adoption that they are not aware of material nonpublic information about the issuer or its securities and that they are adopting the plan in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 10b5-1. The amendments also created enhanced disclosure requirements for 10b5-1 plans. The new amendments became effective February 27, 2023.

Conclusion

The DOJ's and the SEC's cases against Peizer make it clear that they are focused on pursuing executives who attempt to evade the requirements of insider trader laws by abusively using Rule 10b5-1 plans. During his keynote address at the ABA National Institute on White Collar Crime on March 3, DOJ Assistant Attorney General Kenneth Polite Jr. noted that the case against Peizer "is remarkable" and alerted his listeners to expect additional such cases. And as has been demonstrated by countless prosecutions and enforcement actions, insider trading penalties can be harsh. Companies should ensure that they review the Rule 10b5-1 amendments and update relevant policies and procedures to comply with the amended rule. Officers, directors and other individuals should be vigilant in making sure they are complying with the new rules when executing Rule 10b5-1 plans and when they are buying or selling company stock.

Notes

1. Press Release, DOJ, "CEO of Publicly Traded Health Care Company Charged for Insider Trading Scheme" (March 1, 2023), *https://www.justice.gov/opa/pr/ceo-publicly-traded-health-care-company-charged-insider-trading-scheme*.
2. A "cooling-off" period is a specified period that an executive must wait to engage in trading after entering into a 10b5-1 plan.
3. Press Release, SEC, "SEC Charges Ontrak Chairman Terren Peizer With Insider Trading" (March 1, 2023), *https://www.sec.gov/news/press-release/2023-42*. The indictment is at *https://www.justice.gov/opa/press-release/file/1570711/download*. The complaint filed in in the Central District of California is at *https://www.sec.gov/litigation/complaints/2023/comp-pr2023-42.pdf*.
4. Press Release, SEC, "Prepared Remarks at the Meeting of SEC Investor Advisory Committee" (June 10, 2021), *https://www.sec.gov/news/speech/gensler-iac-2021-06-10*.
5. Press Release, SEC, "SEC Adopts Amendments to Modernize Rule 10b5-1 Insider Trading Plans and Related Disclosures" (Dec. 14, 2022), *https://www.sec.gov/news/press-release/2022-222*.

BOARD DUTIES

Delaware Court of Chancery Dismisses *Caremark* Claims Against Directors for Failure to Allege Bad Faith Conduct

By Daniel J. Kramer, Daniel S. Sinnreich, Matthew D. Stachel, and Elizabeth Wang

On March 1, 2023, the Delaware Court of Chancery dismissed *Caremark* oversight claims brought against the directors of McDonald's Corporation for their alleged failure to address "red flags" suggesting widespread sexual harassment and workplace misconduct at the company.[1] The court found that the plaintiffs' allegations criticizing the directors' efforts to address such red flags failed to plead that the directors acted in bad faith. *McDonald's* reaffirms the vitality of Delaware's strict *Caremark* pleading standard and should help allay recent concerns that it had been diluted.

Background on *Caremark* Claims

Delaware law has long recognized that directors' fiduciary duty of loyalty requires that they supervise a corporation's affairs by both establishing a system of internal controls and responding to "red flags" suggesting corporate misconduct. Claims that directors breached their oversight responsibilities are described as "among the hardest to plead and prove" because such claims require a showing of bad faith conduct.[2] Lawsuits asserting such claims had historically and routinely been dismissed at the pleadings stage under this strict standard.

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The Delaware Supreme Court's 2019 decision in *Marchand* v. *Barnhill*[3] was perceived as a turning point and potential dilution of the historically strict standard. In *Marchand*, the Supreme Court reversed the Court of Chancery's dismissal of *Caremark* claims against the directors of an ice cream company, Blue Bell Creameries USA, Inc., stemming from a widespread listeria outbreak. The Supreme Court reasoned that the allegations that the directors failed to implement any "board-level compliance monitoring and reporting" concerning the "intrinsically critical" issue of food safety were sufficient to plead that the directors acted in bad faith. *Marchand* and a series of subsequent decisions declining to dismiss *Caremark* claims at the pleadings stage have led to a perception that *Caremark* claims have become easier to plead.[4]

The Court of Chancery's Opinion

Certain McDonald's stockholders filed a consolidated complaint alleging that, under the watch of the CEO and CPO, the company cultivated and promoted a culture of sexual harassment and workplace misconduct. The stockholders alleged that McDonald's directors were put on notice of this misconduct by employee complaints, strikes and even an inquiry from a US senator. The plaintiffs' complaint also detailed the actions the directors had taken in response, including "(i) hiring outside consultants, (ii) revising the Company's policies, (iii) implementing new training programs, (iv) providing new levels of support to franchisees, and (v) taking other steps to establish a renewed commitment to a safe and respectful workplace."[5] The stockholders criticized

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the directors' response as ineffective and alleged that the directors violated their fiduciary duties under *Caremark* because they "did not fix the problem."[6]

In addition, the stockholders alleged that the directors breached their fiduciary duties by entering into a without-cause separation agreement with McDonald's CEO. The stockholders alleged the directors acted out of self-interest, purportedly fearing that a for-cause termination would invite a litigation challenge by the CEO and publicize the company's pervasive culture problems that the directors had allegedly failed to remedy in bad faith.[7]

The Court of Chancery dismissed the stockholders' claims against the directors as insufficient to plead a claim. The court reasoned that the stockholders' own allegations and documents incorporated into the complaint demonstrated that the directors acted in good faith to remedy the alleged misconduct brought to their attention. The court further reasoned that the allegations the directors' responses were ineffective did not demonstrate bad faith, explaining that fiduciaries "cannot guarantee success . . . What they have to do is make a good faith effort."[8]

The court also dismissed the stockholders' claims that the directors breached their fiduciary duties by agreeing to a without-cause separation agreement. In addition to finding no allegations suggesting bad faith conduct by the directors, the court reasoned the stockholders failed to allege that the directors were interested or lacked independence in reaching that decision. The court thus explained that the directors' decision "was a classic business judgment" entitled to deference.[9]

Implications

Dispelling the perception that Delaware courts have lowered the *Caremark* pleading bar, *McDonald's* highlights that directors fulfill their duty of loyalty by making a good faith effort to respond to reports of misconduct. In addition, the good-faith decisions of disinterested and independent directors to part ways with members of management alleged to have been involved in reported misconduct will continue to be protected by business judgment deference. Accordingly, complaints charging only that the directors' actions were ineffective or even grossly negligent should still be expected to fail at the pleadings stage. The same is also true with good-faith business judgments made by a majority of unconflicted directors.

McDonald's also highlights the importance of sound formal corporate recordkeeping. The directors' good-faith efforts to address the alleged red flags were documented in board meeting minutes and materials that were provided to the court in support of their motion to dismiss. Although noting that director defendants' overreliance on such documents in their motions to dismiss can sometimes lead to the court converting a pleadings-stage motion to one for summary judgment, the court found that conversion in this instance was not warranted.

Notes

1. In re McDonald's Corp. S'holder Derivative Litig., 2023 WL 2293575 (Del. Ch. Mar. 1, 2023).
2. *See* In re Clovis Oncology, Inc. Derivative Litig., 2019 WL 4850188, at *12 (Del. Ch. Oct. 1, 2019).
3. Marchand v. Barnhill, 212 A.3d 805 (Del. 2019).
4. *See, e.g., Clovis Oncology*, 2019 WL 4850188; Inter-Mktg. Grp. USA, Inc. on Behalf of Plains All Am. Pipeline, L.P. v. Armstrong, 2020 WL 756965 (Del. Ch. Jan. 31, 2020); Hughes v. Xiaoming Hu, 2020 WL 1987029 (Del. Ch. Apr. 27, 2020); Teamsters Loc. 443 Health Servs. & Ins. Plan v. Chou, 2020 WL 5028065 (Del. Ch. Aug. 24, 2020); In re Boeing Co. Derivative Litig., 2021 WL 4059934 (Del. Ch. Sept. 7, 2021).
5. *McDonald's*, 2023 WL 2293575, at *1.
6. *Id.* at *12, 21.
7. *Id.* at *28.
8. *Id.* at *21.
9. *Id.* at *28.

SETTLEMENT CYCLE

New SEC Rules and Amendments Shorten the Standard Securities Transaction Settlement Cycle to T+1

By David M. Lynn, Justin R. Salon, Kelley A. Howes, Derek N. Steingarten, and Hillel T. Cohn

On February 15, 2023, the US Securities and Exchange Commission (SEC) adopted rules and amendments to shorten the standard settlement cycle for transactions in most securities from two business days after the trade date (T+2) to one business day after the trade date (T+1).[1] The rules and amendments will directly apply to registered broker-dealers and will also impact the trading-related responsibilities of investment advisers registered with the SEC under the Investment Advisers Act of 1940 (Advisers Act).

The principal purpose of the new rules is to increase market efficiency and reduce the risk of failed transactions. Compliance with the new rules will require significant adjustments to current business practices by broker-dealers, clearing agencies, and investment advisers. The compliance date is May 28, 2024.

Background and SEC Goals in the Progression to T+0

On February 9, 2022, the SEC proposed amendments to Rule 15c6-1 and new Rule 15c6-2 under the Securities Exchange Act of 1934, as amended (Exchange Act), to reduce the standard settlement cycle to T+1 for transactions in certain securities.[2] In adopting final rules based substantially on this proposal, the SEC has taken its most recent step in a series of initiatives that have dramatically shortened the standard settlement cycle over the past two decades.

In 1993, the SEC first shortened the standard settlement cycle under Rule 15c6-1 from T+5 to T+3, and did so again in 2017 from T+3 to T+2. Each amendment came as a response to changes in markets, technology, operations, and infrastructure. In the Adopting Release, the SEC notes that, informed in part by increased market volatility resulting from the COVID-19 pandemic and heightened interest in certain "meme" stocks, the SEC believes that "shortening the settlement cycle from T+2 to T+1 can promote investor protection, reduce risk and increase operational and capital efficiency." The SEC also asserts in the Adopting Release that it believes that the transition to a T+1 settlement cycle can be a useful step in identifying paths to a T+0 settlement cycle in the future.[3]

The SEC believes that shortening the standard settlement cycle will result in a reduction in the number and total value of unsettled trades that exist at any point in time and decrease the total market value of all unsettled trades in the United States clearance and settlement system. This would also reduce a market participant's overall exposure to market and credit risk arising from open transactions. Further, a shorter settlement cycle aims to reduce central counterparties' exposure to credit, market, and liquidity risks arising from its obligations to participants. The SEC notes that shortening the settlement cycle to T+1

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will enable investors to access the proceeds of their securities transaction sooner than they are able to in the current T+2 environment.

Amendments to Rule 15c6-1—Standard Settlement Cycle

Rule 15c6-1(a) establishes the standard settlement cycle for the purchase or sale of a security effected by a broker-dealer. As amended, Rule 15c6-1(a) now prohibits broker-dealers from effecting or entering into a contract for the purchase or sale of a security (other than an exempted security, a government security, a municipal security, commercial paper, banker's acceptances, or commercial bills) that provides for payment of funds or delivery of securities later than the first business day after the date of the contract unless otherwise expressly agreed to by the parties at the time of the transaction.[4]

The SEC amended Rule 15c6-1(b) to exclude security-based swaps from the T+1 standard settlement cycle under Rule 15c6-1(a), noting the key differences between security-based swaps and other types of securities. Most security-based swap contracts include contract terms that specify the timing of contractual obligations, and, for that reason, there is no need for a rulebased "default" contract term that provides for the timing of such obligations.

The SEC also amended Rule 15c6-1(c) to shorten the standard settlement cycle for firm commitment offerings for securities that are priced after 4:30 p.m. ET, unless otherwise expressly agreed to by the parties at the time of the transaction. The amendment to Rule 15c61(c) will shorten the standard settlement cycle for those transactions from T+4 to T+2. The SEC proposed to remove paragraph (c) from Rule 15c6-1 based on the belief that the expanded application of the "access equals delivery" standard for prospectus delivery supported such a change, but was persuaded that the standard settlement cycle for such transactions should be shortened to T+2 rather than T+1 to prevent firm commitment offerings priced after 4:30 p.m. ET from failing to settle on time due to unforeseen circumstances at the time of pricing.

The SEC did not amend Rule 15c6-1(d), which enables underwriters and the parties to a transaction to agree, in advance of the transaction, to a settlement cycle other than the standard settlement cycle specified in paragraphs (a) and (c) of Rule 15c6-1. The SEC notes that market participants in firm commitment offerings of certain debt and preferred securities commonly rely on paragraph (d) of Rule 15c6-1 to extend the settlement date for such transactions to allow time for the completion of the extensive documentation associated with those offerings.

The SEC solicited comment regarding its existing exemptive orders issued pursuant to Rule 15c6-1 and determined that the existing exemptive orders will remain in effect without modifications, because no changes are needed to facilitate and orderly transition to a T+1 standard settlement cycle.

New Rule 15c6-2—Same-Day Affirmation

The SEC adopted new Rule 15c6-2 under the Exchange Act to require that any broker or dealer engaging in the allocation, confirmation, or affirmation process with another party (for example, an investment adviser or other market participant acting as an agent for the broker or dealer's customers) to achieve the settlement of a securities transaction that is subject to the requirements of Rule 15c6-1(a) shall take one of the following two actions:

1. Enter into a written agreement with the relevant parties to ensure completion of the allocation, confirmation, affirmation, or any combination thereof for the transactions as soon as technologically practicable and no later than the end of the day on trade date in such form as necessary to achieve settlement of the transaction; **or**
2. Establish, maintain, and enforce written policies and procedures reasonably designed to ensure completion of the allocation, confirmation or affirmation, or any combination thereof for the transaction as soon as technologically practicable and no later than the end of the day

on trade date in such form as may be necessary to achieve settlement of the transaction.

In providing broker-dealers with discretion to select either of these two options, the Adopting Release affirms that broker-dealers will be able to choose which approach "aligns best with their business practices and customer relationships, and to consider the approach that best enables the broker-dealer to ensure the completion of allocations, confirmations, and affirmations as soon as technologically practicable and no later than the end of the trade date." Notably, both of these options will necessarily involve the implementation of a coordinated effort by broker-dealers, investment advisers, and other industry participants to achieve same-day deadlines for buy-side functions such as trade allocations among customer accounts, as well as the acceleration of various middle and back-office trade affirmation and reconciliation processes conducted by investment advisers and other institutional investors.

When a broker-dealer elects to pursue the second option noted above, it becomes subject to additional requirements established in paragraph (b) of Rule 15c6-2, which states that, to ensure completion of the allocation, confirmation, affirmation, or any combination thereof for the transaction as soon as technologically practicable and no later than the end of the day on trade date, the reasonably designed written policies and procedures shall:

- Identify and describe any technology systems, operations, and processes that the broker or dealer uses to coordinate with other relevant parties, including investment advisers and custodians, to ensure completion of the allocation, confirmation, or affirmation process for the transaction;
- Set target time frames on trade date for completing the allocation, confirmation, and affirmation for the transaction;
- Describe the procedures that the broker or dealer will follow to ensure the prompt communication of trade information, investigate any discrepancies in trade information, and adjust trade information to help ensure that the allocation, confirmation, and affirmation can be completed by the target time frames on trade date;
- Describe how the broker or dealer plans to identify and address delays if another party, including an investment adviser or a custodian, is not promptly completing the allocation or affirmation for the transaction, or if the broker or dealer experiences delays in promptly completing the confirmation; and
- Measure, monitor, and document the rates of allocations, confirmations, and affirmations completed as soon as technologically practicable and no later than the end of the day on trade date.

The terms "allocation," "confirmation," and "affirmation" are not defined in Rule 15c6-2, but the SEC explained in the Proposing Release that "allocation" refers to the process by which an institutional investor (often an investment adviser) allocates a large trade among various client accounts or determines how to apportion securities trades ordered contemporaneously on behalf of multiple funds or non-fund clients. Further, the SEC explained that "confirmation" and "affirmation" refer to the transmission of messages among broker-dealers, institutional investors, and custodian banks to confirm the terms of a trade executed for an institutional investor. The SEC believes that these terms are widely used and generally understood by market participants who engage in institutional trade processing.

When a broker-dealer is considering whether and with which entities to enter into written agreements, the broker-dealer must identify only the relevant party or parties that will have a role or roles in completing the allocation, confirmation, and affirmation process. The SEC notes in the Adopting Release that Rule 15c6-1 does not require a broker-dealer to enter into agreements with parties that do not have a role in the allocation, confirmation, and affirmation process.

The SEC notes in the Adopting Release that it is appropriate to impose obligations on the brokerdealer under Rule 15c6-2, even though the

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broker-dealer is only responsible for its own actions and not the actions of others under Rule 15c6-2, because the broker-dealer has the ability, in some circumstances, to modify the conduct of other relevant parties with which the brokerdealer may participate in the allocation, confirmation, and affirmation process to ensure its own compliance with the rule. Further, the SEC believes that Rule 15c6-2 will incentivize brokerdealers to identify and deploy effective practices for future allocations, confirmations, and affirmations that will improve the rate of allocations, confirmations, and affirmations over time.

Amendment to Rule 204-2 for Investment Adviser Recordkeeping

Rule 204-2 under the Advisers Act prescribes the books and records that are to be maintained by investment advisers. With the move to T+1 settlement, Rule 204-2(a)(7)(iii), as amended, will now require registered investment advisers to make and keep records regarding any transaction that is subject to the requirements under Rule 15c6-2(a), specifically transactions for which a brokerdealer engages in the allocation, confirmation, or affirmation process with another party or parties to achieve settlement of a securities transaction.

The required records include each confirmation received, and any allocation and each affirmation sent or received, with a date and time stamp for each allocation and affirmation that indicates when the allocation and affirmation was sent or received. As with other records required under Rule 204-2(a)(7), advisers will be required to keep originals of written confirmations received and copies of all allocations and affirmations sent or received but may maintain records electronically if they satisfy certain conditions.

The SEC has acknowledged that advisers allocate trades through various means and often rely on internal systems, portfolio management systems, and order management systems for this purpose. The Adopting Release also notes that, in many cases, affirmation is performed by the asset owner's custodian (or its prime broker) on the asset owner's behalf (and not directly by the adviser) and that an adviser may rely on a third party to make and keep the required records, although using a third party to make and keep records does not reduce an adviser's obligations under Rule 204-2.

The Adopting Release states that these records will be "important" to SEC's Staff for use in its regulatory and examination program and will be helpful to monitor the transition from T+2 to T+1. Accordingly, advisers should expect the SEC Staff to make specific requests for these records during any examination that follows implementation.

Adoption of Rule 17Ad-27—Requirement for CMSPs to Facilitate Straight-Through Processing

The SEC adopted Rule 17Ad-27(a) under the Exchange Act to require that central matching service providers (CMSPs) establish, implement, maintain, and enforce written policies and procedures reasonably designed to facilitate straight-through processing of securities transactions. The SEC uses the term "straight-through processing" to refer generally to the processes that allow for the automation of the entire trade process from trade execution through settlement without manual intervention.

Under Rule 17Ad-27, a CMSP will facilitate straightthrough processing when its policies and procedures enable its users to minimize or eliminate, to the greatest extent that is technologically practicable, the need for manual input of trade details, the manual intervention to resolve errors and exceptions that can prevent the settlement of the trade, or the transmission of messages regarding errors, exceptions, and settlement status information among the parties to a trade and their settlement agents that impede the ability of a CMSP to achieve a straight-through processing environment.

As adopted, Rule 17Ad-27 gives CMSPs flexibility in drafting and adopting their policies and

procedures reasonably designed to facilitate straight-through processing of securities transactions. The SEC notes in the Adopting Release certain factors that a CMSP may consider relevant in assessing whether any identified issues can or should be addressed, and, if so, how best to implement those changes. Such factors include:

- The significance of certain obstacles to straight-through processing as it relates to other clearance and settlement functions and objectives, including operational efficiency and operational risk management;
- The frequency and impact of a particular issue; or
- The cost of resolving the issue versus the benefit.

Rule 17Ad-27(b) further requires a CMSP to submit to the SEC an annual report describing its current policies and procedures for straight-through processing, its progress in facilitating straight-through processing during the 12-month period covered by the report, and any steps the CMSP intends to take to promote straight-through processing during the following 12month period.

The annual report must include the following five components:

1. A summary of the CMSP's policies and procedures, current as of the last day of the 12-month period covered by the report;
2. A qualitative description of the CMSP's progress in facilitating straight-through processing during the 12-month period covered by the report;
3. A quantitative presentation of data that includes (i) the total number of trades submitted for processing, (ii) the total number of allocations submitted, (iii) the total number of confirmations submitted as well as total number of confirmations canceled by a user, (iv) the percentage of confirmations submitted that are affirmed on trade date, (v) the percentage of allocations and confirmations submitted that are matched and automatically confirmed, and (vi) metrics concerning the use of manual and automated processes by the CMSP's users;
4. The data provided must be (i) organized on a month-by-month basis, beginning with January of each year, (ii) where applicable, separated between the use of the CMSP and electronic trade confirmation services, (iii) separated, as appropriate, by asset class, (iv) separated by type of user, and (v) presented on an anonymized and aggregate basis; and
5. A qualitative description of the actions the CMSP intends to take to further facilitate straight-through processing during the following 12-month period.

The report must be filed within 60 days of the end of the 12-month period, which begins on January 1 of the calendar year. Further, it must be submitted using the SEC's EDGAR filing system and must be tagged using Inline XBRL.

The SEC believes this annual report requirement will enable an assessment of the qualitative and quantitative progress of CMSPs and its users to further straight-through processing efforts, evaluate the need for additional regulatory action, and further its oversight of, and development of, the national clearance and settlement system.

Compliance Dates

The shortened settlement cycle and each of the subsequent adopted rules and amendments will become effective 60 days following the date of publication of the Adopting Release in the Federal Register. Broker-dealers, investment advisers, CMSPs, and investors will need to comply with the new requirements beginning May 28, 2024. Certain industry organizations (for example, SIFMA and the Investment Company Institute) and one of the SEC Commissioners, while supporting the move to T+1, believe that the compliance date may be overly ambitious and contend that it should be deferred to September 2024. The annual report required of CMSPs under Rule 17Ad-27(b) must be filed within 60 days of the end of the 12-month period covered by the report, therefore it must be filed by no later than March 1, 2025.

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Notes

1. Release No. 34-96930, *Shortening the Securities Transaction Settlement Cycle* (Feb. 15, 2023) (Adopting Release), *available at https://www.sec.gov/rules/final/2023/34-96930.pdf*.
2. Release No. 34-94196, *Shortening the Securities Transaction Settlement Cycle* (Feb. 9, 2022) (Proposing Release), available at *https://www.sec.gov/rules/proposed/2022/34-94196.pdf.*
3. In the Proposing Release, the SEC solicited comment on whether shortening the standard settlement cycle to T+1 is a logical step on the path to a T+0 standard settlement cycle, or if a T+1 standard settlement cycle would instead require investments or processes that would be outdated or unnecessary in the T+0 environment. In the Adopting Release, the SEC acknowledged that, while a move to a T+0 standard settlement cycle could "produce considerable additional benefits to investors compared with shortening the settlement cycle to T+1," shortening the settlement cycle to T+0 would require the industry to develop solutions to several operational and technological challenges, and overcoming those challenges would take longer to design and implement than would be the case with a move to a T+1 standard settlement cycle. The SEC notes in the Adopting Release that market participants have already taken significant steps and made substantial progress in planning for a move to T+1 and that it continues to believe that the transition to a T+1 settlement cycle can be a useful step in identifying paths to a T+0 settlement cycle in the future.
4. Transactions in Treasury securities already generally settle on a T+1 basis.

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